ECONOMIC REVIEW AS OF 6-30-10:

Gross Domestic Product (GDP): GDP in the fourth quarter of 2009, fueled by the rebuilding of severely depleted business inventories, grew by a solid 5.6%, but by the first quarter of 2010 with inventories roughly balanced, the pace had slowed to a more pedestrian 2.7%. Still, the first quarter had ended with a prevailing sense of economic optimism, but the second quarter brought an abrupt shift. The pessimism that settled over the financial markets by the end of June was appropriate, the news was bad. In addition to stubbornly high unemployment, soaring foreclosures and abrupt downturns in a number of major U.S. economic indicators, the financial markets had to grapple with the volcano eruption in Iceland, the mysterious "flash crash", the massive BP oil spill, uncertainty surrounding the U.S. financial reform bill, a 15% broad stock market decline in the last 60 days of the quarter and the sovereign debt crisis in Europe. The events in Europe, and in particular Greece, may have been the lynchpin, which is unusual in that it wasn't so much an event as it was a sudden realization; a realization that a huge debt problem largely ignored during years of orchestrated prosperity, had grown too big to solve without considerable pain. And Greece was hardly alone in its reckless spending habits; it suddenly seemed that a majority of the world's largest economies were heading down the same path, including the United States. The severe austerity measures necessary to save the troubled European countries seemed likely to push them back into recession, while the U.S. seemed to gain the political will to tighten its own belt, increasing the possibility of its own "double-dip" recession in the U.S. sometime in 2011.

Employment: Late in 2009, some economists were predicting a jobless recovery, but non-farm payrolls turned positive in early 2010 and grew by nearly a million from February through May. Unfortunately, the bulk of these new employees represented census workers and although these temporary government employees bulked up numbers early in the year, they had the opposite effect later on. This became clear in the June employment data as 225k census workers were laid-off, pushing overall non-farm payrolls down by 125k. Private sector employment, a more accurate indicator of hiring, rose by 83k during the month, bringing the total number of private sector jobs created in 2010 to 593k. Although this may seem like a lot, it doesn't even keep pace with the estimated 125k new workers entering the labor force every month. An even grimmer statistic is that economists estimate an average of 250k to 300k jobs per month will be required in order to return the U.S. to full employment within five years. That's a huge number of jobs to be created over a long period of time, considering that several sectors of the economy, most notably housing, are experiencing recessionary conditions. The unemployment rate did creep down from 9.7% to 9.5% in June. The rate decrease could give a tiny boost to confidence, but is really just a sign that more discouraged workers have stopped looking and exited the labor force. Nearly 46% of unemployed workers who are still looking have now been out of work for six months or more. This is unprecedented. By some estimates, there's only one full-time position available for every five who would like a job, and the level of weekly jobless claims is consistent with zero job creation. If it's any consolation, it usually takes a while after a recession before businesses feel confident enough to hire back employees. It took four years to gain back jobs lost during the relatively minor 2001 recession, and a majority of those jobs were added to support the ill-fated housing boom.

U.S. Home Sales: Virtually all of the news coming from the housing sector is abysmal. In fact, in many cases, the data appears worse than it did during the depths of the recent recession. The primary reason is that the government tax credit for first-time buyers ended in April. In all likelihood, the program may have simply pulled future buyers into the present, which is expected to leave a big void going forward. Many believe that without government support, the housing market will deteriorate further, at least in the short run. New home sales fell 33% in May after rising by a combined 29% in the previous two months. May established a record low of 300k annualized new homes sold, more than 78% below the high set during the peak of the housing boom in the summer of 2005. In some ways, existing home sales were worse. New home sales are calculated as of contract date, while existing sales are tallied later at closing date. Thus, the 2.2% drop in existing home sales in May was an unexpected disappointment as experts had predicted that the last minute April rush wouldn't show up in the sales data until the following month. So, although mortgage rates have dropped to record lows with Freddie Mac reporting a 4.58% average 30-year fixed mortgage rate as of July 1, existing home sales are likely to deteriorate a bit more before improving. And improvement may be very gradual.

Retail Sales: The consumer is still repairing a severely damaged balance sheet, with home prices still down roughly 25%, and stock values in the midst of yet another bear market decline. Retail sales fell by 1.2% in June, marking the first outright decline in that series since September 2009. While spending has slowed, the savings rate has increased from 3.3% in March, to 3.8% in April and 4.0% in May. Thriftiness is a double-edged sword. Because few have much of a nest egg to fall back on, a shift to saving mode means a shift away from spending, and the path to renewed economic prosperity here in the U.S. goes through the malls and strip centers. The prospects for meaningful recovery in the consumer sector in the coming months are tough to imagine. The key lies in the labor market. There are approximately 15 million unemployed workers. Until there is significant improvement here, consumer spending will likely remain feeble. For a while, economists were reporting that spending had been given a boost by distressed homeowners who, for whatever reason, were no longer making payments on their mortgages. Many of these were homeowners who had chosen "strategic defaults", which is when homeowners who are financially able to make payments chose not to, presumably because the value of the house is substantially below the mortgage amount. According to the Chicago Booth/Kellogg School, strategic defaults accounted for 31% of all foreclosures in first quarter of 2010, up from 22% a year earlier, and well above the 12% rate that Morgan Stanley had estimated earlier this year.

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