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ABOUT BILL SULLIVAN

William V. Sullivan, Jr. serves as Chief Economist at JVB Financial Group, working closely with the firm's trading desk, providing analysis and commentary on the U.S. economy and the financial markets. Among his duties are authoring a weekly report on credit market trends and maintaining a regular schedule of conference calls that focus on interest rate developments. He appears frequently on Bloomberg TV and is often quoted in Barron's.

Mr. Sullivan is the familiar voice that JVB features on our weekly conference call, where he discusses the economy and the events that affect the marketplace.

He was previously associated with Morgan Stanley in New York City for more than twenty years, where he was an Executive Director and a Senior Economist in the firm's Retail Fixed Income Division. Bill published a widely quoted weekly letter on the financial markets and was a frequent guest commentator on several business networks, including Bloomberg TV, CNBC, and Fox News.

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JVB FINANCIAL

Weekly Commentary

by Bill Sullivan, JVB Chief Economist

January 4, 2010

Excessive optimism in early 2010 unwarranted

The challenges to a vigorous, self-sustaining recovery process in the United States during 2010, in our judgment, are numerous and overall growth during the New Year is likely to disappoint investors. Indeed, as trading gets underway in the opening sessions of January, it is quite apparent that the markets are being priced for a very strong performance in the domestic economy as the year progresses. Although the optimism is understandable, given the bullish predilections of the Wall Street community, in reality, significant headwinds are in place that will limit the extent of any ongoing rebound in the quarters ahead.

A major restraint on general activity this year will be a reluctance of business firms to hire new workers. Clearly, there is a strong recognition among corporate managers that the upturn in the economy during the second half of 2009 was largely related to the stimulus that was provided by the Federal Government and the central bank. Ultimately, these programs will diminish in their support for the economy or will eventually be removed, thus creating a large degree of uncertainty about the outlook for the economy later this year and beyond. Further diminishing the incentive to add to staffing are the unknown costs that will be associated with the Congressional effort to restructure the health care system. Although the legislation has not been finalized, the bills that have been proposed do include various fees and penalties for many companies that will obviously add to the cost of doing business. Against that backdrop, the upcoming additions to payrolls could prove quite anemic by past standards, a development that will limit income growth and eventually any increase in discretionary consumer spending. Admittedly, the worst of the layoffs are now in the past, but that consideration is unlikely to prevent a further rise in the nationwide unemployment as individuals reenter the labor force in greater numbers. A jobless rate of 10.5% by mid-year still seems possible. As unemployment sustains its upward move, a dampening effect on household psychology would be applied, a situation that could also place a braking impact on consumption.

Another influence on the tempo of the 2010 recovery will be the availability of credit to both businesses and households, especially from the banking sector. While the environment could shift, the latest input is worrisome as the data continue to point toward an abrupt contraction in bank lending. To provide perspective, within the last four months, loans and leases on the balance sheets of U.S. commercial banks have tumbled by $2ll.0 billion or at a 9.2% annual rate. Loans to businesses have dropped particularly hard during this period, falling $112.4 billion, which would represent a 23.2% annualized pace of decline. Consumer lending has tumbled as well with this category off by nearly 9.0% since August. The unwillingness to extend credit could be an acknowledgement by banks that write-offs of outstanding loans will remain at high levels throughout the year as foreclosures reaccelerate and commercial real estate conditions continue to deteriorate. The prospect for additional losses points

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towards a regimen of tightened lending standards for the foreseeable future that will restrict access to credit, which will in turn limit expenditures for inventories, capital goods and other durable items.

Given the events over the holidays regarding airport safety, one wonders whether the geopolitical environment once again needs to be factored into the risk setting for investors during the New Year. As an example, if international tensions are perceived as becoming more dramatic in scope, questions could easily arise regarding the security of global oil supplies. A spike in energy costs would transpire in a fragile milieu and would obviously rob purchasing power from consumers both here and abroad. While cold weather seems to be the dominant factor of late, the per barrel price of crude oil has soared by $13.00 over the last three weeks to nearly $82.00. The upturn has set the stage for higher retail gasoline prices this winter, effectively removing some of the relief that drivers were experiencing in the final months of 2009.

An overlooked challenge to the recovery process early in the New Year may actually prove to be excessive optimism among investors. If the enthusiasm for growth ramps up in the January/February period, that attitude is likely to be associated with a measurable rise in open market interest rates. From our perspective, the economy could not handle any meaningful increase in borrowing costs at this point in time. Clearly, if investors continue to flock to equities and other riskier assets, Treasury yields will be pushed well above their recent trading range. The higher returns on Government debt will boost private borrowing costs above current readings, particularly for mortgage loans. A jump in mortgage rates could easily lead to another period of retrenchment for housing sales and new home construction. The ability to modify mortgage contracts would also be eroded by any rise in borrowing costs, increasing the likelihood of another round of record foreclosure activity. A second down leg in housing would act as a major drag on the economy later this year and would essentially represent a pay back for the excessive optimism that may be in place as 2010 gets underway. ■

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