



**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

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Highlights of the 2Q09 Flow-of-Funds

The Federal Reserve Board's Flow-of-Funds report for the second quarter of 2009 continued to portray a financial system that was undergoing an historical adjustment. Indeed, for the second quarter in a row the private sector paid down outstanding debt while all of the borrowing that took place during the three month period under review was government-related. Listed below are some of the highlights of the Fed's latest quarterly report.

- Despite the worst recession in nearly seventy years, debt formation continues to expand in the U.S. economy. According to the Federal Reserve Board, total debt rose at a 4.9% annual rate during the April-June interval, up from a 4.1% pace during the first three months of the calendar year. At mid-year, total debt outstanding for domestic non-financial sectors posted \$34.4 trillion or 2.44 times greater than nominal Gross Domestic Product for the same period. As recently as 2004, total debt was just 2.05 times greater than current dollar G.D.P., underscoring the heavy usage of credit by different segments over the last half decade.
- Households continued to restructure their balance sheets, liquidating another \$233.2 billion in debt during the three months ending June, 2009. The net pay-down was the fourth consecutive quarter in which the household group reduced borrowings. Mortgage credit usage declined for the fifth quarter in a row, falling at a \$147.0 billion annualized rate.

No doubt partly reflecting tightened lending standards, households reduced consumer-related borrowings at a \$166.8 billion annual rate. Even with these liquidations, households still maintained an overall debt loan of \$13.7 trillion during the second quarter. Total debt now exceeds wages by \$6.4 trillion. To provide perspective, five years ago, total debt exceeded salaries by only \$4.3 trillion, suggesting that a visibly larger share of household budgets is now being directed toward debt service expense as compared to the recent past.

- The pay-down of outstanding borrowing by the business sector was huge, registering \$202.8 billion on an annualized basis. The liquidation occurred despite the issuance of nearly \$400.0 billion in corporate bonds during the period. The reduced indebtedness was concentrated in bank loans, commercial paper and mortgages. Clearly, some of the proceeds from bond offerings were utilized to repay outstanding short-term borrowings. A sharp roll-off in inventory positions during the second quarter also reduced the need for businesses to seek external financing. Somewhat surprisingly, the business sector actually raised \$88.0 billion in fresh funds via the issuance of equities during the second quarter. The net increase represented a tremendous turnaround from previous years' experience, wherein business firms were shrinking their equity positions.

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- Sustaining the ongoing effort to reverse the downward slide in the economy, the Federal Government continued to borrow huge sums of money in the domestic capital markets. In particular, the Flow-of-Funds report reflects a \$1.9 trillion annualized increase in outstanding Treasury debt during the second quarter, up from a \$1.4 trillion gain over the January-March interval. It should be noted that the total increase over the first six months of 2009 is still less than the \$2.1 trillion gain recorded over the second half of 2008, when Treasury support for the credit market was at a peak. State and local governments boosted their outstanding borrowings as well, as investors apparently became more comfortable in placing funds with this group. In particular, state and local government debt expanded at a \$187.0 billion annual rate over the April-June quarter. As recently as last year's fourth quarter, these entities could not raise any new cash and were forced to redeem about \$5.0 billion in outstanding debt.
- After several quarters in a row in which net wealth declined, households experienced a rebuilding in financial asset positions during the April-June period. According to Federal Reserve Board statistics, household wealth increased by \$2.0 trillion during the second quarter. Direct equity holdings added \$1.04 trillion, driven by the huge rally in the broad stock market averages during the spring months. The gains in share values were also reflected in the mutual funds and pension reserves that households own. Real estate values climbed

by \$139.0 billion, as home prices in several regions around the country edged higher. Partly offsetting these improvements was another contraction in the value of the non-corporate businesses that households operate, with this category falling another \$280.0 billion in the three months ending June. With the equity market rally continuing through the summer, it appears highly likely that household wealth positions will increase again during the third quarter. While a welcome development, it is doubtful the recent gains in share values will lead to any substantive shift in consumption patterns. As a rule, changes in household wealth affect consumer behavior only after an extensive period of time has elapsed. Moreover, the recent increases in portfolio valuations have transpired in the context of rising joblessness and eroding personal incomes, forces that are likely to have a much bigger impact on the household sector's willingness to spend as compared to the potential influence of a stock market rally. ■

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