ABOUT BILL SULLIVAN

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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

November 9, 2009

Rhetoric and Reality

The Federal Open Market Committee (FOMC) provided some additional insights on monetary policy at last week's formal meeting. Indeed, contrary to widespread expectations within the financial community, the Committee continued to offer a benign assessment of the inflationary environment. Against that backdrop, the membership concluded that the Federal funds target could be maintained at an exceptionally low level for the indefinite future. In the process, the central bank basically dismissed the significance of several market developments that many observers regard as important barometers of future price pressures.

Perhaps the most notable attribute to the FOMC's decision-making process is the willingness to disregard any input from the commodity or foreign exchange arenas regarding the ultimate prospects for U.S. inflation. Gold prices, along with several other precious metals, have soared to new historic highs in the opening trading sessions of November. Many base metal prices, such as copper, have more than doubled since earlier in the year. In the energy complex, crude oil and refined product prices are well above the quotes that were evident six or seven months ago, thus providing some upward momentum to the cost of living for most households. The run-up in many key commodity prices has been driven in part by a continued deterioration in the value of the dollar on world foreign exchange markets. The weaker greenback, of course, raises the prices of imported goods, a development that can also add to overall inflationary pressures. Notwithstanding these influences, the Committee stated that it expected inflation to remain "subdued for some time."

The rational for the Federal Reserve's inflation outlook is built around the huge volume of spare capacity that exists in the nation's product and labor markets. Although this acknowledgement has been evident at past meetings, the latest statement occurs in the context of the seemingly huge challenges that are emanating from the commodity and exchange markets vis-à-vis the potential for price stability. Essentially, by ignoring these inputs, the central bank is suggesting that the degree of resource slack – both here and abroad – is so tremendous that it will swamp any inflationary impulses that could be provided by higher commodity valuations or a weaker dollar.

Clearly, the employment situation report for the month of October that was published two days after the November meeting seemingly validated the Committee's approach. Once again, the tempo of labor market activity was far weaker than expected as the degree of slack within the employment backdrop continued to deepen as the fourth quarter got underway. Beleaguered industries, such as construction and manufacturing, continued to shed jobs in an aggressive fashion, even as other data series allegedly pointed toward some healing in these sectors. At the same time, the recent pronounced discrepancy between the household and establishment surveys on employment trends continued into the October period. The gap between these two indicators could be signaling a re-acceleration in payroll declines in the months ahead, an

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added reason for the Committee to sustain its accommodative stance.

Whereas the policymakers may be attuned to the differing surveys of employment, the equity markets are apparently willing to ignore the varied input. Stock prices were able to hold their own in Friday's session despite the disappointing news and were appreciably higher as trading got underway this week. While the focus on one set of data versus another is not unusual among Wall Street practitioners, the household survey is nonetheless very worrisome for the economy's ultimate performance as well as for the financial market outlook. To provide perspective, total civilian employment has contracted by 1.374 million individuals over the last two months as compared to the 409,000 drop reflected in the payroll statistics. Virtually all of the job losses since August in the household survey have been in the full-time category, resulting in an October unemployment rate for full-time employees of 11.1%, up from just 6.8% one year ago. Although strict comparisons are difficult, a similar discrepancy between the household and establishment surveys was evident in the October/November, 2002 period, with non-farm payrolls revealing far more strength in relative terms as compared to civilian employment. Following that differential, payrolls actually recorded three sizeable drops over the next four months as the two series came into better alignment.

Even if the non-farm payroll data don't reveal renewed weakness in the months to come, it is quite apparent that the labor markets will begin 2010 with far more slack than envisioned just a short while ago. With job creation non-existent and layoffs still proliferating, the household survey points towards an extraordinarily cautious consumer through the holidays and beyond, notwithstanding the current buoyancy of the broad equity averages. Those that are employed will remain riveted on reducing debt loads and building liquidity until some genuine signs of job creation do surface. Consumption will likely trail optimistic forecasts in this setting and the overall economy will remain sluggish by past standards. Needless to say, the repercussions of a near record jobless rate are not limited to the pattern of future consumption. With 15.7 million individuals now without jobs and another 11.2 million underemployed, questions naturally arise as to how these households will handle their outstanding debt loads. In our judgment, the vast pool of joblessness that is now in place points towards rising loan write-offs, higher delinquencies, more bankruptcies and credit downgrades that are not allowed for in market valuations as 2009 comes to a close. ■

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November 9, 2009

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