Broker Dealer / Institutional / Advisor Use Only

JVB FINANCIAL

Weekly Commentary

by Bill Sullivan, JVB Chief Economist

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.

Mr. Sullivan received his Bachelor of Arts Degree in Economics from Fairfield University.

July 28, 2009

Does FOMC Growth Estimate Mesh with Jobless Forecast?

The Federal Open Market Committee (FOMC) has had a difficult time over the last year or so in anticipating ongoing changes in the U.S. employment situation. Indeed, the Membership has consistently underestimated the level of joblessness that the current recession has produced and has tended to pay little or no emphasis to the prevailing shift to part-time employment. Perhaps in response to these persistent forecast errors, the Committee's latest outlook displays extreme caution regarding the expected pace of new job creation. Notwithstanding the anticipated sluggish performance in hiring, the FOMC still envisions a brisk expansion in real Gross Domestic Product once the recovery gets underway during 2010. Clearly, it will be interesting to observe the Fed's explanation of how the economy in aggregate terms can do so well, despite the job markets remaining in a historically weak position for a sustained period of time.

In many respects, the FOMC has been playing "catch-up ball" when assessing the changes in labor market activity. As the pace of layoffs accelerated dramatically late last year and in the opening months of 2009, it became quite apparent that the central bank was overly optimistic regarding the employment picture. To provide perspective, at the June, 2008 policy meeting, the majority of participants pegged the 2009 year-end unemployment rate in the 5.3% to 5.8% range. By late October, with the financial market meltdown well underway, the Committee revised upward their projection for joblessness and envisioned a rate of between 7.1% to 7.6% for the fourth quarter of 2009. At this year's first policy meeting in January, the FOMC once again raised its projection for unemployment ,placing the late 2009 range at 8.5% to 8.8%. With the economy losing tremendous momentum over the winter months, the Committee rendered another adjustment to the employment outlook at the April, 2009 FOMC meeting, forecasting the year-end jobless rate at 9.2% to 9.6%. The April shift again fell short of economic realities and in testimony before Congress last week Chairman Bernanke confirmed that the Committee was now projecting an unemployment rate of 9.8% to 10.1% of the total labor force by this December.

Given the history of wide misses, the FOMC is now calling for a job market recovery that falls well short of the improvements that were registered the last time the employment situation was as poor as it currently is. In particular, the peak jobless rate in the post-World War II period was reached in December, 1982, with 10.8% of the workforce considered without jobs. However, within one year, the overall jobless rate had plunged by 2.5% to 8.3%. Over the next twelve months, the pace of new hiring remained strong and by December, 1984, the unemployment rate had fallen to 7.3%, or 3.5% below the cyclical high watermark. Obviously, the composition of the labor force has changed over recent decades, suggesting the early 1980's experience may be difficult to repeat. In fact, it does appear as if the FOMC envisions some significant restraints on labor market activity in the quarters ahead. As an example, the latest official projections call for the nationwide unemployment rate to drop to just 9.5% to 9.8% by the fourth quarter of 2010, or marginally under the 10.1% peak reading that the Committee is now calling for later this year. Over the final months of 2011, Fed Governors and Bank presidents are forecasting a jobless rate of 8.4% to 8.8%. If accurate, the Committee's outlook points

(Continued on page 2)

(Continued from page 1)

toward an overall drop in the unemployment rate of only 1.3% to 1.7% or well below the 3.5% decline that transpired over the first two years of the recovery process that ensued in the wake of the 1982 jobless peak.

It should be noted that even with the projected improvement, the nationwide jobless rate in the fourth quarter of 2011 will still be at a quarter-century high. Prior to the current business cycle contraction, the unemployment rate during the previous decade averaged about 5.0%, underscoring the extensive degree of slack that will remain in the job market over the next two years. The Committee's outlook is consistent with as many as 13.9 million individuals being out of work over the final months of 2011, or just marginally below the 14.7 million that were looking for jobs this June. Against this backdrop of tepid job creation, the FOMC is nonetheless targeting above trend G.D.P. growth over the next two years. In particular, the Membership believes real Gross Domestic Product could expand as rapidly as 3.3% during 2010, which is actually three-tenths higher than the April projection for this period. During 2011, the economy is expected to record an annual growth rate of 3.8% to 4.6%, building on the recovery that begins in the prior year.

Admittedly, the Gross Domestic Product series can fluctuate widely from quarter-to-quarter. A cessation in inventory liquidations or an abrupt downward shift in imports can give a short-run boost to aggregate activity. However, over a longer term, personal consumption will remain the driving force behind G.D.P. expansion as this component comprises nearly two-thirds of that measure. In our judgment, it seems improbable the Fed's growth projections, especially for 2011, can be achieved given the historically high level of unemployment that the FOMC forecasts over the next 2 ½ years. The sluggish performance in the job markets is likely to be associated with very modest gains in wages and salaries that will place some restraints on discretionary spending power. Moreover, the access to credit for households over the next few years is likely to be well below the standards that prevailed in previous recoveries, another development that could hold consumption in check. Against that backdrop, the FOMC's growth outlook seems overly positive when juxtaposed against their own assessment for the job markets. Eventually, the official projection for real G.D.P. must be lowered or the Committee has to revise downward its forecast for the nationwide unemployment rate. ■

William V. Sullivan, Jr.
Chief Economist
JVB Financial Group
July 28, 2009

For Broker Dealer, Institutional, and Advisor Use Only
Not to be distributed to individual investors

This document has been furnished to you solely for your information and may not be reproduced in any manner or provided to any other person. The information contained herein is based on sources that we believe to be reliable, but we do not represent that it is accurate or complete. Nothing contained herein should be considered as an offer to sell or a solicitation of an offer to buy any financial instruments discussed herein. All references to prices and yields are subject to change without notice. Any opinions expressed herein are solely those of the author. As such, they may differ in material respects from those of, or expressed or published by or on behalf of JVB Financial Group, LLC or its officers, directors, employees or affiliates.