Weekly Economic Commentary

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Highlights

- This week is an extraordinarily busy one for economic data and policy events.
- How much longer can the economic data continue to surprise?

Economic Calendar

Monday, October 31
Chicago Purchasing Managers Index
Oct

Dallas Fed Survey
Oct

Tuesday, November 1
Construction Spending
Sep

ISM Manufacturing
Oct

Domestic Light Vehicle Sales
Oct

Wednesday, November 2
MBA Mortgage Applications Index
wk 10/28

ADP Employment Change
Oct

Challenger Layoff Announcements
Oct

FOMC Decision

Bernanke Press Conference

Thursday, November 3
Productivity
Q3

Initial Claims
wk 10/29

ISM-Non Manufacturing
Oct

Factory Orders
Sep

Chain Store Orders
Oct

Friday, November 4
Unemployment Rate
Oct

Nonfarm Payrolls
Oct

What a Surprise

As is often the case during the first week of the month, this week is an extremely busy one for economic data. But the data, which includes key reports on ISM, chain store sales and the labor market in October, may be reduced to a side show, given all of the other potentially market moving events on tap this week. Last week's batch of economic data—including the third quarter gross domestic product (GDP) report-marked yet another week that the economic data in the United States surprised to the upside. How much longer can the data continue this pattern?

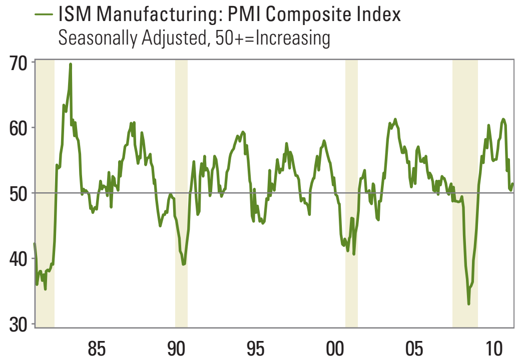
This week (October 31 through November 3) is chock full of key economic reports in the United States. But the data itself may only be a side show given the myriad of policy and corporate events also competing for the market's attention this week. The key reports this week include the Institute of Supply Management's (ISM) report on manufacturing for October, the chain store sales data for October and of course the October employment report. However, there are several other potentially market moving events on tap, including:

- Vehicle sales for October
- Challenger layoff announcements for October
- ADP employment change for October
- Initial claims for unemployment insurance for the week ending October 29
- Weekly retail sales for the week ending October 29
- The ISM's non-manufacturing survey for October

In addition, the October ISM report for China is set to be released late Monday night, October 31, as fears continue to swirl in the marketplace about a so called "hard landing"—a sharp and unwanted slowdown in economic growth in China to around 5 or 6% from the current growth rate around 9%. Our view remains that China can achieve a soft landing, and that Chinese authorities are close to taking steps to stimulate the Chinese economy.

The ISM report in the United States is expected to show that manufacturing sentiment improved slightly in October, but remained well below its early 2011 peak. The ISM peaked above 60 (a reading above 50 suggests that the manufacturing sector is expanding, while a reading below 50 suggests that the manufacturing sector is contracting) in early 2011. But the ISM almost never stays above 60 for very long. In fact, during the middle part of expansions (mid-1980s, mid-1990s and mid-2000s) the ISM often dips below

1 The ISM Continues To Point To Further Expansion in the Economy



Source: Institute for Supply Management, Haver Analytics 10/31/11

The ISM index is based on surveys of more than 300 manufacturing firms by the Institute of Supply Management. The ISM Manufacturing Index monitors employment, production inventories, new orders, and supplier deliveries. A composite diffusion index is created that monitors conditions in national manufacturing based on the data from these surveys.

(Shaded areas indicate recession)

50 for a month or two without signaling a recession. Historically, a reading on the ISM below 42.5 is consistent with a recession in the United States.

The consensus for the October ISM report (based largely on the October readings from the various regional Fed manufacturing surveys that have already been released) is for the ISM in October to move slightly higher to 52.0 from 51.6 in September. The low estimate (among the 82 estimates compiled by Bloomberg) is 50.5 while the high estimate is 53.7. Thus, it would likely take a reading below 50 or above 54 to substantially move markets when the data are released at 10 AM eastern time on Tuesday, November 1. The market will also want to pay close attention to the new orders and employment components of the ISM report. The new orders component is a solid indicator of future manufacturing activity, and the employment reading can provide some insight into the labor market in the manufacturing sector. The employment reading within the ISM has been above 50 in each of the past 24 months dating back to October 2009.

Jobs remain a key concern for markets, and the October employment report will provide a comprehensive look at the labor market in the month. Our view remains that the labor market is stuck in neutral. The economy is growing just enough to produce some job growth, but not quickly enough to substantially lower the unemployment rate or the number of people filing for new unemployment benefits each week. In short, the economic, policy and regulatory uncertainty that is restraining the rest of the economy is still clearly being felt in the labor market, and only a resolution of that uncertainty will lead to an improved labor market in the months and quarters ahead.

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The unemployment rate—which is derived from a survey of 60,000 households—is expected to remain at 9.1% in October. The unemployment rate is calculated by dividing the number of unemployed persons seeking work (about 14 million) by the number of people in the labor force (about 154 million). A 9.1% reading in October would mark the fourth consecutive month at 9.1%, demonstrating some stability in the labor market, but no improvement. The unemployment rate peaked at 10.1% in October 2009, but was as low as 4.4% as recently as early 2007.

The monthly job count is derived from a survey of businesses (140,000 businesses representing more than 400,000 worksites) and has been conducted each month for more than 60 years. The market is expecting an increase of 125,000 private sector jobs in October, a slight deceleration from the 137,000 private sector jobs created in September. Year-to-date through September, the economy has created an average of 150,000 private sector jobs per month. This is about the same pace at which the labor force increases each month, which helps to explain why the unemployment rate has remained around 9.0% this year. While the private sector is expected to have added about 125,000 jobs in October, the public sector (federal, state, and local governments) is expected to see another drop in jobs. In particular, the state and local government sector has shed jobs in eight of the nine months in 2011 and in 30 of the past 38 months. In all, state and local governments have shed 597,000 jobs since mid-2008, an average of about 15,000 per month. We expect this pace of downsizing in the state and local government sector to persist for the foreseeable future as they struggle to realign costs with revenues.

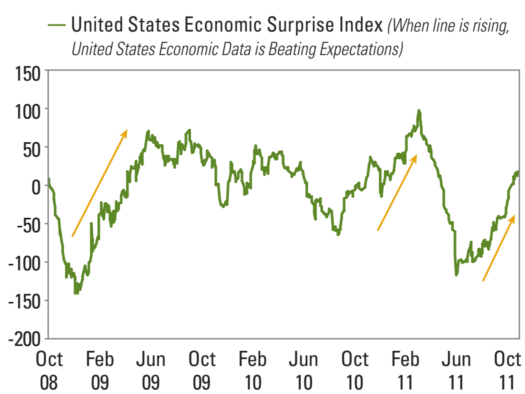
This week also features a Federal Open Market Committee (FOMC) meeting—accompanied by a press conference and a new economic forecast by Federal Reserve (Fed) Chairman Bernanke, and central bank meetings in Australia, Iceland, and in Europe. The market is expecting a rate cut in Australia, and the European Central Bank (ECB) under the new leadership of Mario Draghi, may also cut rates. The G-20 is set to meet this week, where the details of the European rescue plan are likely to be discussed, and 116 other earnings reports and outlooks from S&P 500 companies are scheduled for this week.

Lowered Expectations Opened the Door for the Economic Data to Beat Expectations

Last week's batch of data in the United States—which included third quarter gross domestic product (GDP), along with data on housing, consumer spending and sentiment—marked another week in which the economic data in the United States surprised to the upside. How much longer can the data continue this pattern? If the past three years are any guide, we may only have a few more weeks of better-than-expected economic data, as economic expectations continue to move higher.

The Citigroup Economic Surprise Index (CESI) measures whether or not incoming economic data are beating economists' expectations. There have been three distinct periods since 2008 in which the United States economic data has exceeded expectations, including the current period. The first came as the market first priced in (and then priced out) another Great Depression in late 2008 and early 2009. This episode of better than expected data lasted 23 weeks.

2 Economic Data in the United States Has Been Better Than Lowered Expectations Since June



Source: Citigroup Global Markets 10/28/11

The next wave of better than expected economic data came in late 2010 through early 2011, just after market fears of a European debt crisis-induced double-dip recession pushed economic expectations sharply lower in the spring and summer of 2010. This wave of good news (relative to lowered expectations) began just after Fed Chairman Bernanke hinted at another round of quantitative easing—Fed purchases of Treasuries in the open market—in late August 2010, and lasted until just prior to the Japanese earthquake in mid-March 2011. This episode lasted about 28 weeks.

According to the CESI, the current run of better-than-expected economic data in the United States began in early June 2011, as economic expectations washed out after a post-Japanese earthquake improvement in the United States economic data fizzled and fears of a European debt contagion increased. This prelude was remarkably similar to (and caused by the some of the same fears) as the period just before economic expectations began to rebound in late 2010.

Since early June 2011, more often than not, the United States economic data has surpassed these lowered expectations. But now 19 weeks into this run of better than expected data, we are closing in on the average of the prior two episodes of better-than-expected economic data. Thus, if the past three years are any guide, we may only have another few weeks of better-than-expected economic data, as market participants continue to revise up their economic forecasts, after revising them down while pricing in a recession between the Japanese earthquake in March 2011 and early June 2011.

Our view remains that the United States economy will avoid recession, but that growth is likely to remain tepid, at best, over the next year or so, with the economy growing near its long term growth rate of around 2.0 to 2.5%. This pace of growth would be enough to avoid recession, but not enough to push the unemployment rate meaningfully lower.

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Citigroup Economic Surprise Index (CESI) measures the variation in the gap between the expectations and the real economic data.

The ISM index is based on surveys of more than 300 manufacturing firms by the Institute of Supply Management. The ISM Manufacturing Index monitors employment, production inventories, new orders, and supplier deliveries. A composite diffusion index is created that monitors conditions in national manufacturing based on the data from these surveys.

Purchasing Managers Index (PMI) is an indicator of the economic health of the manufacturing sector. The PMI index is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment.

The Group of Twenty (G-20) Finance Ministers and Central Bank Governors is the premier forum for our international economic development that promotes open and constructive discussion between industrial and emerging-market countries on key issues related to global economic stability. By contributing to the strengthening of the international financial architecture and providing opportunities for dialogue on national policies, international co-operation, and international financial institutions, the G-20 helps to support growth and development across the globe.

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