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GOVERNMENT'S SUPPORTING ROLE

Is Consumer Spending Really On A "Sugar-High" ?

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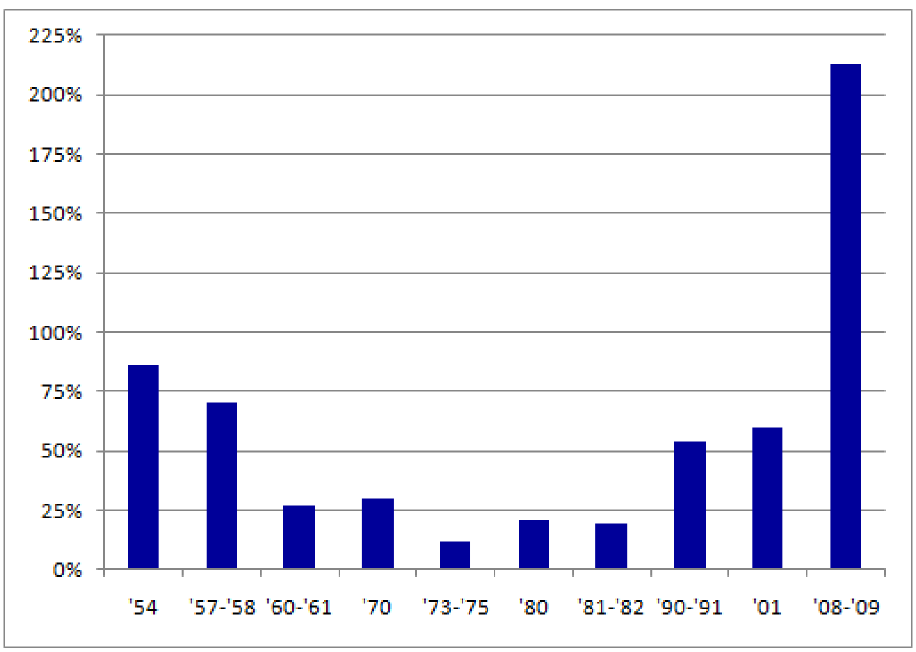
Sadly, the "Sugar-High" analogy appears appropriate. Personal income data provides disturbing evidence that spending could be heading for another cliff. The amount of government support in personal income has surpassed all records, raising serious concerns about the sustainability of consumer spending.

While an increasing majority of investors are falling into the "V-shaped" recovery camp, as both job creation and consumer spending show promise, we remain highly suspicious of both. Admittedly, we have been in suspicion mode for over three years, beginning with the market denial of a sharp housing decline in late 2006. But to us, the spending data appears built on similar sand.

Investors may need to temper their convictions and look more thoroughly under-the-hood. Recent spending data is, indeed, typical of a "V" but is unfortunately based on **unprecedented income replacement from government stimulus that massively surpasses any recession on record.**

Government Support During Recessions

(as % DPI Change)



Government transfer payments alone add up to the entire improvement in disposable personal income (DPI) as we exited the Great Recession last summer. Combined with tax reductions, the government has contributed an amount equal to 213% of the net growth in DPI. This is **five times the average government role** over the past nine recessions, and well over double its highest contribution in 60 years!

Contribution to Change in Disposable Personal Income

Recession	Government Social Benefits		Reduced Taxes		Combined	
Aug 53 - Jun 54	33	%	53	%	86	%
Sep 57 - May 58	59		11		70	
May 60 - Mar 61	38		-11		27	
Jan 70 - Dec 70	26		4		30	
Dec 73 - Apr 75	29		-17		12	
Feb 80 - Aug 80	32		-11		21	
Aug 81 - Dec 82	24		-5		19	
Aug 90 - Apr 91	43		11		54	
Apr 01 - Dec 01	24		36		60	
Jan 08 - Jul 09	100	%	113	%	213	%

Source: BEA

Methodology: Differentials of annual run-rates in Government Social Benefits to Persons, Personal Current Taxes, and Disposable Personal Income. Differentials chosen from quarters just preceding recession onset to quarters at recession end.

The role of government income support during recessions is not in question. The elevation of benefits, the reduced tax burden, and the critical importance of unemployment insurance are all expected, responsible and laudable measures taken to soften the blow in any downturn.

What concerns us is the **degree** of support. To some extent, both the length and severity of the recent recession partly explains this extraordinary degree of income supplement. However, we must also now recognize that replacing government support with more concrete employment income will take longer and be larger than anything we may recall since the Great Depression. Either the U.S. Government deficit is headed much higher than currently projected, or spending must fall back to levels more commensurate with current employment levels.

What does this mean? Employment recovery, also increasingly seen through a "V-shaped" lens, will have to massively accelerate to an equally unprecedented trajectory, far above that suggested in recent monthly payroll data (150,000+/month). To recover the jobs lost during our last recession, and to keep pace with embedded workforce growth, we estimate that net new job creation would have to reach 500,000 per month – and stay there for three years!

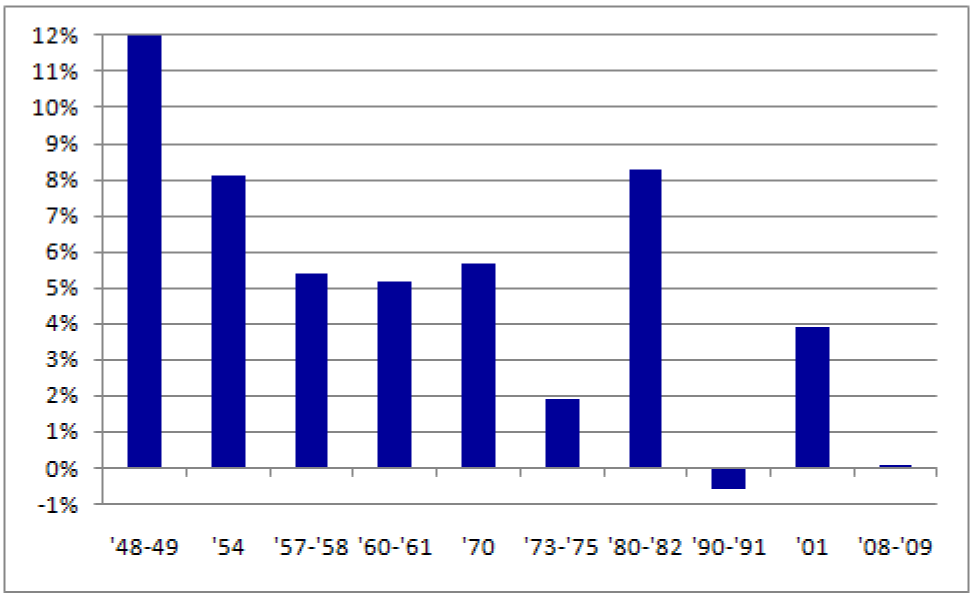
Perhaps this is achievable, and/or perhaps the quality and pay of incremental job creation could favorably transform this equation, but the sheer size of our job loss, which exceeds anything experienced since World War II, suggests an enormous, ongoing obstacle.

The imbalances in spending and income at the consumer level are already suggested in our sluggish economic recovery to date. While first-quarter GDP exhibited continuing consumer spending momentum, it has been decidedly sub-par for this stage of an incipient recovery. First-quarter Personal Consumption Expenditures (PCE) was only 3.5% above its late 2007 annual run rate in nominal terms, and essentially flat adjusted for inflation.

We are now, theoretically, in the third consecutive quarter of recovery. The exhibit below illustrates the real change in PCE for this same stage of the cycle versus the PCE level just prior to recession onset for all recessions since World War II. Recalling that the 1990-91 "recession" was almost entirely in the corporate sector, the current consumer spending recovery appears - if any - extremely anemic at best.

Consumer Spending (PCE) Recoveries

(% Real)



Source: *BEA*

Methodology: *Differentials of annual run-rates in Personal Consumption Expenditures, chosen from quarters preceding recession onset to three quarters following recession end. 1980-82 period shown as a single, overlapping recession.*

First-quarter GDP growth relied equally and entirely on PCE growth and inventories. The former seems prone to stall and the latter is transitional by definition. Avoiding a "W" and continuing a "V" strikes us as increasingly improbable without a sharp and sustained acceleration in new job creation.

The U.S. economic outlook is looking more like a Hobson's Choice: Either the role of government support must extend for many more years, which will ultimately drive deficits, debt and interest rates to unacceptable levels, or the revival in spending will falter, consigning GDP growth to stagnancy or worse. Furthermore, we are only examining and quantifying the direct economic support to DPI. Monetary policy support is an important, additional factor.

This should be the context for evaluating future jobs data. The consensus for April Nonfarm Payrolls, due out this Friday, is for a net change of only 189,000 and includes temporary census workers. This is well less than half the employment generation needed to validate a "V."

The more important strategic implication for financial sector investors and the management of financial companies is the longer-term outlook for interest rates. As it is not properly represented in future U.S. Government deficit projections, a "V" may carry more risk than a "W" as it would likely extend reliance on, and expand the cumulative cost of Government support.

Disturbances in Europe somewhat mask the underlying over-extension of U.S Government debt. These disturbances have renewed a global flight-to-safety, increased the marketability of U.S. Treasury bonds and bills, and have temporarily extended the low-rate bias for the U.S. Dollar in its expanding reserve currency role. Meanwhile, the U.S. debt pool grows and the debt service burden accumulates. Any eventual resolution of European default risks will likely be to the relative, and possibly abrupt detriment of U.S. "risk-free" interest rates.

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