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Concerns about sovereign debt in Europe, not to mention some sobering projections in our own budget for fiscal 2011, led to a spike in volatility this past week as the Dow swung 100 or more points in three of its five sessions, including a 268.37 nosedive on Thursday. In fact, the index was as low as 9,835.09 on Friday before rallying on the report of a lower jobless rate to stay over the 10,000 point mark.

All things considered, it was surprising that the Dow began last week with its best back-to-back run since early November of last year (it was up a total of 229.52 points on Monday and Tuesday) given the grim numbers in the president’s proposed \$3.83 trillion budget for 2011 that was unveiled on Monday. Despite the inclusion of some spending freezes, as promised, the budget projects a \$1.3 trillion deficit in 2011 following a record \$1.6 trillion shortfall this year. That adds up to a deficit equal to 8.3% of gross domestic product in 2011 after 10.6% of GDP this year, whereas economists say that 3% is considered to be “sustainable.” (For the record, when he came into office Mr. Obama inherited a \$1.3 trillion deficit that was 9% of GDP and pledged to cut it in half by the end of his term in 2013.) The annual deficit is projected to only go as low as 4% of GDP in 2013, after which it will rise again. Worse still, the total of our publicly held debt, much of it currently in the hands of China and Japan, would equal \$18.6 trillion or 77% of GDP by 2020, compared to \$7.5 trillion or 53% of GDP last year. Given those numbers, it’s not surprising that there’s growing concern that as we become

	Key Market Data		
	Week ending		
	2/5/10	1/29/10	Change
Dow Jones Industrial Average Index	10,012.23	10,067.33	-0.55%
S&P 500 Index	1,066.19	1,073.87	-0.72%
NASDAQ Composite Index	2,141.12	2,147.35	-0.29%
10-Year Treasury Note Rate	3.546%	3.611%	-0.065 pct. pts.
NYMEX Crude Future (Barrel)	\$71.19	\$72.89	-2.33%
Euro/U.S. Dollar	\$1.3665	\$1.3863	-\$0.0198

increasingly reliant on China to buy our debt – and fund our nation – it will become harder to find much leverage over a country that we are regularly at odds with about censorship, Tibet and Taiwan, Iran, and currency manipulation, all issues over which our two countries have crossed swords in recent weeks. Finally, the budget projects unemployment staying at 10% through 2010 before falling to 9.2% next year, and forecasts GDP growth of 3% in 2010 (the consensus is 2.9%) and 4.3% in 2011 (the consensus is 3.2%).

Though the jobless rate for January fell from 10.0% to 9.7%, there was little excitement because the Labor Department also reported that the economy lost 20,000 jobs last month. Further, the department revised downward its estimates for the number of total jobs in the economy for December. The January rate also included the annual adjustment the department makes as a result of the census, and some analysts therefore dismissed the drop as a statistical quirk. The underemployment rate, which includes those

who have stopped looking for work as well as those part-time workers who want full-time jobs, fell from 17.3 million to 16.5 million but was still nearly double the level of three years ago. The one bright spot was that manufacturing added 20,000 jobs, the first uptick there since November of 2007. One other note, as the result of some other revisions and recalculations, women now represent the majority of America's workforce for the first time (50.3%), though it is primarily the result of more men (7.4 million) than women (3.9 million) having lost their jobs since the recession began and it may revert once the male-dominated construction and manufacturing sectors bounce back.

The Labor Department also announced that worker productivity rose 6.2% in the fourth quarter. Over the last year, productivity was up 5.1%, the best 12-month run since 2002. And Thomson Reuters reported that retail sales at stores open for at least a year (a.k.a. same store sales) rose 3.3% in January year-to-year, the biggest jump since April of 2008 though the figures were largely discounted as last January's numbers were so weak (down 5.6%).

The Institute of Supply Management (ISM) reported that its index of purchasing managers reached its highest level since August of 2004, rising to 58.4 in January from 54.9 in December, the sixth straight increase and above the projected 55.5 (any reading above 50 means expansion). In the wake of the report, consensus estimates for GDP growth in the first quarter rose from 2.6% to 3%. Later in the week, the ISM said that its reading for the economy's service sector also improved in January, up to 50.5, the highest level since May of 2008.

The Commerce Department reported that personal income rose 0.4% in December, before being adjusted for inflation. However, consumer spending increased by only 0.2% while the personal savings rate rose to 4.8%, not good signs for those hoping for an

upswing of the spending that accounts for 70% of GDP growth. Along the same lines, the Federal Reserve reported that consumer borrowing fell in December for the eleventh month in a row, the longest losing streak since the Fed began tracking the data in 1943, dropping 0.8% or \$1.7 billion to \$2.457 trillion. The Commerce Department also reported that construction spending fell 1.2% in December and a total of \$939.1 billion was spent for all of 2009, down 12.4% from 2008.

As the bonus season came to an end, Lloyd Blankfein, the chairman of Goldman Sachs, received "only" \$9.6 million in deferred stock despite the firm's record-setting year in yet another sign of wariness from Wall Street (by way of comparison, Mr. Blankfein got a bonus of \$68.5 million in 2007 though he didn't receive any bonus in 2008). James Gorman, who took over as the CEO of Morgan Stanley in January said that the bonuses his firm just gave out, a record 62% of net revenue (compared to 36% for Goldman and 19% for Bank of America) were the kind that "nobody on my management team will ever see again."

Meanwhile, the call for reform of financial regulations that has been taken up anew by Mr. Obama reached an impasse in the Senate as its finance committee was unable to reach consensus about a proposed bill, particularly the whys and wherefores of a new financial consumer protection agency. The committee's chairman, Senator Christopher Dodd (D, CT) decided to send it to the Senate for a vote as is, without GOP support, even though the Democrats will no longer have the 60 votes they need there to avoid a filibuster. As his fellow Democrat Senator Jack Reed of Rhode Island said, "We're just trapped in endless discussion. You've got to stop the discussion and start voting." The hope is that the Republicans will not risk the public backlash of doing nothing to amend the loose regulations that many feel led directly to the recession.

Regarding regulation, the point man for the Obama administration is Paul Volcker, who was the chairman of the Fed from 1979-87; indeed, the move to prohibit proprietary trading at what he calls the “mega commercial banks” has become known as the “Volcker Rule.” Last Sunday, Mr. Volcker took his case for financial reform to the editorial pages of *The New York Times*, calling for a broad international consensus and concluding, “We need to face up to the needed structural changes and place them into law. To do less will simply mean ultimate failure – failure to accept responsibility for learning from the past and anticipating the needs of the future.” At the same time, the current chairman Benjamin Bernanke was sworn in for a second term in a low-key ceremony, saying he took the job, “with considerable gratitude and not a little humility.”

The broader view

The tremors that shook our stock market last week largely originated in Europe and were the result of the questionable finances of the countries that have been derisively dubbed the “PIGS” – Portugal, Ireland, Spain, and Greece – as all of them have annual budget deficits at or approaching 10% of GDP. The issues are many, but in essence, they are countries that overspent during the boom, and now that the bill has come due in the form of large deficits and high jobless rate, they may not have the economic growth or productivity to stay solvent. (Though we have similarly high projections of debt to GDP in the United States, our growth and productivity prospects are far better; Greece’s GDP, for example, is expected to shrink 1.1% this year.) Greece has also been accused by the European Commission of



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deliberately misreporting its finances to gain entry into the euro zone. The consensus seems to be that the stronger European countries, notably Germany and France, or perhaps the International Monetary Fund, will step in to prevent default but do not want to come out and say as much until Greece, among other countries, has made some real progress toward putting its economic house in order. The Greek government has pledged to adopt an austerity plan that was approved by the European Commission last week, but at home the plan was met with protests and work stoppages. A similar plan proposed by Portugal’s government was voted down in its Parliament, and last week Spain raised the forecast for its budget deficit. Even so, the combined GDP of Greece, Portugal, and Ireland is only 6% of the 16-nation euro zone and it’s Spain, which accounts for 20%, that is the bigger concern because its economy is both too big to rescue and too big to fall.

A look ahead

It will be a comparatively quiet week by recent standards – no major news releases are on tap from the Fed, the Labor Department, or the White House – though there will be updates on wholesale and business inventories, mortgage applications, and the trade gap. Instead, investors will continue to sift through earnings releases, which have managed to be both well above expectations and largely disappointing because of a lack of revenue growth, and also monitor the state of the “PIGS” and, more importantly, the response of their euro zone partners.

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ISM Index is a monthly index released by the Institute of Supply Management which tracks the amount of manufacturing activity that occurred in the previous month.