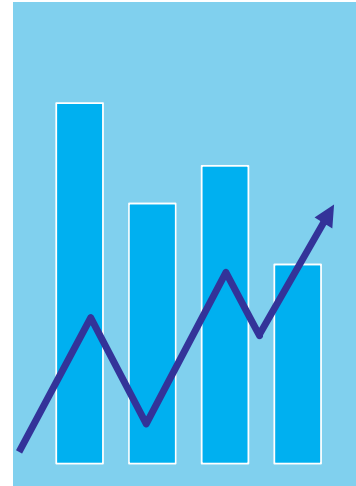


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Economic Update

The Moon is Shrinking



August 2010

Industry Insights

Overview: “The pace of recovery in output and employment has slowed in recent months,” said the Federal Reserve in August. “Too few jobs, too little wage income and too little consumer spending” was the sentiment in an August *Wall Street Journal* forecasting survey

Retail: Commerce Department data show that, outside of autos and gasoline, sales remain lackluster

Motor Vehicles: The sales pace over the last five months has moderately improved

Consumer Products: Federal Reserve data continue to show that production has slowed in tandem with retail sales

Aerospace & Defense: Following earlier weakness, A&D production improved in June and July

Process & Industrial Products: Machinery production has increased for 8 months, likely helped by the gains in corporate spending on equipment

Lodging: An anomaly in this otherwise-slowing economic recovery. Gains in revenue per available room (revPAR) continue to strengthen according to STR

... and so is this economic recovery.

NASA and the journal *Science* reported in August that, based on evidence collected by NASA’s lunar orbiting spacecraft, the moon shrank in the “geologically recent past,” (which could be as long as one billion years ago, according to NASA) and might still be shrinking today.

In Earth’s economically recent past (only the last several months) there is a growing body of evidence that shows that the recovery is shrinking. Further, many analysts suggest that this shrunken recovery pace could continue for the rest of this year. The good news however is that there still is little to suggest that the economy will soon crater and fall back into recession.

The latest report on economic activity confirms that growth has slowed. The Bureau of Economic Analysis (BEA) reported that real GDP in the second quarter rose at an annualized rate of only 1.6%, the second

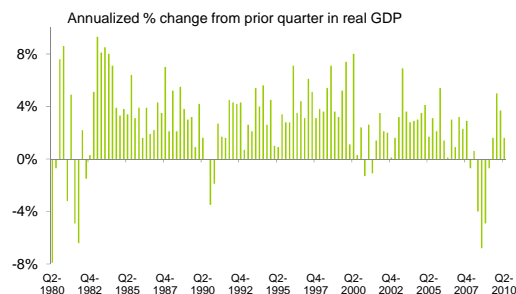
consecutive slowdown in growth. With the pace of inventory rebuilding moderating, other areas, notably consumer spending, have not picked up the slack in any meaningful way.

Further, BEA’s revisions show that the Great Recession was even “greater” than first estimated. The economy contracted by a large 4.1% on a peak-to-trough basis, compared with the earlier estimate of a 3.7% decline. Both these numbers assume that the recession ended in June 2009, even though the National Bureau of Economic Research has not called the end of the recession.

Revisions also show that consumers over the last several years spent less than previously thought. And since the start of the recovery, quarterly growth rates for consumer spending have also been revised lower.

While consumer spending growth has mostly been sluggish in this recovery, BEA’s release showed business spending on equipment and software has been basking in the moonlight. Not only did business spending hold up slightly better in the recession than first reported, it has recently been improving at a faster clip than first estimated. The investment areas with the highest rates of growth in the second quarter were industrial equipment

The Recovery is Shrinking



Source: Bureau of Economic Analysis

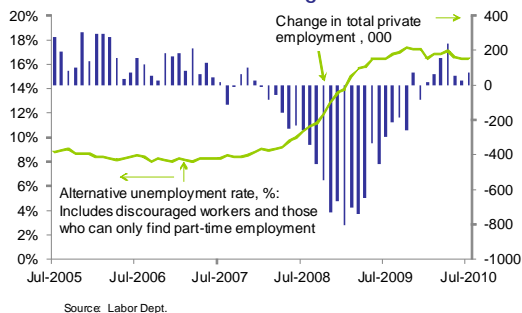
and transportation equipment. Some analysts suggest that, with businesses investing more in their factories and offices, stronger gains in employment cannot be far behind.

Consumer Fundamentals Remain Squeezed

The average Man (or Woman) on the Street probably feels for the shrinking Man on the Moon. There's lots that's been downsized for Earth-bound inhabitants too.

Take employment. Currently there are 14.6 million persons looking for work. That figure has nearly doubled since the start of the recession, according to the Labor Department. There are 6.6 million individuals who have been out of work for six months or more; 400% higher than at the start of the recession. The more comprehensive unemployment rate, which includes those employed part time for economic reasons and those only marginally attached to the labor force, has been above 16% for the last 14 months.

Small Employment Gains at Private Employers; The Alternative Measure of Unemployment Remains High



The Labor Department's latest report also showed that total nonfarm employment declined in June and July mostly as a result of the Federal government letting go the temporary workers hired for Census 2010 and state and local governments laying off workers due to budget problems. Private employers, meanwhile, have recently been hiring at a slower pace. In May, June, and July, they added a paltry 150,000 workers in total, only one-third the number of the prior three months. Even temporary-worker hiring, which had been growing – implying that companies might soon begin bringing on full-time, permanent staff – faltered in July. Further, initial claims for unemployment have recently risen and are now back up to their highest level since last November.

With employment barely growing, it's not surprising that employee compensation has also shown minimal gains. In tandem with the 2010 growth in employment, total compensation (mostly wages and salaries) has been rising since January 2010, according to the Bureau of Economic Analysis. Gains have been meager, however. In contrast, government transfer payments – mostly unemployment and social security – grew by large double-digit percentages throughout the recession; and growth has continued to outpace compensation gains in 2010. As a result, these transfer payments now represent 18.3% of consumers' total personal income –

an increase of three percentage points since the start of the recession.

Strong Growth in Transfer Payments is Helping Consumers' Incomes



Businesses Beginning to Think Real Improvement May Be 238,857 Miles Away

... or about the distance from the Earth to the Moon. As with consumers, business confidence is again receding, after rising early in 2010. The National Federation of Independent Business reported in August that its index of small business optimism fell to its lowest level in four months. In The Conference Board's survey of CEOs, only 48% expect the economy to improve over the next six months. And Moody's Economy.com noted that global business confidence has "weakened measurably since peaking in the spring," according to its ongoing surveys of businesses.

The Sales Pace has Slowed; Will Inventory Rebuilding Be Affected?



Increasing pessimism is partly explained by the recent three-month easing in growth rates for total business sales, as reported by the Commerce Department. Sales gains for all three groups, manufacturers, wholesalers, and retailers, have slowed. Inventory rebuilding was a source of economic growth early in this recovery, and while these gains have recently moderated, a further easing in demand could create problems for manufacturing. And in fact, August surveys from the various regional Federal Reserve banks show a general softening in manufacturing activity, with an outright decline being reported by the Philadelphia bank.

Economic Indicators				
	2009 Year	May 2010	June 2010	July 2010
Employment (SA change in nonfarm, 000) <i>Labor Dept.</i>	-489*	432	-221	-131
Unemployment Rate (SA %) <i>Labor Dept.</i>	9.3*	9.7	9.5	9.5
Consumer Price Index (SA % ch. prior period) <i>Labor Dept.</i>	-0.4	-0.2	-0.1	0.3
Consumer Confidence Index (1985 = 100) <i>Conference Board</i>	45.2	62.7	54.3	50.3
Real Disposable Personal Income (% chg. prior period, SAAR) <i>Commerce Dept.</i>	0.6	0.4	0.2	NA
Gasoline Price (\$/gal., Reg. unleaded)* <i>Energy Dept.</i>	2.35*	2.84	2.73	2.73
Existing Home Sales (mil. units)** <i>Natl. Assoc. Realtors</i>	5.16	5.66	5.26	3.83
Hotel revenue per available room (% change year ago) <i>STR</i>	-16.7	7.1	8.0	8.5
Motor Vehicle Sales (mil. units)** <i>Commerce Dept.</i>	10.4	11.6	11.1	11.5
Industrial Production (SA, % ch. prior period): <i>Federal Reserve</i>				
Total Manufacturing	-10.9	1.0	-0.4	1.2
Consumer Products, ex high tech, energy and vehicles	-5.6	1.4	-1.1	0.1
Aerospace and Defense	-1.6	-1.7	0.5	1.7
Nonenergy Materials	-14.4	0.9	-0.1	1.0
Machinery	-21.8	2.3	1.2	1.1
Capacity Utilization, Total Mfg. (%)	67.0	71.9	71.6	72.4
Retail Sales (SA, % change from prior period): <i>Commerce Dept.</i>				
Total (incl. Food Service)	-6.5	-1.0	-0.3	0.4
Total, excluding MotorVeh.& Gas	-2.0	-1.1	0.2	-0.1
Motor Vehicles & Parts	-12.5	0.50	-1.3	1.6
Building Materials, Garden	-11.5	-8.9	-0.8	-0.3
General Merchandise Stores	-0.7	-1.2	0.3	-0.2
Apparel & Accessories Stores	-3.7	-0.5	-0.1	-0.7
Furniture & Home Furnishings	-11.4	-0.9	-1.6	-0.3
Electronics & Appliances	-8.2	0.9	1.2	-0.1
Food & Beverage Stores	0.4	-0.3	-0.4	-0.3
Restaurants & Bars	0.3	-0.2	0.0	0.2

Notes: *Monthly average. **Monthly figure = Seasonally Adjusted Annual Rate. SA = Seasonally Adjusted. SAAR = Seasonally Adjusted Annual Rate. *Italics* = source of data. STR = Smith Travel Research

The Lending Eclipse May Be Ending

Since the start of the recession, one of the darkest areas for both businesses and consumers has been the lack of lending from banks. The situation may be brightening. The most recent surveys of senior lending officers from the Federal Reserve shows that banks are finally easing their standards for loans.

Following a lengthy 3-1/2 year period of banks tightening their loan standards to small firms, senior loan officers said that standards eased in the third quarter. Standards for large firms have been easing since the start of this year. Loan standards for consumer credit cards also loosened in the third quarter, for the first time in two years. In addition, mortgage standards have also eased. Thus, spending by businesses and consumers could move out from the dark side in the coming months as loan access improves.

The Recovery Has Been Knocked Off its Orbit

The recovery started out somewhat normally. Businesses restocked their low inventories, and consumers, with a push from the government's various incentives, began spending a bit more. That's how many of our past recoveries have begun. Typically, as consumers start spending again, releasing the pent-up demand that grew during the recession, companies respond by hiring more workers to meet the higher demand. Historically, increased spending drives employment gains, not the other way around.

Recently things seem to have gotten a bit out of kilter. As noted in the last several *Updates*, both business and consumer sentiment has again moved downward. Yet a number of positive fundamentals for this economy remain intact. Last month's *Update* discussed how consumers have dramatically worked down their debt. That deleveraging has been so dramatic that the credit bureau Equifax reported to Reuters that the average consumer's credit score in July was up to 704, the highest reading in 12 years! Additionally, the gains in business spending on equipment mentioned earlier – coupled with the large amounts of corporate cash discussed in last month's *Update* -- suggest that employers could begin hiring more workers. Thus it would seem that many consumers, like many businesses, have the wherewithal to spend, when they decide to do so. But until they do, this economy will likely continue to spin aimlessly.

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