



What a Difference a Month Makes

Since our last report, economic data have shown signs of improvement, the Europeans have seemingly made progress in working through the sovereign debt crisis, and stock prices have surged. While we are thankful for the turn of events, we know that we are not out of the woods yet.

Let us begin by briefly reviewing some of the key economic releases in October.

On October 7th, the government released its national employment report for September. The market had expected net job gains of around 60,000. Instead, the economy added 103,000 jobs in September. Furthermore, prior estimates for July and August were revised higher by 42,000 and 57,000, respectively. The unemployment rate held steady at 9.1% (Exhibit #1). The market regarded this report positively.

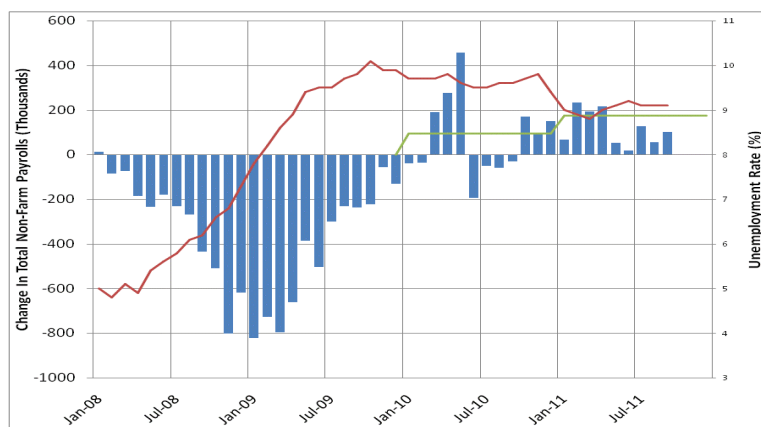
Earlier this year, we developed a framework for analyzing the economy during the year. As part of this framework we set 175,000 monthly new jobs as the level required to confirm the viability of the economic recovery (the green line in Exhibit #1). We selected the specific number—175,000—based on past observations of employment data during periods of modest to moderate economic growth, such as we forecast for 2011.

From February through April, monthly new jobs exceeded this amount. Since May, the reported numbers have fallen short. An optimist would combine September's new jobs figure with the prior-period revisions and see 202,000 new jobs. A pessimist would say July, August and September all fell short of 175,000, notwithstanding the upward revisions.

Part of the reason for setting up the framework like we did was so we could evaluate the monthly results simply, as wins and losses. So far in 2011, the labor market has three wins and six losses, and currently is mired in a five-game losing streak. If a football team had produced this record, we would not think highly of their chances of winning the Super Bowl.

In short, we would feel more confident in the viability of the economic recovery if the employment numbers showed better consistency and higher levels of job gains.

Exhibit #1
Change in Total Nonfarm Payrolls (bars)
& Unemployment Rate (line)



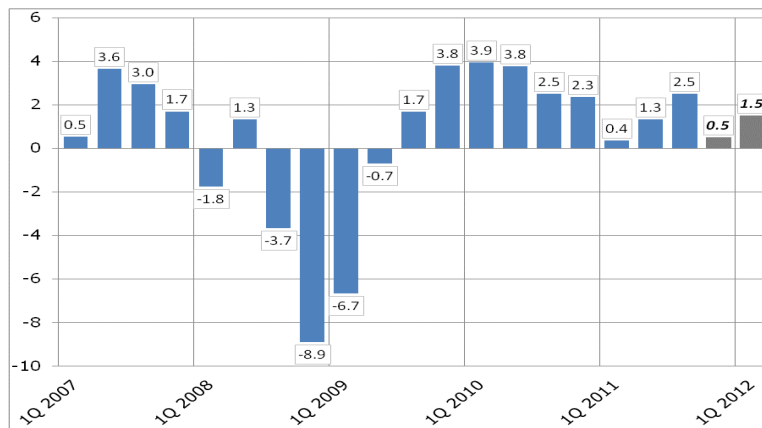
Sources: U.S. Dept. of Labor, Bureau of Labor Statistics; Federal Reserve Bank of St. Louis

The September regional and state employment report contained good news for Californians. According to the report, California led the nation in year-over-year changes in employment. California added 250,700 new jobs, narrowly edging Texas (+248,500). Of course, California has the highest population and thus the largest labor force, so under normal circumstances California *should* create the most new jobs. But in recent months California did *not* create the most new jobs. Texas did. Despite this favorable turn of events, California continues to have the nation's second highest unemployment rate at 11.9%. There remains much need for improvement.

On a more positive note, initial jobless claims have trended lower for the past five months. Initial jobless claims is a weekly report that measures the number of new people filing for unemployment benefits. Typically, rising initial jobless claims signal a worsening economy, while falling claims signal an improving economy. One would not expect to see initial jobless claims near five-month lows if the economy were about to fall into recession.

On October 27th, the government released its advance estimate of 3rd quarter real gross domestic product (GDP). This report indicated that the U.S. economy grew at a real annualized rate of 2.5% during the 3rd quarter, exceeding market expectations (Exhibit #2).

Exhibit #2
Real Gross Domestic Product (GDP)
Compounded Annual Rate of Change



Sources: U.S. Dept. of Commerce, Bureau of Economic Analysis; Federal Reserve Bank of St. Louis; Rabobank International

Real personal consumption expenditures (consumer spending) increased 2.4% in the 3rd quarter, compared with an increase of 0.7% in the 2nd quarter. Consumer spending was an unexpected source of strength in this report. It is good (but puzzling at the same time) to see such levels of consumer spending, considering the backdrop of high unemployment, underwater mortgages, economic and political uncertainty, and negative sentiment. Consumer spending accounts for about 70% of the overall U.S. economy so it is key to overall economic health.

We may have created confusion last month by featuring ECRI's Lakshman Acuthan's predictions of impending recession so prominently. Our base case scenario for the U.S. economy is continued "bumping along the bottom," rather than impending recession. Our preliminary estimate for real GDP growth in 2012 is a 1.5% annualized rate. We expect to use plenty of "m-words" to describe the economy in the next year, such as meager, modest, and maybe moderate. We do not expect to use many "r-words," such as robust, raging, and rip-roaring. We hope not to use the dreaded "r-word" recession either, but acknowledge that it is a possibility.

Let us now shift focus to the ever-changing European sovereign debt crisis. In October, news from Europe caused global financial markets to experience heightened levels of volatility. However, aside from a few hiccups along the way, the news was generally good. As of October 27th, Eurozone leaders appear to have hammered out a rescue package that includes three main provisions. First, the European Financial Stability Facility (EFSF) would be substantially enlarged. The EFSF is an entity that the member states of the European Union created in

May 2010 to provide relief from the sovereign debt crisis. In theory, it works by issuing debt to raise funds that it can then use to provide loans to troubled nations or to buy sovereign debt. Second, European banks would “voluntarily” accept a 50% haircut on Greek debt. Third, European banks would be subject to a recapitalization plan.

The uncertainty in Europe was a huge factor in depressing global equity markets through September, as was the threat of recession. As these threats eased in October, global stock markets rallied. U.S. stocks—as measured by the S&P 500 index—posted their highest single-month investment returns since December 1991, a welcome relief to beleaguered investors (and beleaguered portfolio managers). Specifically, the S&P 500 index jumped from 1,131.42 on September 30th to 1,253.30 on October 31st, a 10.8% increase.

Meanwhile, bond yields returned to somewhat more normal levels in October. The bellwether 10-year Treasury note yield climbed from 1.80% to 2.42% before settling at 2.17% on October 31st. Our use of the term “normal levels” implies a value judgment, not necessarily fact. It is possible that sub-2% Treasury note yields will become the new normal, but for now they seem abnormal. Even in the depths of the Great Recession the 10-year Treasury note yield bottomed at 2.08%.

As stated in last month’s report, we continue to believe U.S. stocks offer investors compelling value in the intermediate-term, but the risk of heightened volatility in the short-term. We are less favorably inclined toward international stocks, particularly European stocks, due to the sovereign debt issues described above. We continue to find the investment return potential of investment-grade bonds to be sub-par. High-yield bonds offer more compelling return potential, but in moderation.

The evolution of current events could radically alter our financial market outlook, so we must remain diligent in monitoring such events, adjusting investment strategy accordingly.

Just as we put the finishing touches on this month’s economic review and outlook, Greek prime minister George Papandreou shocked the world by announcing plans to put the terms of the bailout to the Greek people for a vote. This news immediately sent shockwaves through European political circles and global financial markets. Stock prices fell sharply around the world. U.S. bond yields plunged as investors flocked to the relative safety of this asset class. This news constitutes a major “evolution of current events.” We will monitor this development closely.



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