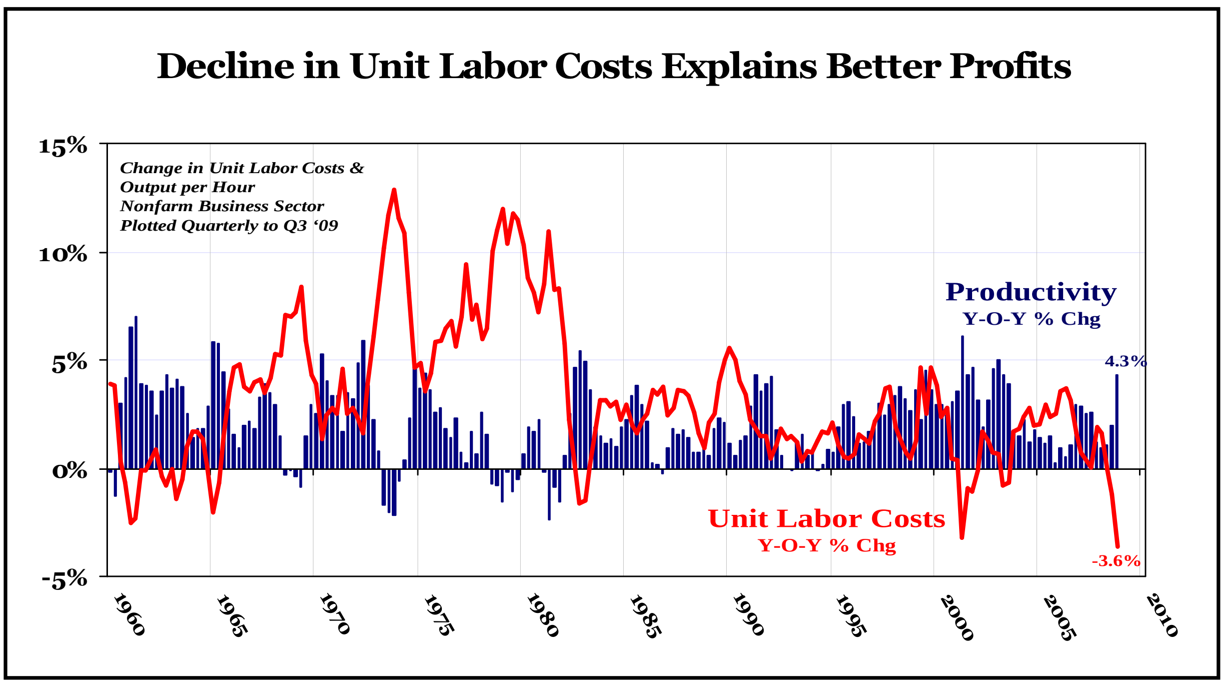
Stocks higher on decline in jobless claims, rise in productivity, Cisco guidance…

November 5, 2009…The S&P 500 squandered a strong post-election, post-Fed meeting rally in the final hour of trading Wednesday, ending the session up just 0.1%, but it more than made up for it on Thursday, climbing 1.9% for the day. Today's initial claims report showed 512k jobs were lost in the latest week, 20k fewer than in the prior week, 10k below Street expectations, and the lowest number since January. Investors apparently took this as a cue to Friday's Labor Department report on employment conditions in October, to be released at 8:30 tomorrow morning. Combined with the favorable ISM manufacturing report earlier this week, for which the employment component registered 53.1% (a three-year best), the suggestion is that labor in the manufacturing sector has finally begun to improve. The indications in the bigger nonmanufacturing economy are less benign, as this week's survey showed a slight contraction in service sector employment. In any case, Friday's nonfarm jobs release will settle – for one month at least – which sector's trend is more pronounced, the positive one in manufacturing or the stagnant one in services. The Street consensus going into tomorrow's report is that 175k jobs were lost in the nonfarm economy last month.

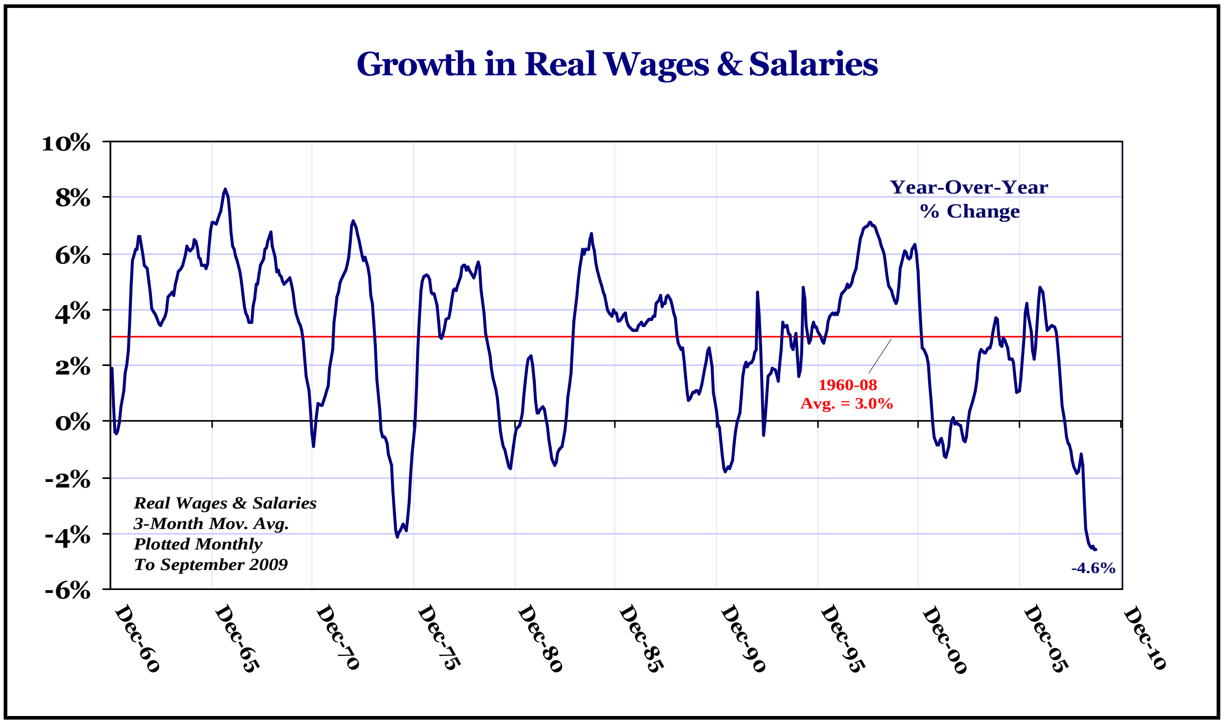
- **The other eye-catching report out Thursday was Labor's 9.5% estimate of Q3 productivity growth, the highest in six years and second best in almost 40.** Some aspects of today's productivity report were not as flattering for the economy: aggregate hours worked during the third quarter were down 7.5% from the year-earlier level, the biggest decline since 1947; compensation was down 7% for the same period. But insofar as corporate profits are concerned, the fact that unit labor costs declined 3.6% over the past 12 months (-5.4% so far in 2009) goes a long way toward explaining the large number of companies that beat earnings expectations during Q3.



- **Cisco is the latest big tech company to beat expectations in the latest quarter: revenues were down 13% year-over-year (the Street was forecasting -16%) and earnings per share of 36 cents easily beat the Street's 31 cents estimate.** While the amount by which sales beat expectations was hardly overwhelming, perhaps more important was management's forecast that sales will rise 1% to 4% in the current quarter. By comparison, with more than 80% of the S&P 500 companies having reported Q3 results, five times as many firms have beaten as have disappointed on the bottom line; on the revenue line, the percentage beating is only 58% versus 41% missing forecasts. In the aggregate, the average sales report was essentially right on estimates, a far cry from the average 15% that earnings per share beat by. If Cisco is correct and if higher tech sales broaden to higher sales generally, still a somewhat iffy proposition, then the improved profit margins produced by the big productivity gains being chalked up by U.S. business will combine to produce sizeable earnings gains. Indeed, that may be what investors were seeing in today's productivity, weekly claims and CSCO earnings reports.

INVESTMENT OUTLOOK…Pretty clearly the U.S. economy is no longer in the steep swoon it was in late last year and early in 2009, when GDP declined at an average annual rate of 6%. But, as the latest Fed beige book report made clear, neither is it in the sort of robust recovery typically seen following a steep recession. Still, "cash for clunkers" and inventory restocking pushed real GDP growth to a 3.5% annual rate for Q3, effectively ending the recession. The powerful monetary and fiscal policy actions taken over the past 18 months will likely keep the recovery started in Q3 going into Q4 and 2010. But consumers may continue to drag their feet and commercial real estate may be a drag on economic growth for some time yet, and we won't be surprised if it takes several more quarters before U.S. real GDP returns to a trend growth rate around 2.5%. While the persistence of the stock market rally that began in March and improvement in the credit market have been indeed impressive, most market rallies do not go so long without experiencing a correction of some significance.

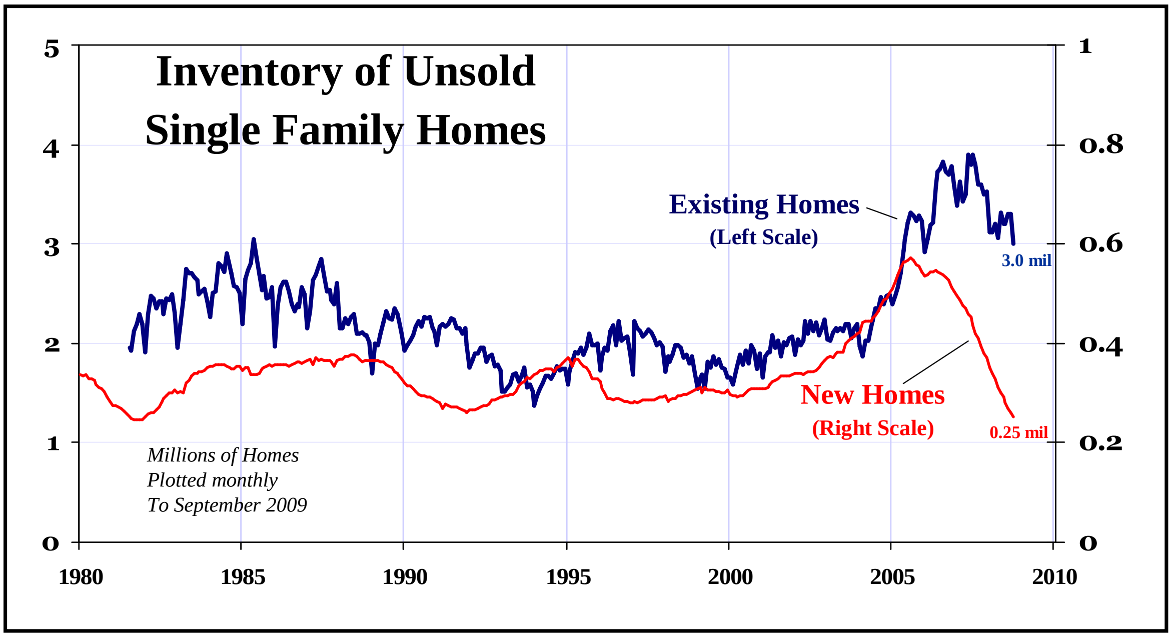
October 30, 2009…Stock price volatility reared its ugly head again Friday, with the major market averages declining between 2.5% and 3% and the VIX volatility measure climbing to its highest level since July. The S&P 500's 2.8% drop today was the biggest one-day decline for the market since July 2 – as the last semi-serious correction of this year's rally was winding down – and it easily pushed the big-cap benchmark into the red for the month (-2.0%). After seven positive months for stocks, the tail end of October was indeed disappointing for investors, although a correction that amounts to only one-tenth of the prior gains (roughly 6% down after 62% up) cannot come as too great a surprise. Also disappointing was the jump in volatility to end the month, especially Friday's increase, when the VIX increased by almost one-quarter, from 25% to 31% – the biggest percentage increase in just over a year. The meaning of October's final three days, when the S&P 500 fell 2.0% (Wed.) then bounced 2.3% (Thu.) only to fall 2.8% (Fri.), was somewhat difficult to fathom. Certainly the week's mix of economic news cannot account for the pre-Halloween spooking.



- **While Thursday's ebullient market action was probably an exaggerated assessment of economic conditions in the wake of the 3.5% increase in Q3 GDP reported by the Commerce Department, Friday's sharp downdraft following the news that consumer spending declined 0.5% in September was equally puzzling.** After four months of increased spending, September's pull-back by consumers was virtually guaranteed by the August ending of the Cash for Clunkers program; realistically, it will take at least another month to assess how robust consumer spending will be in the post-clunkers world. Granted, the retail environment going into the holiday season is somewhat dour, but it is nowhere as bleak as it was one year ago. What's more, a large amount of fiscal stimulus dollars have yet to work their way through the economic system, and we don't expect the Fed to begin raising interest rates for quite some time – perhaps not for another 12 months or so. To our way of thinking, the most distressing aspect of Friday's personal income release is the poor trend in wage and salary income (see chart above). Consumer confidence probably won't move decisively higher until the job market starts to improve. And that brings us to one of the better statistics of the past week: continuing unemployment claims hit their lowest level since March. If next Friday's employment report for October substantiates the improvement seen in claims, then wages, salaries, and other personal income ought to begin showing a lot more favorable trends.

October 28, 2009…Stock prices declined for a fourth straight session Wednesday (and for the seventh time in 10 days), putting the major market averages in the red for October, with the exception of the Dow, which is 0.5% above its September close. By comparison, the S&P 500 is off 1.4% for October, and other indexes have been even softer: Nasdaq, -3.0%; S&P MidCaps, -4.0%; S&P SmallCaps, -5.0%. From their mid-October highs – which also happen to be 12-month highs – the S&P 500 is down 5.0%, compared with 3.3% for the Dow, 5.4% for Nasdaq, 7.3% for the MidCaps, and 8.3% for the SmallCaps. For the S&P 500, this represents the biggest correction since its 7% retreat during the June-July period. Generally, cyclical sectors led the way lower today.

- **Financial stocks and materials stocks were the weakest sectors of the S&P 500 Wednesday, each losing 3.2%, followed closely by energy stocks, which lost 2.9%, and consumer discretionary stocks, which lost 2.8%.** What do these sectors have in common? Each is acutely leveraged to economic growth, and except for the energy sector, each was among the leaders off the March bottom. In other words, they were ripe for profit taking, particularly given the spate of weak economic data seen in recent days. The sell-off in energy shares – and stocks generally – was abetted by renewed weakness in commodities prices, which again reflected concerns about the economic recovery. Crude oil futures prices were down 3% today, and gasoline lost more than 4%, as gasoline and crude inventories rose in the latest week. The nation's stocks of crude oil, gasoline, and distillate are above the high end of their normal ranges for this time of year.



- **Today's economic reports were mixed to weaker, with the surprise decline in new homes sales during September apparently doing the most damage to investor psyches.** The Dow was actually up on the day prior to the report that, after five months of increase, single-family new home sales fell roughly 4% last month (as against the 3% rise that was expected). On the bright side, the inventories of unsold homes fell to the lowest level in more the 25 years. Congress is expected to extend the tax credit for first-time home buyers, as well as extending unemployment benefits by 14-20 weeks, another in the myriad measures designed to stimulate a consumer sector that lately looks to be moribund.

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