

THE ECONOMY AT A GLANCE

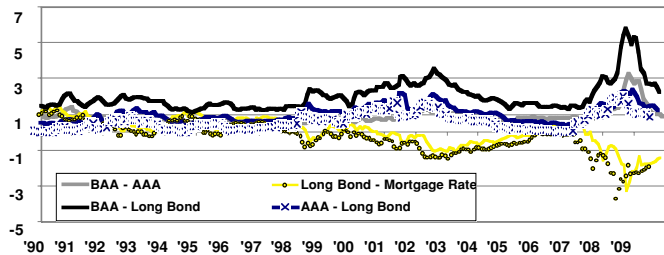
ECONOMIC HIGHLIGHTS

March 8, 2010
Vol. 77, No. 35

GETTING BACK TO NORMAL

The spreads between Treasuries, corporate and mortgage bonds narrowed last month. But we still see values in certain segments of the fixed income market. According to our calculations, the average spread between the government long bond and an AAA-rated corporate bond over the past 55 years is 81 basis points. As of January, the gap was 153 bps. The gap between the government long bond yield and a Baa-rated bond is now 252 bps versus a historical average of 178.

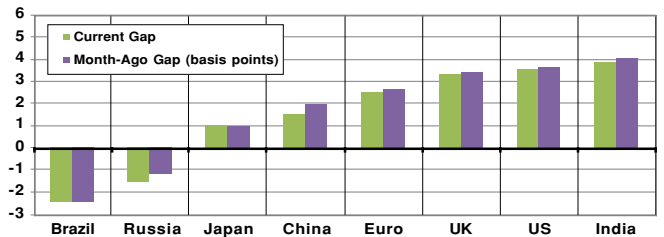
CORPORATES VERSUS TREASURIES



GLOBAL SHORT RATES RISING

Short-term rates in China and India increased as governments and investors began to take steps to keep inflation under control. Although rates did not rise in Brazil and Russia, these yields are already higher than 8.5%. The rise in BRIC-country short-term rates caused long-term rates in industrialized nations to decline. We note that the gaps are still historically wide, suggesting investors expect the economies to expand for the next 12-18 months.

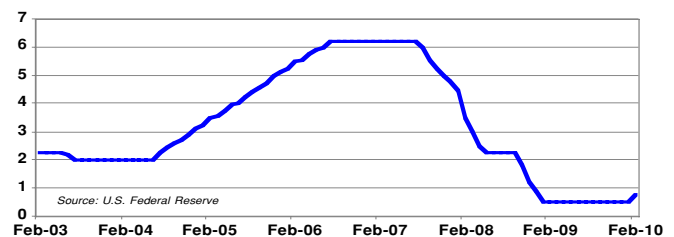
GLOBAL SHORT RATES



THE SECOND STEP

Federal Reserve officials have been telegraphing that the central bank will be pulling back the extraordinary flows of credit, and took a second step by increasing the discount rate 25 basis points. We continue to anticipate a Fed Funds hike in Q4. Markets don't typically fall after the inflection point on rates. One year after the last Fed discount rate hike, the S&P 500 had advanced 6% and still had 40% to rise before its peak in October 2008.

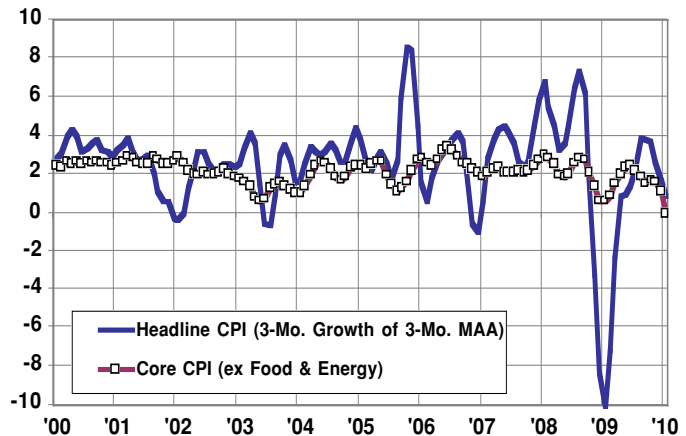
DISCOUNT RATE (%)



INFLATION PRESSURES STABLE

After factoring out volatile food and energy prices and smoothing out trends over a three-month time-frame, “core” prices are stable year-over-year. In the report for January 2010, decreases were recorded in prices for shelter, new vehicles and airline fares. An increase in the gasoline index was the main factor behind the headline CPI gain, although the Bureau of Labor Statistics noted food prices rose as well. In addition to data from the CPI, we note commodity prices have started to climb again, signaling the potential for inflation remains. The Fed took an early step to begin unwinding the extraordinary monetary steps taken to rescue the economy. In his talk to Congress this week, Fed Chairman Bernanke will no doubt shed new light on pricing pressures.

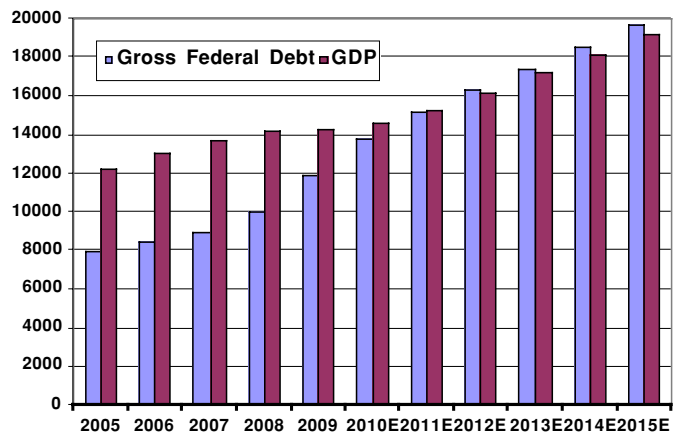
CPI INDEX



GOING DEEP

In the next five years, debt is forecast to surpass GDP, according to the White House Office of Management & Budget. Will President Obama’s plan to reignite the economy work? The goal is to generate jobs and corporate profits, which will increase tax receipts that will be used to pay down the debt. In the next few months, the jobs data is expected to turn modestly positive after more than a year of substantial employment losses. That’s a degree of progress. The real legacy, though, may be on the value of the dollar and inflation. We think the weakened U.S. balance sheet will cause the dollar to depreciate versus global currencies over the intermediate term. In addition, we expect the weak dollar to raise the risk of inflation, and for bond yields to drift higher as well.

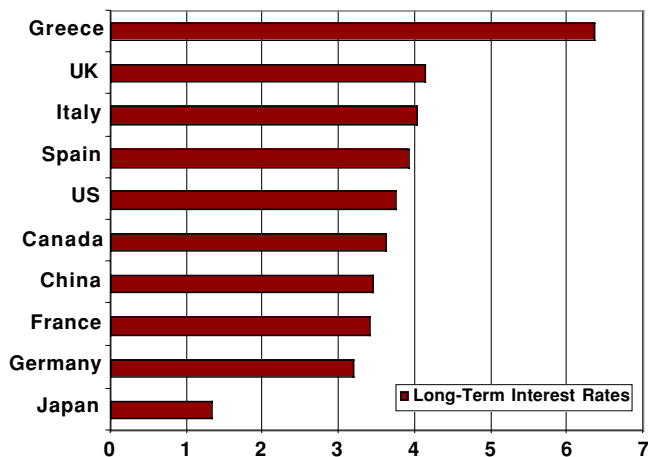
THE NATIONAL DEBT (\$BIL)



NEXT IN LINE?

A surprise loss of confidence in sovereign debt could spike global interest rates higher and send the global economy back into recession. At the same time, if local governments take aggressive steps to improve balance sheets, they run the risk of sinking their economies. To date, U.S. bonds and assets have been viewed as “safe havens” when global crises emerge. And the alternative to higher rates is Japan, where long-term interest rates are at a near-deflationary 1.3% and the economy is only expected to grow 1.5% in 2010. The U.S. Federal Reserve and Obama Administration will continue to navigate this relatively narrow course. As long as U.S. rates stay on par with peers such as Germany and China, the global investment community is signaling it still holds U.S. debt in high regard.

SOVEREIGN DEBT (%)



FINANCIAL MARKET HIGHLIGHTS

FINANCIAL, CONSUMER GAIN

The rally in the dollar in 2010 has caused investors to sell last year's top-performing groups, including Technology and Materials. Slowly, Financial Services and Consumer Discretionary are rising and gaining share. The move is counter-intuitive, in a sense. The consumer is down and out. But in the retail sector, the supply of new stores has ground to a halt. In advertising, global trends are beginning to accelerate. And in most subsectors, management teams have slashed staffs and spending. With the Financial group, ongoing concerns about regulation (and bonuses) are being offset by earnings that are expected to almost double this year. Must all good things come to an end? We expect a resolution over the Greece crisis to reverse the dollar's positive trend.

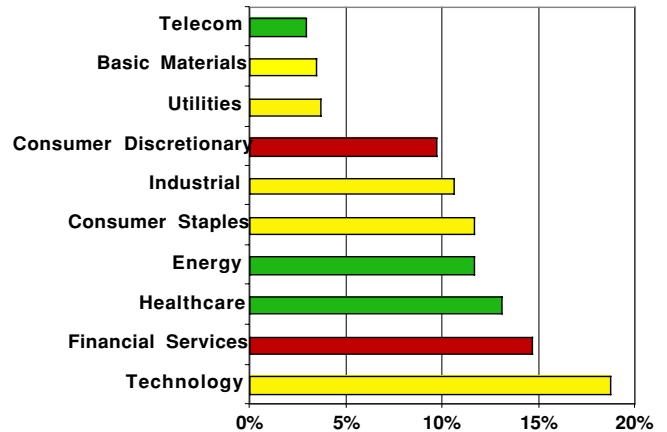
STRONG CAPITAL MARKETS EARNINGS

Fourth-quarter 2009 profits from capital markets activities at major banks — though down from levels earlier in 2009 — were quite healthy. Most of the major firms estimate proprietary trading accounts for anywhere from 1% of total revenue to as much as 10% (in the case of Goldman Sachs). Revenues from principal investing activities would also be at risk if the so-called "Volker Rule" were passed. But the major banks are still best suited to serve the capital markets needs of the largest global companies — and that won't change as a result of this new rule, should it pass. (Note: Goldman Sachs does not break out segment profitability, so we simply applied a 35% net profit margin to the company's \$8 billion in revenue from investment banking, trading and investing).

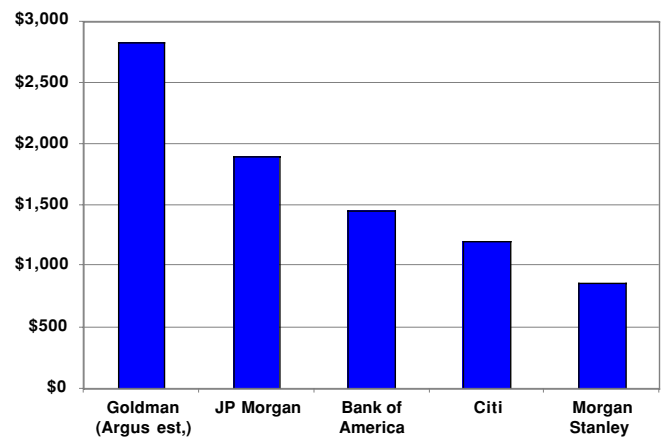
RAISING ESTIMATES

Based on strong Q4 results, we raised our S&P 500 operating earnings forecasts for 2009 and 2010. Our new estimate for 2009 is \$57, up from \$56. Our new forecast for 2010 calls for \$70, up from \$68. Our estimates imply growth of 15% in 2009 and 23% in 2010. We look for growth to subdue a bit in 2011, and our preliminary increased forecast calls for EPS of \$75. These rates imply a sharp recovery from the 2008 lows of \$49.51 — yet they do not go all the way back to the earnings highs of 2007, when S&P 500 earnings past \$90. We reckon earnings will recover at a consistent, but slower pace over the next three years, as profits improve from near 0% of GDP in Q408 to 4% in 2011, which is the average of the past 20 years. As a percent of GDP, profits peaked at just above 6% in 2007.

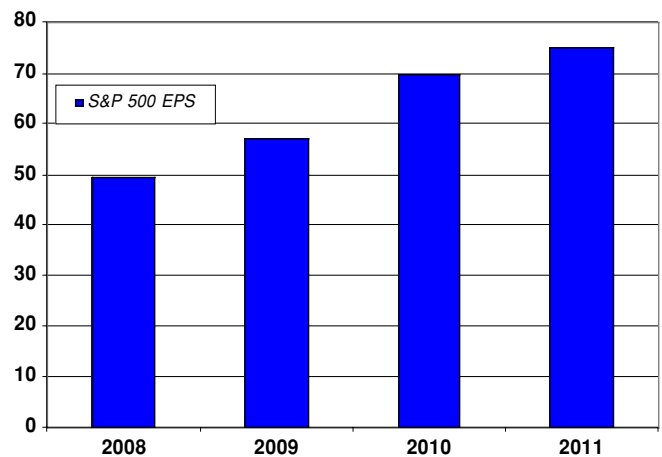
SECTOR MARKET CAP DISTRIBUTION



CAPITAL MARKETS EARNINGS (4Q NET INC. IN MIL, U.S. ONLY)



CORPORATE EARNINGS TRENDS (\$)



ECONOMIC CALENDAR

Previous Week's Releases

Date	Release	Month	Previous Report	Argus Estimate	Street Estimate	Actual
Mon. 3/1	Consumer Spending	January	0.2%	0.3%	0.4%	N/A
	Personal Income	January	0.4%	0.4%	0.4%	N/A
	ISM Manufacturing Survey	February	58.4	59.0	57.8	N/A
	Construction Spending	January	-1.2%	-0.8%	-0.5%	N/A
Tue. 3/2	Beige Book	N/A	N/A	N/A	N/A	N/A
	Total Vehicle Sales	February	8.19M	9.5M	10.5M	N/A
Wed. 3/3	ISM NonManufacturing Survey	February	50.5	52.0	51.0	N/A
Thur. 3/4	Nonfarm Productivity [^]	QIV	6.2%	6.5%	6.2%	N/A
	Unit Labor Costs [^]	QIV	-4.4%	-4.4%	-4.4%	N/A
	Factory Orders	January	1.0%	1.2%	1.2%	N/A
Fri. 3/5	Nonfarm Payrolls	February	-20k	25k	-50k	N/A
	Unemployment Rate	February	9.7%	9.9%	9.8%	N/A
	Manufacturing Payrolls	February	11k	15k	-20k	N/A
	Average Hourly Earnings	February	0.2%	0.2%	0.2%	N/A
	Average Workweek	February	33.9 hrs.	34 hrs	33.7 hrs	N/A
	Consumer Credit	January	-\$1.7B	-\$3.8B	-\$1.7B	N/A

Next Week's Releases

Date	Release	Month	Previous Report	Argus Estimate	Street Estimate	Actual
Tue. 3/16	NY State Manufacturing Index	March	24.9	27.0	N/A	N/A
	Industrial Production	February	0.9%	0.9%	N/A	N/A
	Capacity Utilization	February	72.6%	73.0%	N/A	N/A
Wed. 3/17	Import Price Index	February	1.4%	1.0%	N/A	N/A
	Housing Starts	February	591k	595k	N/A	N/A
	FOMC Rate Decision	N/A	0.25%	0.25%	0.25%	
Thur. 3/17	Producer Price Index	February	1.4%	0.7%	N/A	N/A
	PPI ex Food & Energy	February	0.3%	0.3%	N/A	
Fri. 3/19	Consumer Price Index	February	0.2%	2.0%	N/A	N/A
	CPI ex Food & Energy	February	-0.1%	2.0%	N/A	N/A
	Philadelphia Fed.	March	17.6	20.0	N/A	
	Leading Economic Indicators	February	0.3%	0.3%	N/A	N/A

* Preliminary

** Advance

[^]Final

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