

Capital Market Outlook

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HIGHLIGHTS

- Bernanke sees moderate recovery on track.
- Policy matters.
- Times are tough for the average Chinese household.

ECONOMIC OUTLOOK*

Robert T. McGee

LABOR MARKET BEARS MORE OF THE BRUNT IN CYCLICAL ADJUSTMENTS

The latest Federal Reserve survey of regional economic conditions finds all 12 districts expanding for the first time since the recession began back in December 2007. This is consistent with broadening evidence from economic statistics showing improving trends across the board, albeit at varying speeds. Similarly, a look around the world shows the same basic pattern: a preponderance of rising economic indicators reflecting the multispeed nature of national economic recoveries as well as differentials in the growth rate of various sectors.

Favorable news from Asia and Europe has helped calm down nerves inflamed by the fragile European banking situation. Friendlier comments from Mr. Trichet after the latest European Central Bank (ECB) policy meeting added to the good economic news from around the world, which included strong Chinese exports helping to calm fears that a hard landing is imminent there.

A good example of the differences in speeds of recovery was evident in the latest Federal Reserve flow of funds data, which show the recovery in household net worth is much faster than that in the business sector. Household net worth is up about 13% in the year through March, while noncorporate businesses are still in the red, although sequentially there are signs of a bottoming

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* All sector recommendations must be considered by each individual investor to determine if the sector is suitable for their own portfolio based upon their own goals, time horizon, and risk tolerances.

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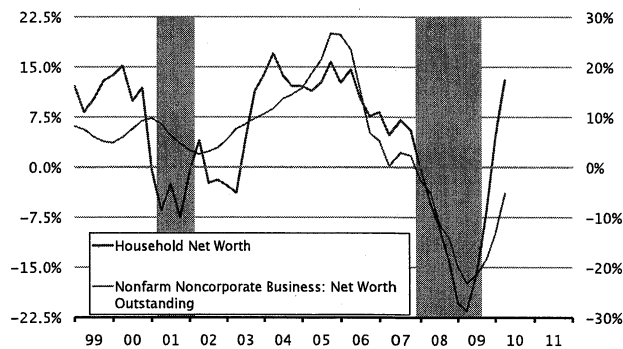
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process (Exhibit 1). This is not surprising because small businesses are much more leveraged to both commercial and residential real estate compared to consumers, a problem we have noted in the past. They also lack the equity holdings of consumers, which account for most of their net worth gains since March 2009.

EXHIBIT 1: SMALL BUSINESS RECOVERY LAGS
(Household Net Worth, 4-Quarter % Change – Left Scale)
(Nonfarm Noncorporate Business: Net Worth Outstanding, 4-Quarter % Change – Right Scale)



Sources: Federal Reserve Board; Census Bureau/Haver Analytics.
Data through June 10, 2010.

While slower, the recovery in the small business sector is still evident in the latest survey from the National Federation of Independent Business (NFIB), where optimism about the economy rose a little bit in May. The NFIB small business optimism index is up about 14% from its low point reached in March 2009. The lag in the small business recovery is evident in labor market statistics, suggesting that it will take longer for the economy to reach its full job-creating potential.

Small businesses create most of the jobs in the economy. That's because an acorn has a lot more growth potential than a fully grown tree. Many acorns don't make it to full-grown tree status, but many are also sprouting. This means there is a lot more dynamism in the small-business sector.

In the last expansion, during the job creation phase, which stretched roughly from 2003 to 2007, the private sector created an average of about 165 thousand jobs per month. The Bureau of Labor Statistics (BLS) payroll survey shows that a peak monthly average of about 163,000 jobs per month was reached in the 42-month stretch up until the summer of 2007. The separate Automatic Data Processing (ADP) survey also shows a peak for that period of 164,000 jobs per month. This

confirms that the ADP survey does an excellent job of capturing BLS job trends over long stretches of time. Over shorter stretches, say the last three months, the differences can be much bigger, as the ADP measure tallies an average of 51,000 jobs, while the payroll measure averaged 139,000. Traders take these monthly numbers to be much more accurate than they actually are, as we saw with the extreme reaction to the May employment report, which was actually quite strong when hours worked are considered.

The ADP employment report breaks the payroll data down among small (less than 50 employees), medium (50 to 499 employees) and large (500 or more employees). Of the 164,000 average monthly gains in private employees during the last expansion, 100,000 jobs were generated at small firms, 60,000 at medium firms and 4,000 at large firms (Exhibit 2). Small firms generate more job growth than their share of overall employment. That is, in the last expansion, small firms generated 60% of job growth despite accounting for 45% of total (private-sector) jobs. Large firms, on the other hand, generated about 2.5% of new jobs despite accounting for about 16% of the total job pool. This just reflects the life cycle of companies (and oak trees).

EXHIBIT 2: COMPOSITION OF PRIVATE-SECTOR JOB GROWTH IN LAST EXPANSION
(Based on Peak 42-Month Average in Thousands)

	Total	Goods	Services
Small Firms (<50)	100	17	84
Medium Firms (50-499)	60	7	52
Large Firms (500+)	4	-6	10
Aggregate	164	18	146

Sources: ADP; Haver Analytics; U.S. Trust Calculations.
Data through June 2, 2010.

The question for the moment is what does this mean for the current recovery in jobs. Exhibit 3 shows the average job growth over the past three months (March — May) measured by ADP.

EXHIBIT 3: LATEST 3-MONTH JOB GROWTH
(Average in thousands)

	Goods & Services	Goods Only	Services Only
Small Firms (<50)	13	-21	34
Medium Firms (50-499)	30	-1	31
Large Firms (500+)	8	2	6
Total All Firms	51	-20	71

Sources: ADP; Haver Analytics; U.S. Trust Calculations.
Data through June 2, 2010.

While three-month averages are more error-prone given the noise in short-horizon data, the numbers do show some reluctance to hire at small businesses, particularly in the goods-producing sectors.

Alternatively, the service-sector jobs mix shows a composition that is roughly consistent with what has been the case in the past: most jobs created in the small business sector. Remember the discrepancy between the private-sector BLS payroll measure average of 139,000 for the last three months and the ADP measure at 51,000 is huge and will wash out over time, suggesting the true number is probably closer to the midpoint of the two estimates (95,000). In any event, the job market has a long way to go to make up the 8 ½ million jobs lost during the recession, *but it is moving in the right direction.*

An interesting study by Robert J. Gordon at Northwestern University documents the changed pattern of labor market dynamics in the past three business cycles compared to prior ones. Professor Gordon, who is a member of the National Bureau of Economic Research Cycle Dating Committee, the official arbiter of when recessions begin and end, believes the changed labor market response to recessions “has added difficulty to the task of the NBER Cycle Dating Committee in choosing the date of the cycle trough.”*

His statistical work shows much greater labor input volatility in the response of firms to recent recessions. In earlier cycles, productivity was sacrificed more and less labor shed as a result. In recent cycles, productivity has been much more stable, with the consequence that labor bears more of the brunt in recessions. This was particularly true in the most recent cycle, when U.S. productivity actually rose through the recession while it plummeted in Japan and Germany, our biggest competitors in global trade.

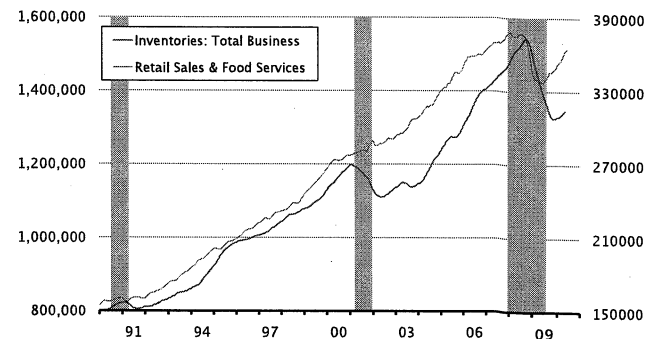
While the cyclical volatility of labor input has almost doubled, according to Professor Gordon’s analysis, the mix has shifted a bit, with the labor force participation rate adjusting more than in the past. Hours worked and job growth combine with the labor force participation rate to create the total labor input. The mix of labor input growth in the early stage of the cycle favors more hours

as the workweek expands. It also favors increased labor force participation. Both these factors are the reason the unemployment rate tends to linger at higher levels in the early phase of an expansion. Nevertheless, as we know from the May employment report, aggregate labor input is growing at a much stronger rate than employment, as is typical at this stage of the recovery.

RETAIL SALES AND INVENTORY CLIMBING

In recent testimony, Fed Chairman Ben Bernanke described three phases of recovery: (1) the stimulus phase; (2) the inventory phase; and (3) the final demand phase. The government stimulus phase dominated the transition from negative to positive growth in the middle of last year. Government spending and transfer payments to individuals stimulated final sales and forced businesses to stop cutting inventories. The inventory phase kicked in the second half of last year and accounted for most of the average 4.3% real gross domestic product (GDP) growth in the fourth quarter of 2009 and first quarter of 2010. This reflected the initial deceleration of inventory declines and transition to inventory accumulation, which is now under way, as seen in Exhibit 4.

EXHIBIT 4: INVENTORY CATCH-UP UNDER WAY
(Inventories: Total Business, 3-Month Moving Average – Left Scale)
(Retail Sales & Food Services, 3-Month Moving Average – Right Scale)



Source: Census Bureau/Haver Analytics.
Data through June 11, 2010.

This phase requires final demand to justify further production and inventory growth. As job and income growth have picked up, sales growth is trending higher. Strong profits are stimulating business equipment demand. This final demand phase is the self-sustaining phase of the cycle. Despite disappointment with the May retail sales report, the three-month average of sales continues to trend higher.

* Robert J. Gordon, “Okun’s Law and Productivity Innovations,” American Economic Review Papers and Proceedings, January 4-6, 2010, pages 11-15.