

Economy On The Rebound

Robert Johnson
Associate Director of Economic Analysis
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robert.johnson@morningstar.com
(312) 696-6103

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Executive Summary

- ▶ Worst Recession Since the Great Depression, Likely Over June, 2009
- ▶ Growth in the 2nd Half Could Exceed 3.5%, 2010 > 3.0%
- ▶ Outlook Still Ahead of Consensus, But Not By as Much
- ▶ Some Indicators Turned In Early 2009, Many by Mid-2009
- ▶ Employment/ Unemployment Still Lagging, Typical of Past

Executive Summary

- ▶ Typically, the Harder the Economy Falls, the Faster it Recovers
- ▶ Still Worried About Commercial Real Estate, Banks, Poor Railroad Shipments, Consumer Deleveraging, Geo-political Issues
- ▶ Bullishness Based on Inventory Restocking, High Productivity, Limited Declines in Housing Construction, Exports to Developing Markets
- ▶ Market Valuations No Longer Dirt Cheap, But Not Outrageously Priced

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Where Are We Now?

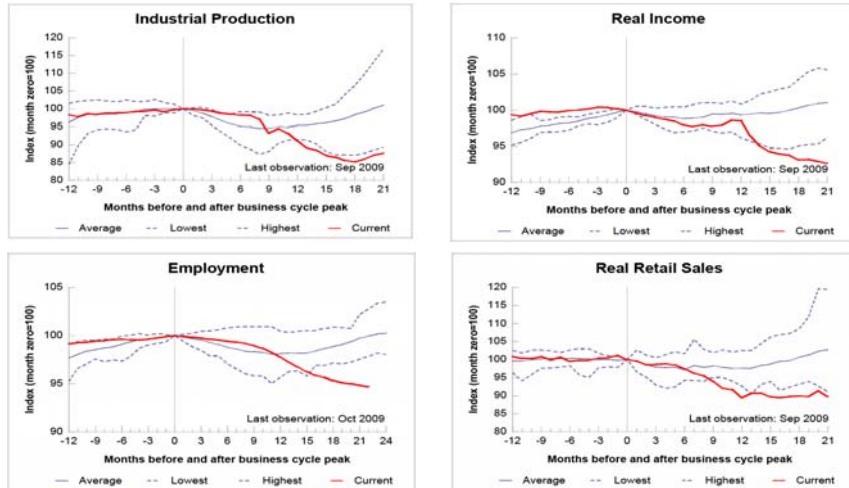


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Tough Recession, Probably Bottomed in May/June

(average last 10 recessions)



Source: St. Louis Federal Reserve, updated Nov. 6, 2009

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Using Average Leads/Lags, Economy Bottomed in May

Factor	Bottom	Average Lead	Forecasted Recession End
ISM Manufacturing Composite	12/2008	+5 months	May, 2009
Personal Consumption	1/2009	+5 months	May, 2009
Initial Unemployment claims	3/2009	+2 months	May, 2009
Industrial Production	6/2009	-1 month	May, 2009

Source: Morningstar

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If Recession Ended in May, Job Losses Should Stop Soon

Factor	Recession End	Typical Lead/Lag Time	Predicted Trough
Employment	May, 2009	-4 Months	September, 2009
Unemployment	May, 2009	-8 Months	January, 2010

Source: Morningstar

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Consensus View of the Economy: Anemic Recovery Driven by Poor Employment/Consumer Deleveraging

WSJ Economic Forecasting Survey –October, 2009

Quarterly GDP		Inflation		Unemployment	
Q1A	-6.4	Dec '07	4.1	Dec '07	5.0
Q2A	-0.7	Jun '08	5.0	Jun '08	5.5
Q3A	3.5	Dec '08	-1.0	Dec '08	7.2
Q4E	2.5	Jun '09	.7	Jun '09	9.5
Annual GDP		Dec '09	1.5	Dec '09	10.0
2007	2.3	Jun '10	1.8	Jun '10	9.9
2008	-1.9	Dec '10	1.8	Dec '10	9.4
2009	-.7				
2010	2.8				

Source: WSJ.com, updated Oct.10, 2009

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There is potential for the economy to perform better than expectations

My GDP View

- Q2** Market Expectation a little high
- Q3/Q4** Growth could exceed 3.5%, because:
- ▶ End of Inventory draw down
 - ▶ Renewed Auto Production
 - ▶ Bottom in Residential Construction

My Inflation Outlook

Inflation 2009	2%
Inflation 2010	3%

My Unemployment Outlook

- ▶ Unemployment Peaks Around 10%
- ▶ Peak Unemployment Around Dec 2009

Source: Morningstar

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The Harder GDP Falls, The Higher It Bounces Could Mean Better Than Anticipated Recovery

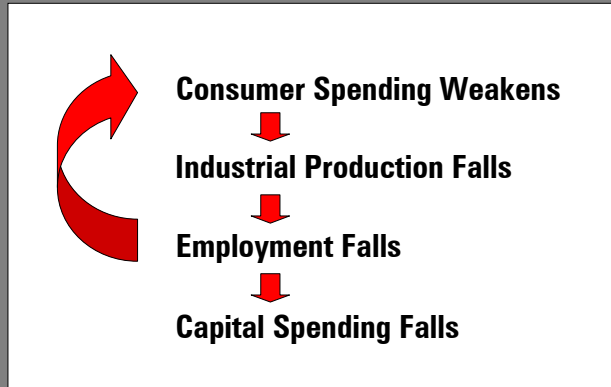
Year	After Bottom, One Year GDP Growth Rate	Prior GDP Contraction
1957	7.5%	-3.7%
1953	6.3%	-2.6%
1960	6.3%	-1.6%
1973	6.2%	-3.2%
1981	5.6%	-2.7%
1969	4.5%	-1.1%
1980	4.4%	-2.2%
1990	2.6%	-1.4%
2001	1.6%	-0.3%
Average	5.0%	-1.7%
2007	?	-3.8%

Source: BEA, Morningstar Calculations

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The Consumer Drives the Economy



Source: Morningstar

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Personal Consumption is the First Part of the Economy to Improve

Leads and Lags Versus the Trough

Personal Consumption	Leads	-4.7	Months
Industrial Production	Lags	0.6	Months
Employment	Lags	3.6	Months
Private Investment	Lags	3.0	Months

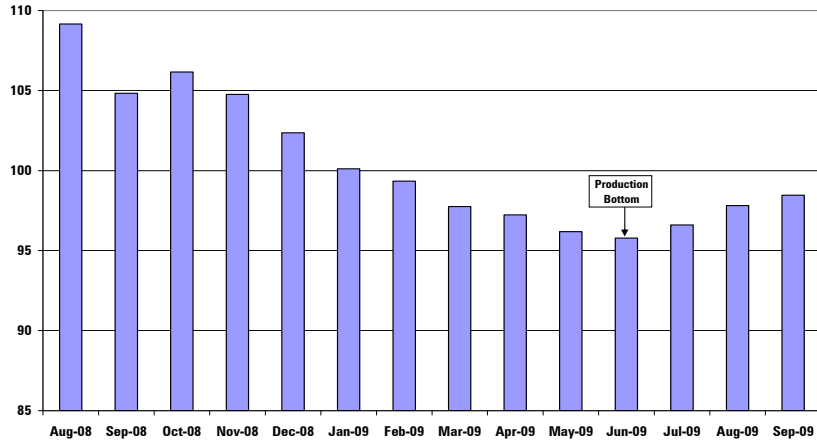
Source: St. Louis Federal Reserve, Morningstar Calculations, Last 7 Recessions

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Production Bottomed Well After Consumption

Industrial Production Index

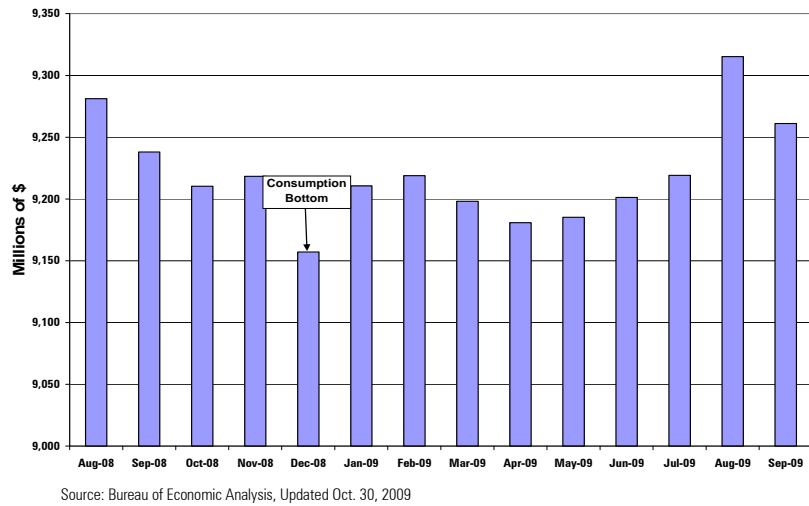


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Consumption Moves Up Erratically From December Bottom

Real Personal Consumption



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Employment Very Bad, Goods Producing Very Hard Hit

Jobs Lost Since 2007 Recession (in 1,000's)				
Employment Data	Service Producing	Good Producing	Government	Total
Employment Dec. 07	93,740	22,043	22,391	138,152
Jobs Lost	-3,679	-3,703	78	-7,304
Percentage Decline	-3.9%	-16.8%	.3%	-5.3%

Source: Bureau of Labor Statistics, Morningstar Updated Nov. 6, 2009

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Finance Sector Hard Hit This Recession

Service Jobs Lost Since the 2007 Recession Began (1,000's)							
	Trade Transportation Utilities	Information Services	Finance	Professional Services	Education & Health	Leisure	Other Services
Employment 12/07	26,725	3,025	8,243	18,109	18,570	13,551	5,517
Jobs Loss	-1,711	-194	-546	-1,470	804	-427	-135
Percent Change	-6.4%	-6.4%	-6.6%	-8.1%	4.3%	-3.2%	-2.4%

Source: Bureau of Labor Statistics, Morningstar Updated Nov. 6, 2009

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Except Initial Unemployment Claims, Employment Data is a Lagging, Not a Leading Indicator

Statistic Trough vs. Recession Bottom

Recession Start	Initial Unemployment Claims	Employment Trough	Unemployment Rate Peak
Dec-69	6 Mo. Earlier	0 Mo. Same	9 Mo. Later
Nov-73	1 Mo. Earlier	1 Mo. Later	2 Mo. Later
Jan-80	1 Mo. Earlier	0 Mo. Same	0 Mo. Same
Jul-81	1 Mo. Earlier	1 Mo. Later	1 Mo. Later
Jul-90	0 Mo. Same	2 Mo. Later	15 Mo. Later
Mar-01	1 Mo. Earlier	21 Mo. Later	19 Mo. Later

Average **1.7 Mo. Earlier** **4.2 Mo. Later** **7.7 Mo. Later**

Sample Interpretation: In the recession beginning in Dec-69, initial unemployment claims bottomed 6 months before the recession bottomed.

Source: St. Louis Federal Reserve, Morningstar Calculations, Last 6 recessions

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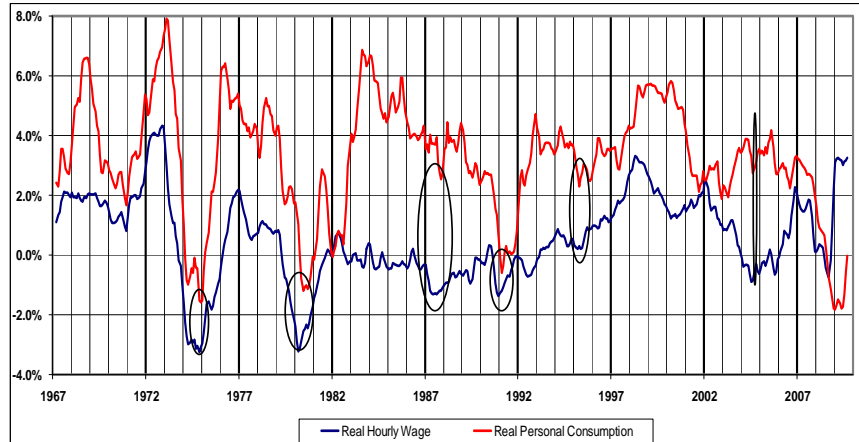
Its All About Attitude and Bargains

- ▶ The Propensity to Spend of Those With Jobs Is Far More Important Than Small Incremental Changes in the Unemployment Rate
- ▶ If the Economy Could Only Improve When Jobs Improved, There Would Be Almost No Way Out of Any Recession
- ▶ Those With Jobs Feeling More Confident and Those With Limited Debt Going Shopping For Bargains Ultimately Drives Recoveries

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Real Hourly Wages Have More Predictive Power for the Economy and Turned Before Consumer Spending



Source: Morningstar, Bureau of Labor Statistics, Bureau of Economic Analysis, Updated Oct. 30, 2009

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Things To Be Positive About



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What Has Bottomed?

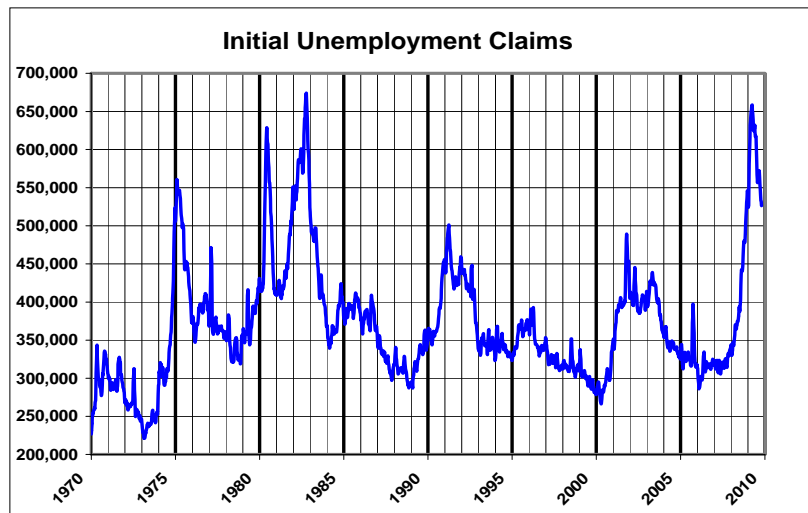
Indicator	Bottom
Real Hourly Wages	Nov-08
10 Year Treasury	Dec-08
Consumer Spending	Dec-09
Commodities	Feb-09
Consumer Confidence	Feb-09
Housing Starts	Feb-09
Stock Prices	Mar-09
Retail Sales	Apr-09
Real Income	Apr-09
Industrial Production	Jun-09

Source: Morningstar

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Initial Unemployment Claims have been Trending Down since April



Source: Bureau of Labor Statistics, Updated November 5, 2009

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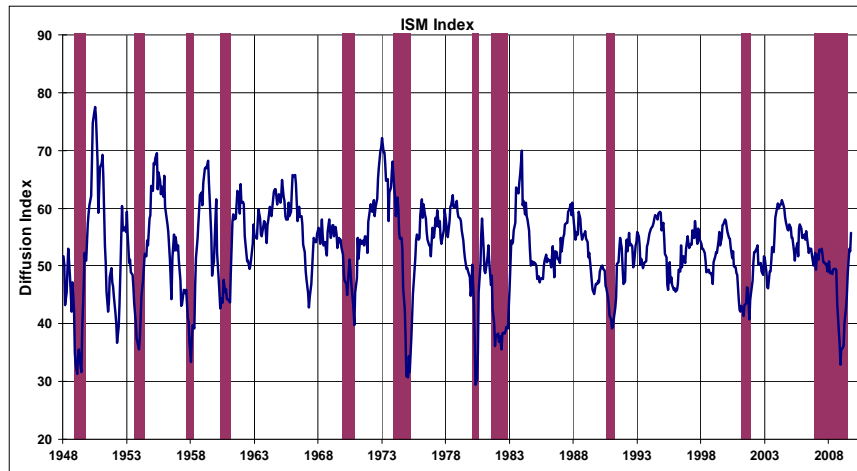
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Interestingly, the Claims % is Well Below Past Recessions

Recession Start Date	Peak Unemployment	Peak Initial Claims/Covered Employment
Dec-69	6.10%	0.65%
Nov-73	9.00%	0.85%
Jan-80	8.60%	0.73%
Jul-81	10.80%	0.77%
Jul-90	7.80%	0.47%
Jul-01	6.00%	0.38%
Average	8.05%	0.64%
Dec-07	9.8%(Sept)	0.49% (.40% now)

Source: St Louis Federal Reserve, BLS, Morningstar, Updated 10/15/2009

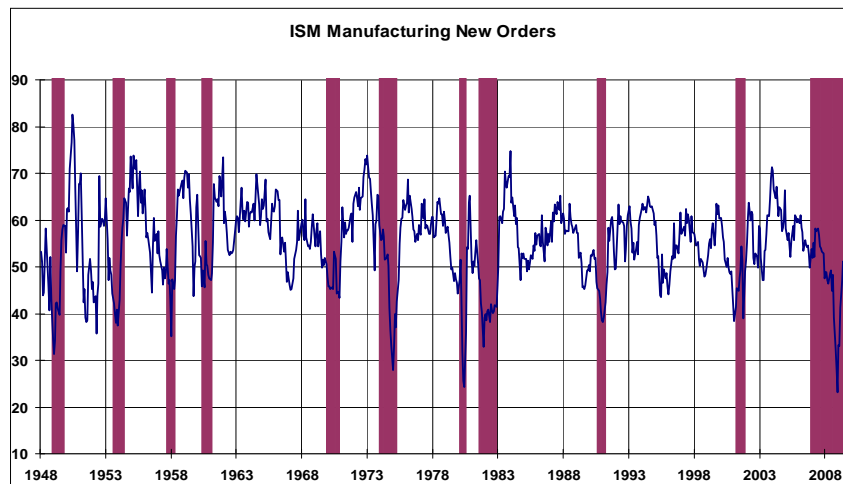
ISM Manufacturing Data Portends GDP Growth Greater Than 3%



Source: ISM Updated 11/2/2009

Solid Bars Are Official NBER Recessions

Manufacturing Orders Were a Great Leading Indicator



Source: ISM, Updated 11/2/2009

Solid Bars Are Official Recession Periods

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ISM New Orders Index an Excellent Economic Indicator

ISM New Orders Trough Versus Recession Bottom

Recession Start	ISM New Orders Peak
Dec-69	0 Months Same
Nov-73	3 Months Ahead
Jan-80	1 Month Ahead
Jul-81	12 Months Ahead
Jul-90	2 Months Ahead
Mar-01	10 Months Ahead
Average	4.7 Months Ahead
Dec. 07	Troughed Dec. 08

Source: ISM, Morningstar analysis and calculations, updated 7/1/2009

Sample Interpretation: In the recession beginning in November of 1973, ISM The New Orders Index bottomed 3 months before the recession bottomed.

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Interest Rates Tame for Now, After Spike



Source: St Louis Federal Reserve

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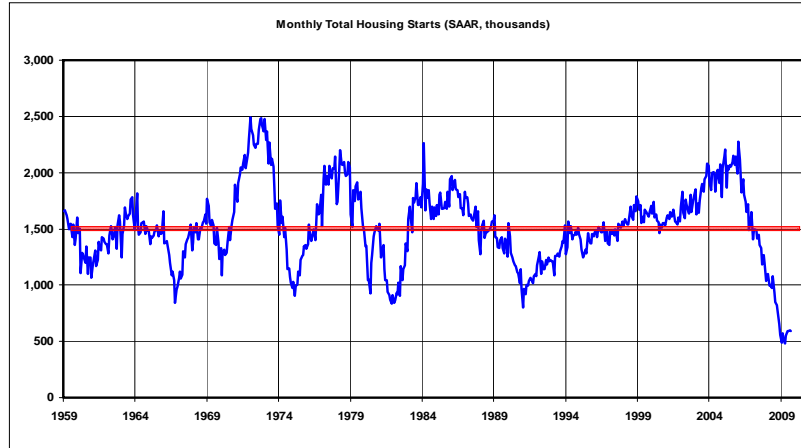
Demand Deferred, Not Lost: The Rubber Band Effect



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Starts Far Below Natural Demand, Improvement Begins



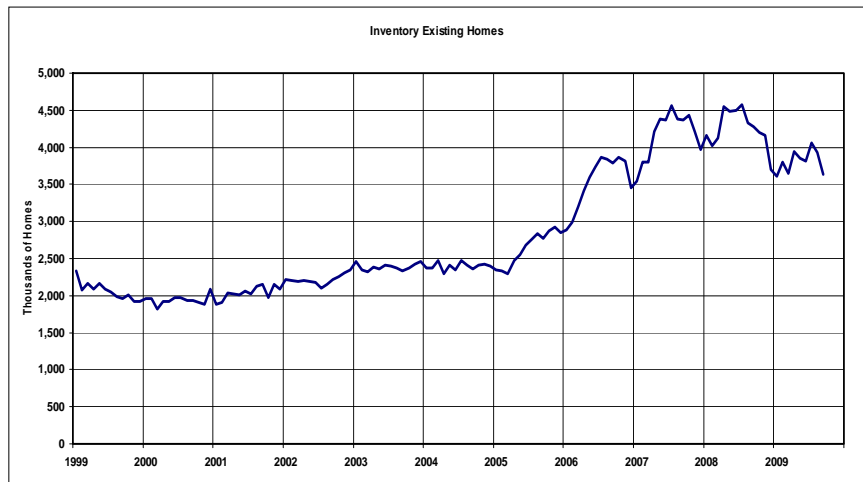
Red Bar Represents Average Natural Demand, Morningstar Estimate

Source: Census Bureau, Morningstar, Updated Oct. 20, 2009

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Existing Home Inventories Declining But Not Fast Enough

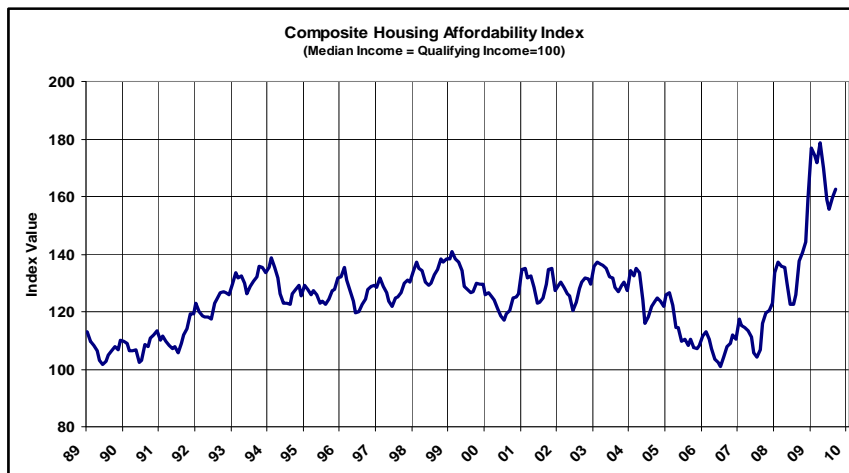


Source: National Association of Realtors, Updated Oct. 23, 2009

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Housing Affordability Still Near Record High

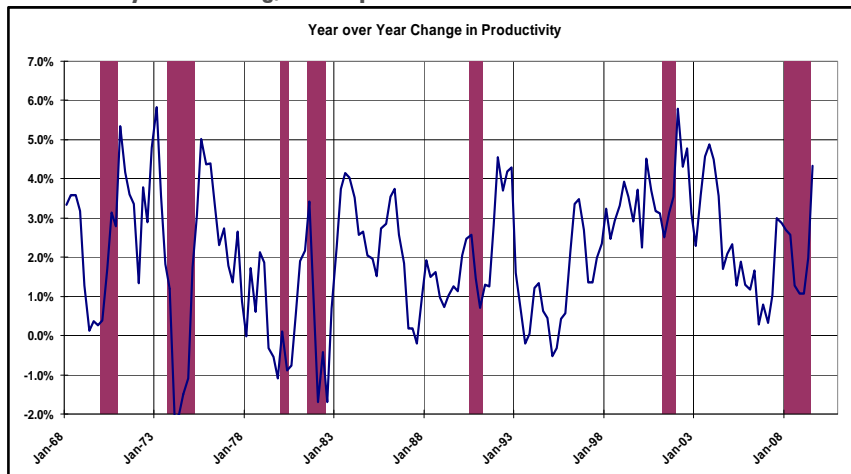


Source: National Association of Realtors, Updated Oct. 30, 2009

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Productivity Rebounding, Held Up Better Than 6 of Last 7 Recessions



Red Bars Equal Recession

Source: Bureau of Labor Statistics, BEA, Morningstar, Updated Nov. 11, 2009

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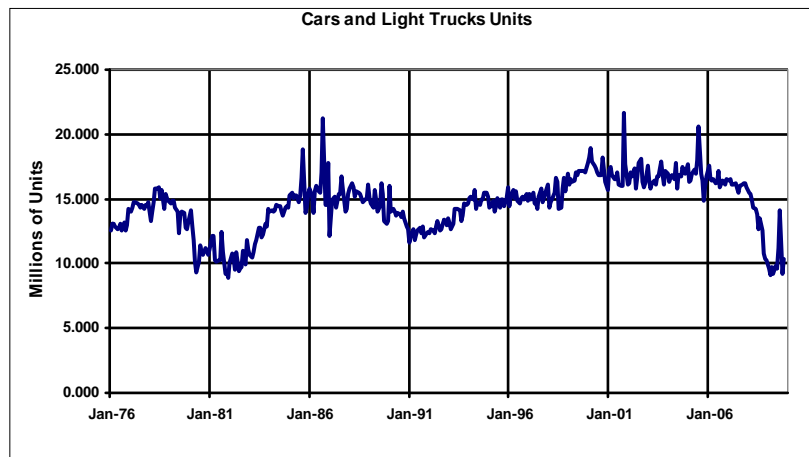
Auto Production/Auto Sales Unsustainably Low



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Auto Production/Auto Sales Were Unsustainable Low

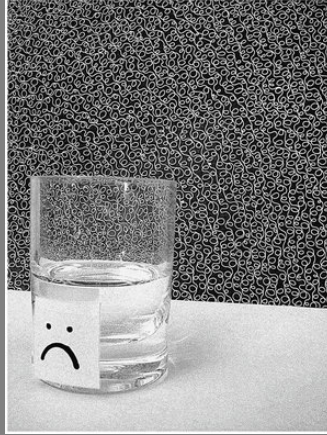


Source: St Louis Federal Reserve, Updated Nov. 6, 2009

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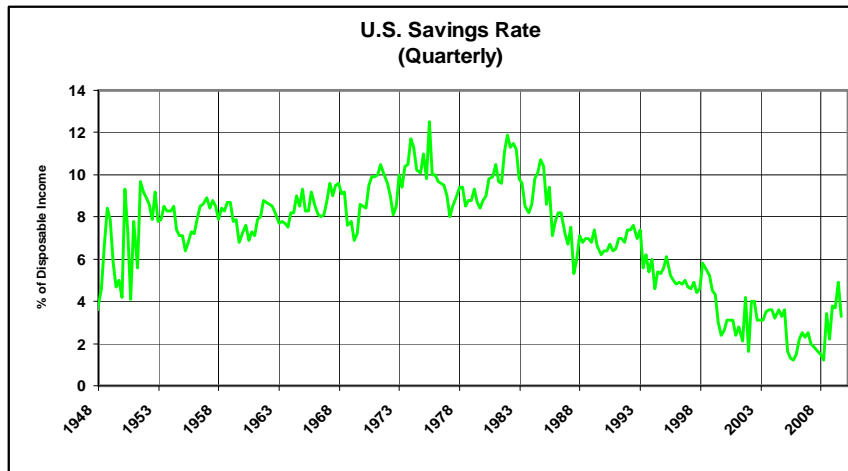
Things To Be Worried About



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Increased Savings Rate, Friend or Foe?

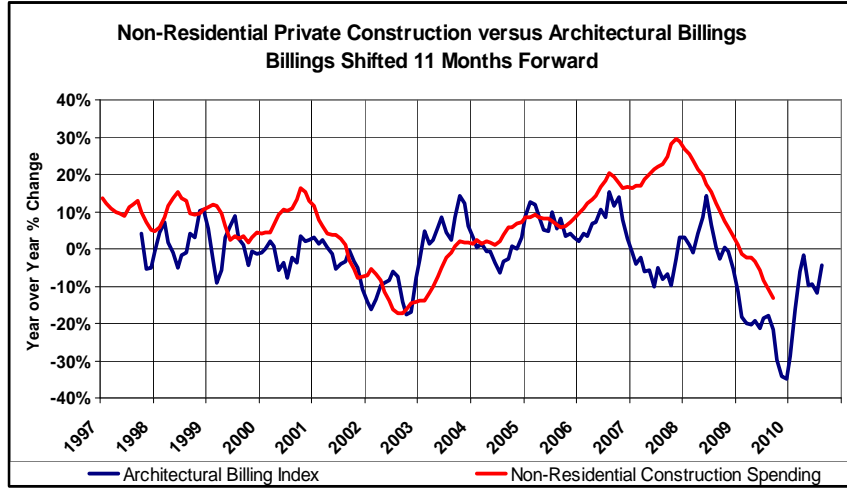


Source: U.S. Bureau of Economic Analysis, Updated Oct 30, 2009

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Non-Residential Construction Continues to Dive, Bottom in Sight

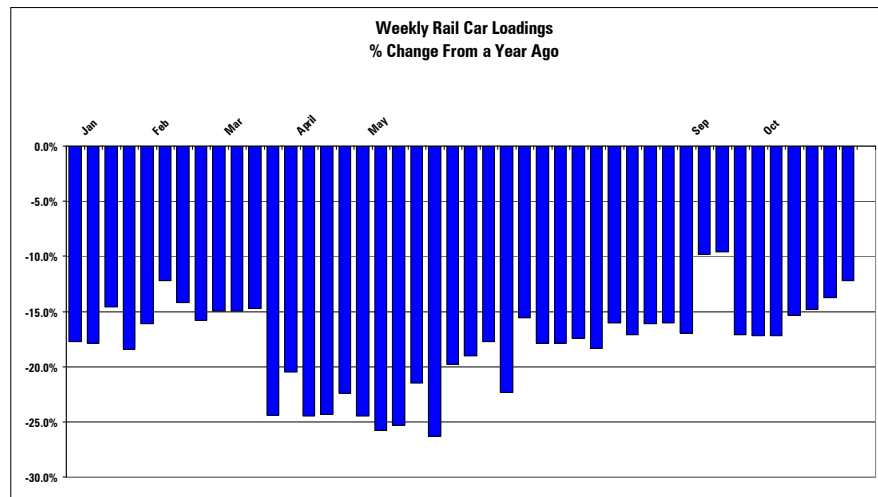


Source: American Institute of Architects, Census Bureau, Morningstar, Updated Nov. 2, 2009

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Rail Volumes Have Yet to Show Much Improvement

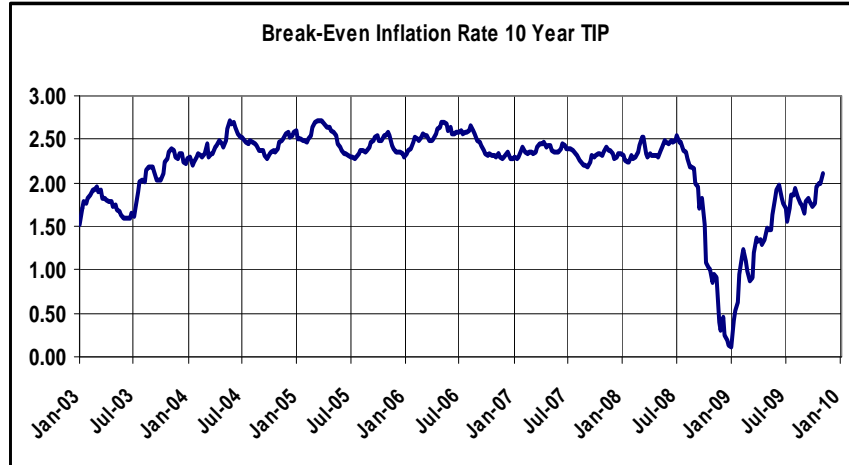


Source: American Association of Railroads. Updated Nov. 12, 2009, Morningstar Adjustment for Labor Day

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Expectations for Inflation Have Increased

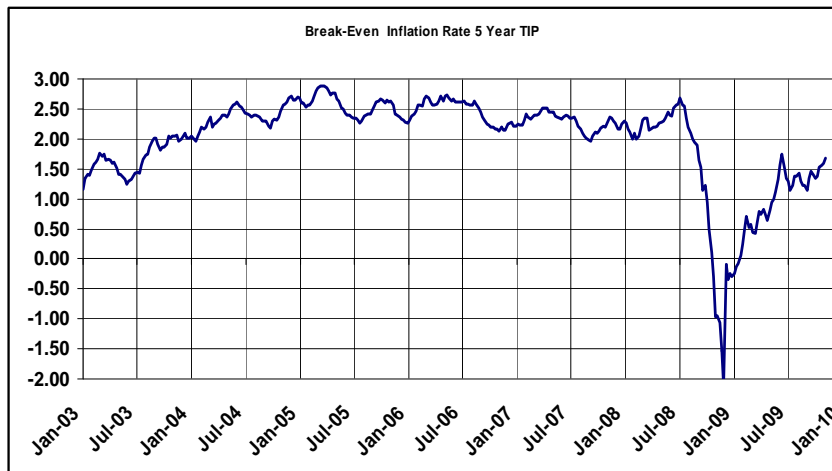


Source: St. Louis Federal Reserve, Morningstar Calculations, As of Nov. 16, 2009

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Swing In Short Term Expectation Even Greater



Source: St. Louis Federal Reserve, Morningstar Analysis, Updated Nov. 16, 2009

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What Has Not Bottomed?

Employment

Unemployment

Source: Morningstar

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Valuations, Not as Cheap



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Market Valuations Anticipated a Turn

S&P 500 Index SPX

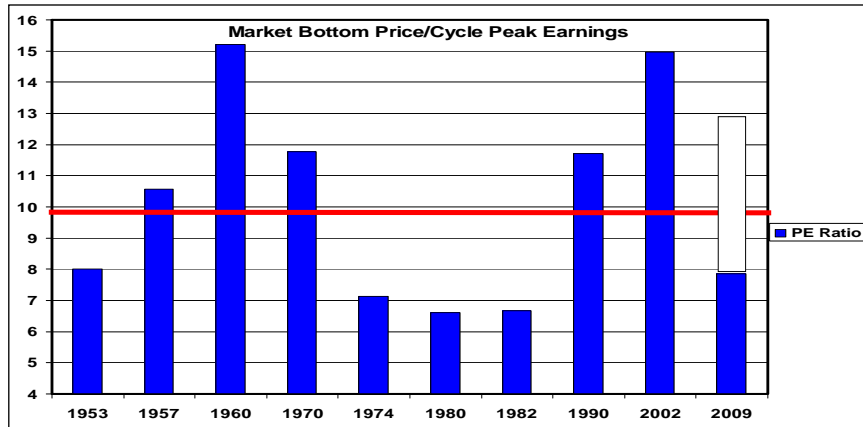
Charts



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Even at the March Bottom, the Market Did Not Reach Record Low Valuation Levels



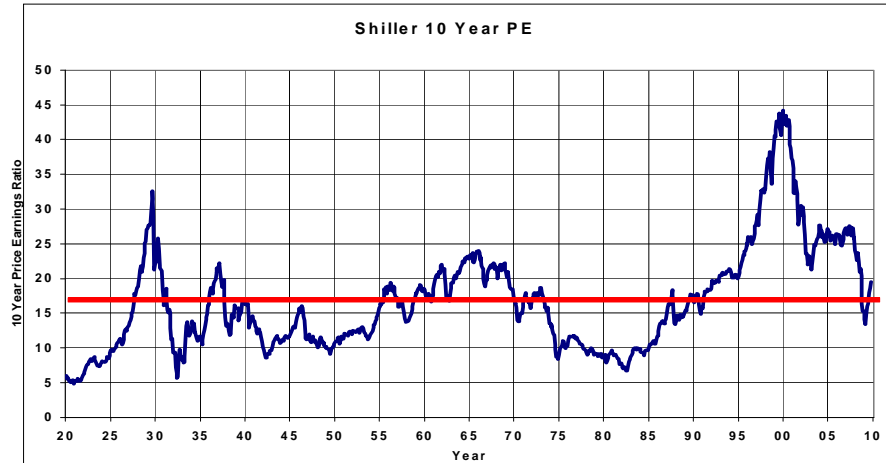
Red Bar Is Average of Last 9 Recessions 2009, Represents March 6, 2009 Intra-day Low,
White Box Is Nov. 13, 2009 PE

Source: Morningstar, updated Nov. 13, 2009

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Shiller 10 Year PE Modestly Below Average



Red Bar Is The Average PE, 1920-2009, Morningstar Calculation, Updated Nov. 13, 2009

Source: Robert Shiller, Irrational Exuberance, http://www.econ.yale.edu/~shiller/data/ie_data.xls

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Investment Implications

- ▶ Long Term Bonds Look Dangerous
- ▶ Large Stocks Look Better Than Small Stocks
- ▶ High Quality Stocks, a Safer Bet Than Risky Assets
- ▶ Emerging Markets Feel Bubbly

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**Consumer Staples, Healthcare and Transportation Sectors
Worth Some Attention**

- ▶ Consumer Staples Near Term Beneficiary of a Weak Dollar
- ▶ Healthcare Stocks Should Improve as Legislation Is Finalized
- ▶ Transportation, a Slow Mover This Recovery. Buffet Bet.