Payden&Rygel

US Economic Outlook: The Debt Hangover

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333 South Grand Avenue Los Angeles, CA 90071

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I

Recovering From Recession

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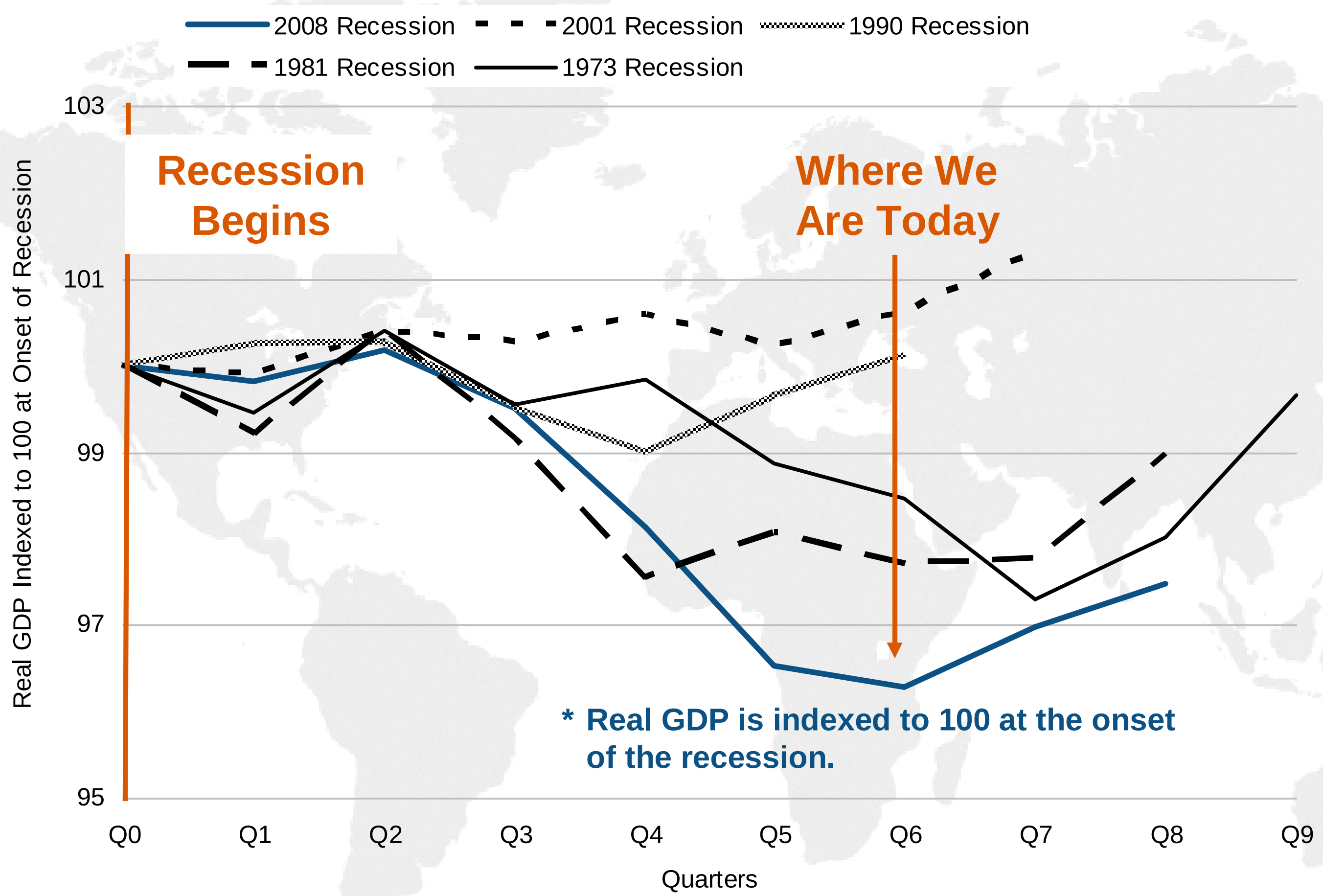
- A Recovery Is Probably Underway
- The US Economy Still Lacks Balance
- Private Demand Will Determine Whether the Recovery Has Legs

Recovering From Recession

2008-2009 Recession Forecast Compared to Prior Recessions

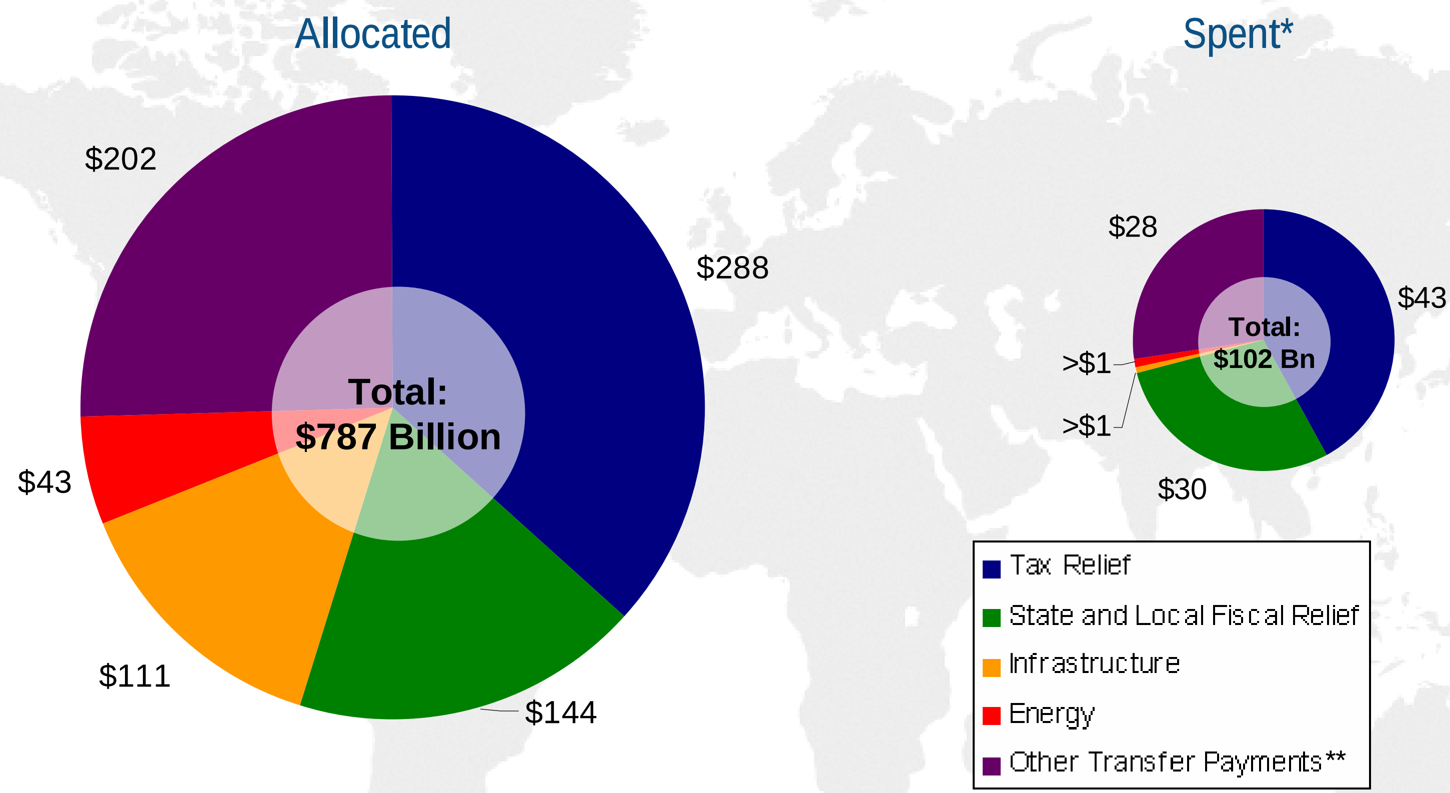


Sources: Commerce Department, Payden & Rygel Estimates

Since World War II, the average peak to trough decline in real gross domestic product during a recession has been on the order of 1.9%. The last two recessions in 1990 and 2001 were much milder with declines of 1.3% and 0.2%, respectively. This time around, we are forecasting a peak to trough decline in real GDP of 3.2%, making this one of the most severe recessions during the post-war era.

Government Spending Is The Aspirin Providing Relief

Fiscal Stimulus Spending in Billions of US Dollars



Source: Recovery Accountability and Transparency Board

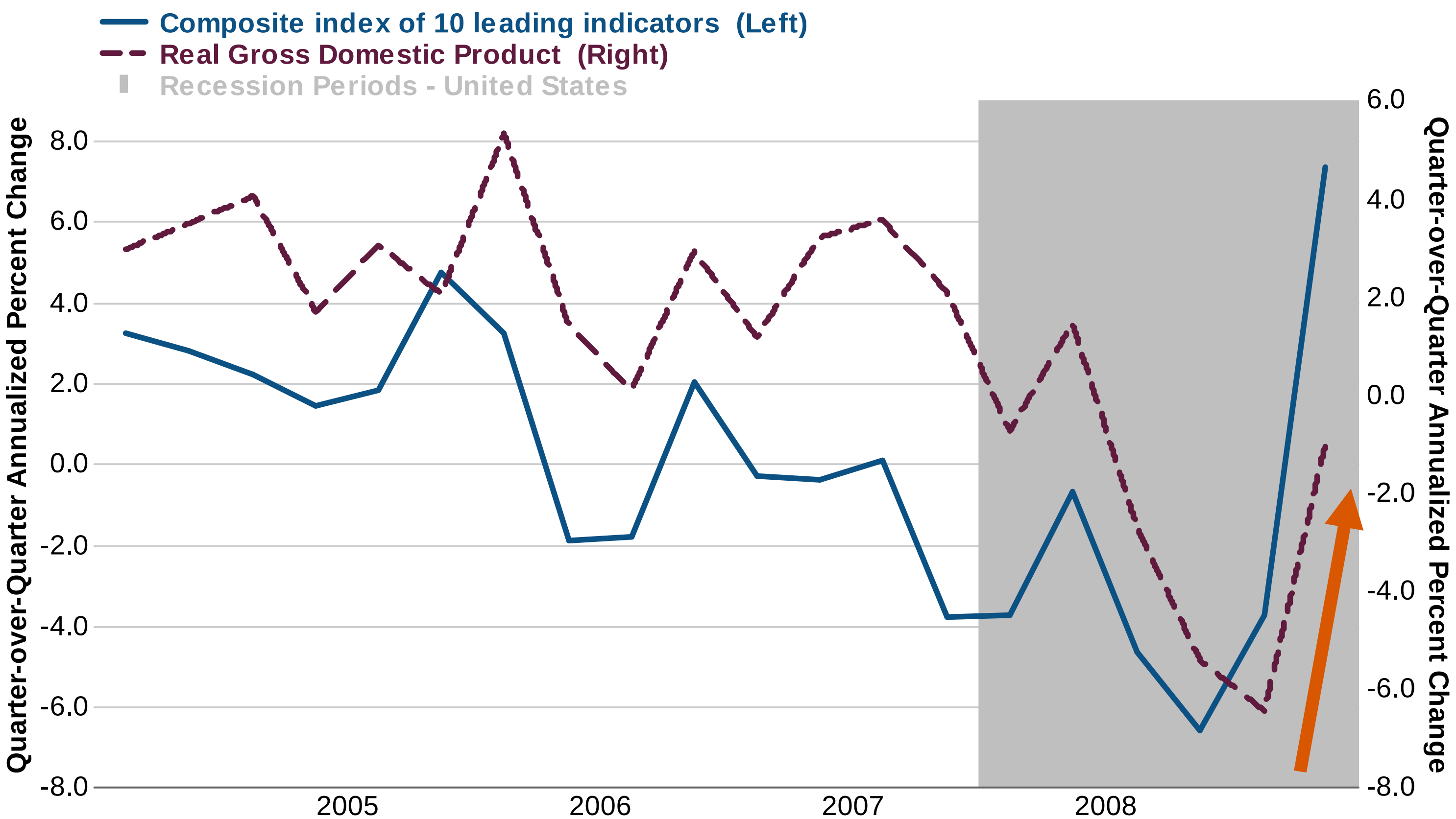
* *As of July 9th, 2009*

** *Other transfer payments includes education and training, health care, and emergency funds for TALF and COBRA programs*

Only $102 billion of the $787 billion fiscal stimulus has been spent through July 2009. The bulk of the package is expected to hit the US economy over the next four quarters, which will help boost economic growth through the first half of 2010.

A Recovery Is Probably Underway

Composite of 10 Leading Economic Indicators and Real Gross Domestic Product (GDP)

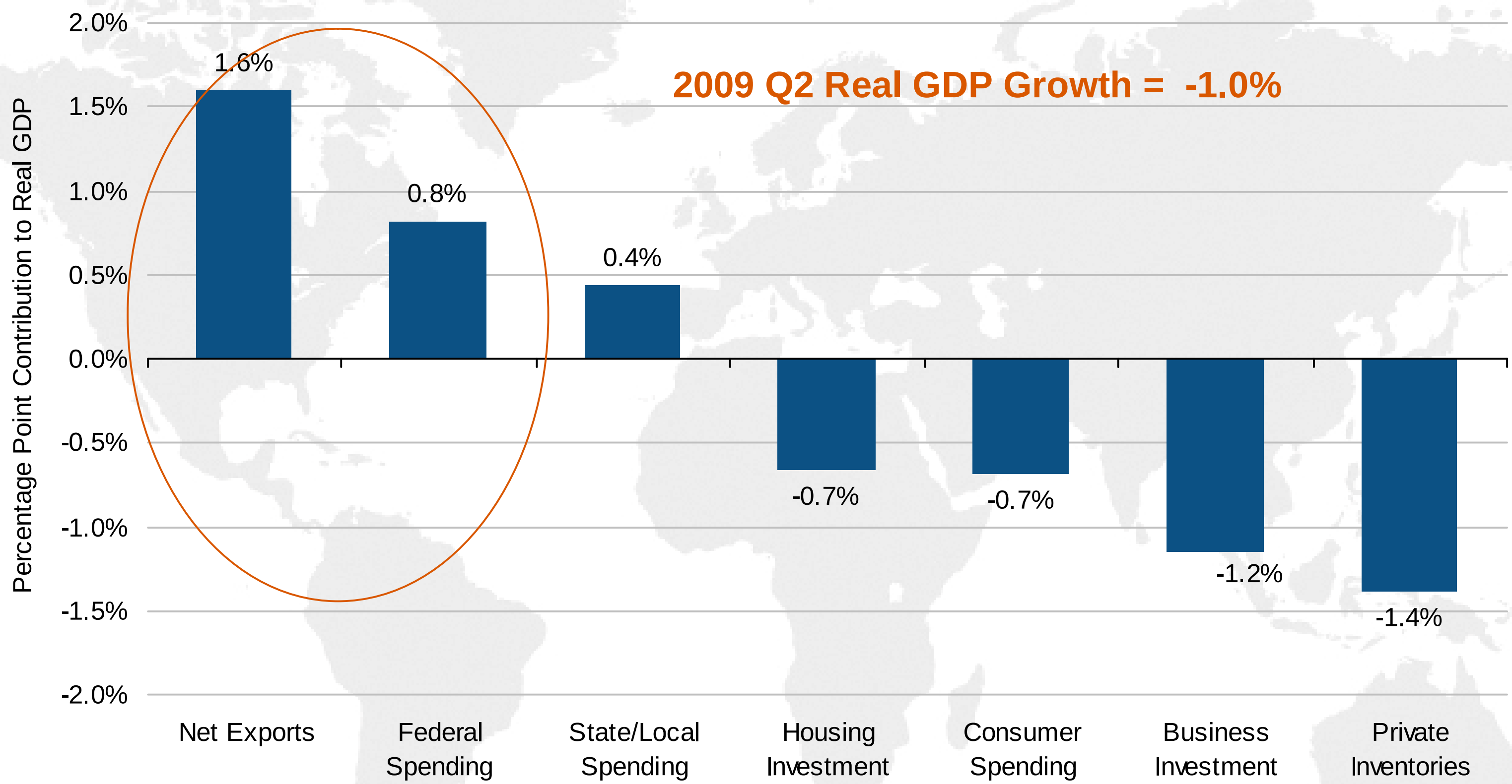


Sources: The Conference Board and The Commerce Department

The Conference Board's Leading Economic Index (LEI) has led turning points in the economy by an average of 7 months over the past 40 years. The range of lead times has varied from as long as 12 months in the 1960 recovery to as little as two months in the 1991 recovery. At the present time, the LEI is pointing to real GDP growth of more than 3% in Q3 2009.

The US Economy Still Lacks Balance

Contribution to Real GDP by Component

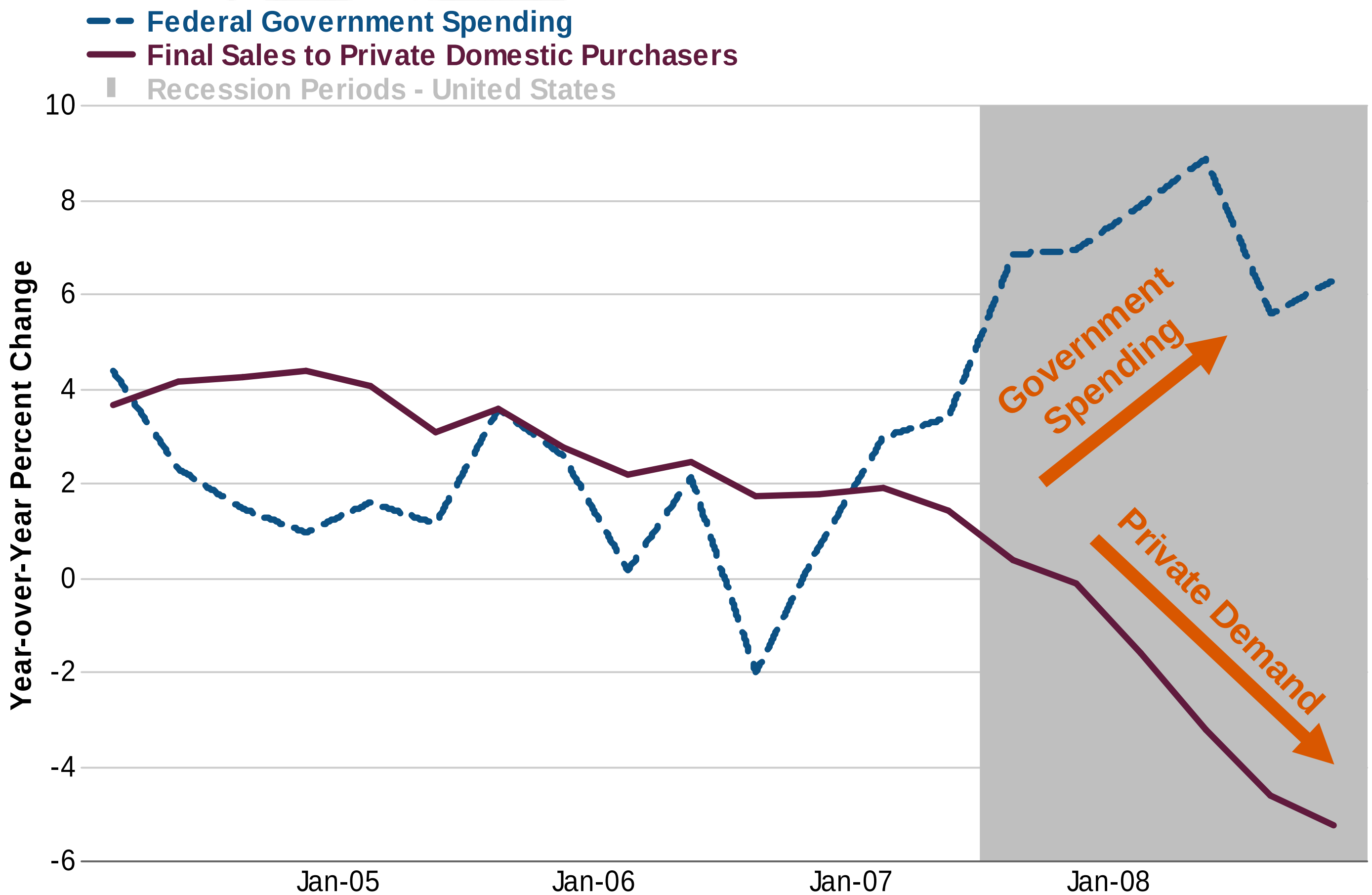


Source: The Commerce Department

The only two positive contributors to economic growth in the second quarter of 2009 were trade and government spending. Unfortunately, the improvement in net exports was the byproduct of collapsing US demand rather than a pick up in exports. Greater balance in the composition of growth is necessary if a sustainable economic recovery is to take hold.

Private Demand Will Determine Whether the Recovery Has Legs

Government Spending and Gross Domestic Product (GDP)



Source: US Department of Commerce

Spending by the federal government, which accounts for 8% of GDP, rose 6.4% in the second quarter of 2009 from a year earlier. By contrast, private demand, which represents more than 80% of GDP, declined 5.2% over the same period.

The Ingredients of a Private Demand Cocktail

Private demand is a measure of demand for goods and services from the non-government sector. It is critical to generating sustainable growth. It has two primary ingredients:

Household Spending

Key Indicators

- Consumer Confidence
- Income/Employment
- Household Balance Sheet

Business Spending

Key Indicators

- Business Sentiment
- Corporate Profits
- Corporate Balance Sheet

2009-2010 Base Line Economic Forecast

	2009 Actual		2009 Forecast		2010 Forecast			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Real GDP (quarter-to-quarter annualized percent change)	-6.4	-1.0	3.0	2.0	2.2	2.5	1.5	2.0
Unemployment Rate (percent)	8.1	9.3	9.6	9.9	10.0	9.8	9.3	9.0
Headline CPI Inflation (year-over-year percent change)	-0.2	-0.9	-1.6	1.6	2.0	1.7	1.5	1.4
Core CPI Inflation (year-over-year percent change)	1.7	1.8	1.6	1.3	1.1	1.0	1.2	1.4
Federal Funds Rate (percent)	<0.25	<0.25	<0.25	<0.25	<0.25	0.50	0.75	1.00
10-Year Treasury (percent)	2.67	3.53	3.60	3.75	3.85	4.00	4.20	4.35

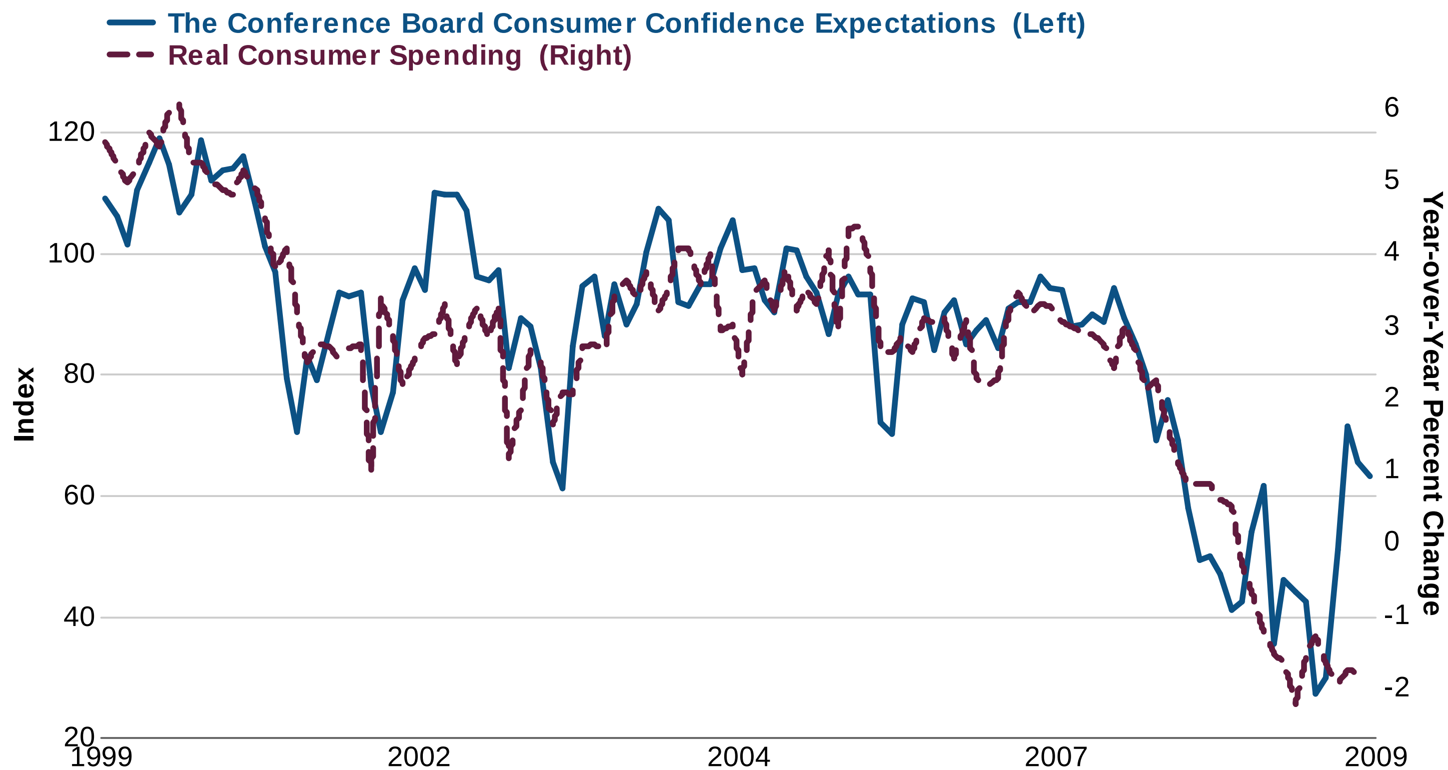
II

Consumers and Businesses Are On the Wagon

- Households Abstaining From Consumption
- Consumer Fundamentals Look Shaky
- Corporate Cost Cutting Creates Another Headache
- Businesses Did Not Get As Drunk On Debt As Consumers

Households Are Feeling Better, Just Not Well Enough to Consume

Consumer Expectations Six Month Hence and Real Consumer Spending

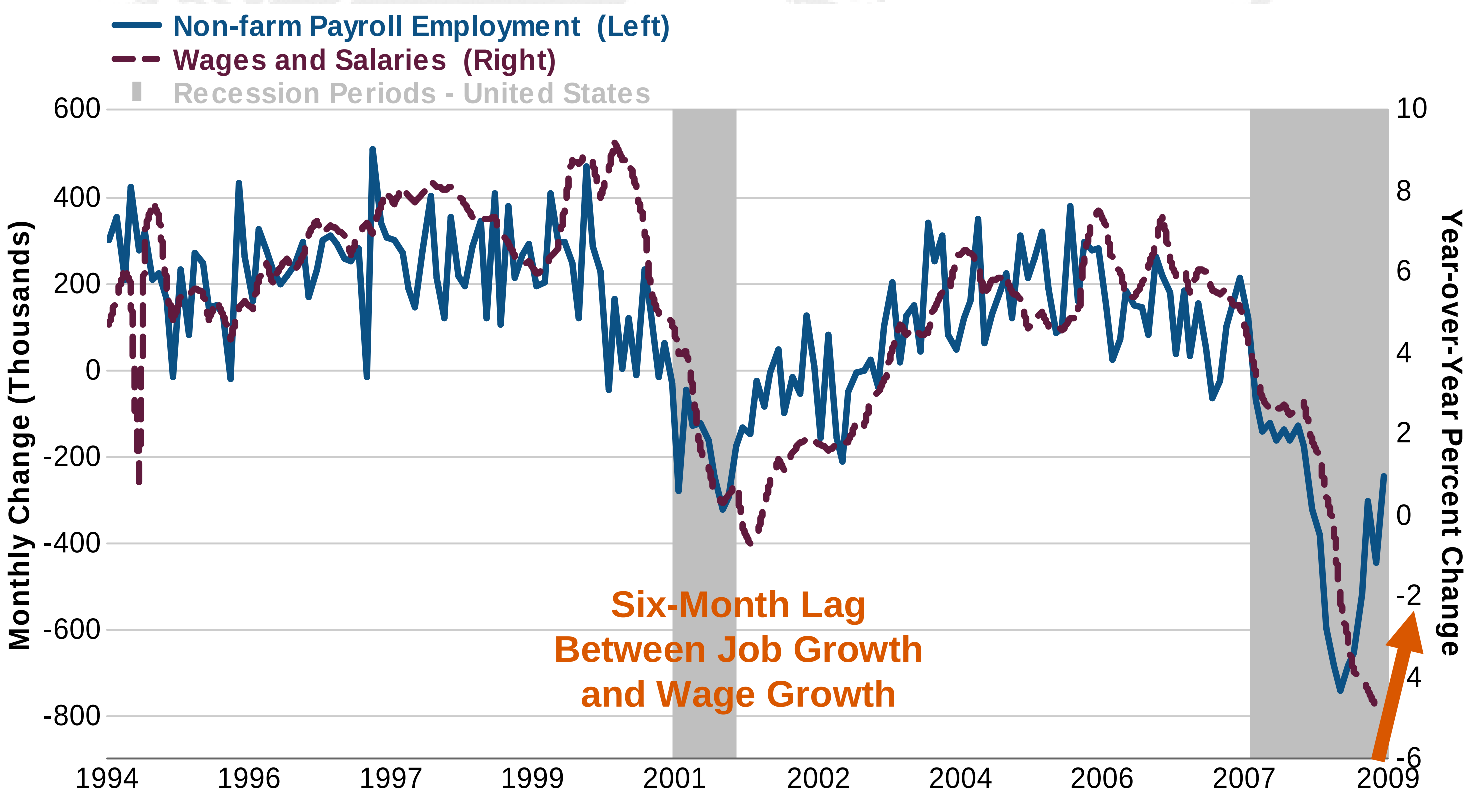


Sources: The Conference Board and The Commerce Department

Consumers have become increasingly optimistic about the economic outlook as the panic in global financial markets subsides. Consumer expectations for the economy six months hence have risen sharply over the past six months. Over the past decade, this series has had an 85% correlation with consumer spending.

Consumer Fundamentals Still Look Shaky

Non-Farm Payroll Employment and the Wages and Salaries Component of Personal Income

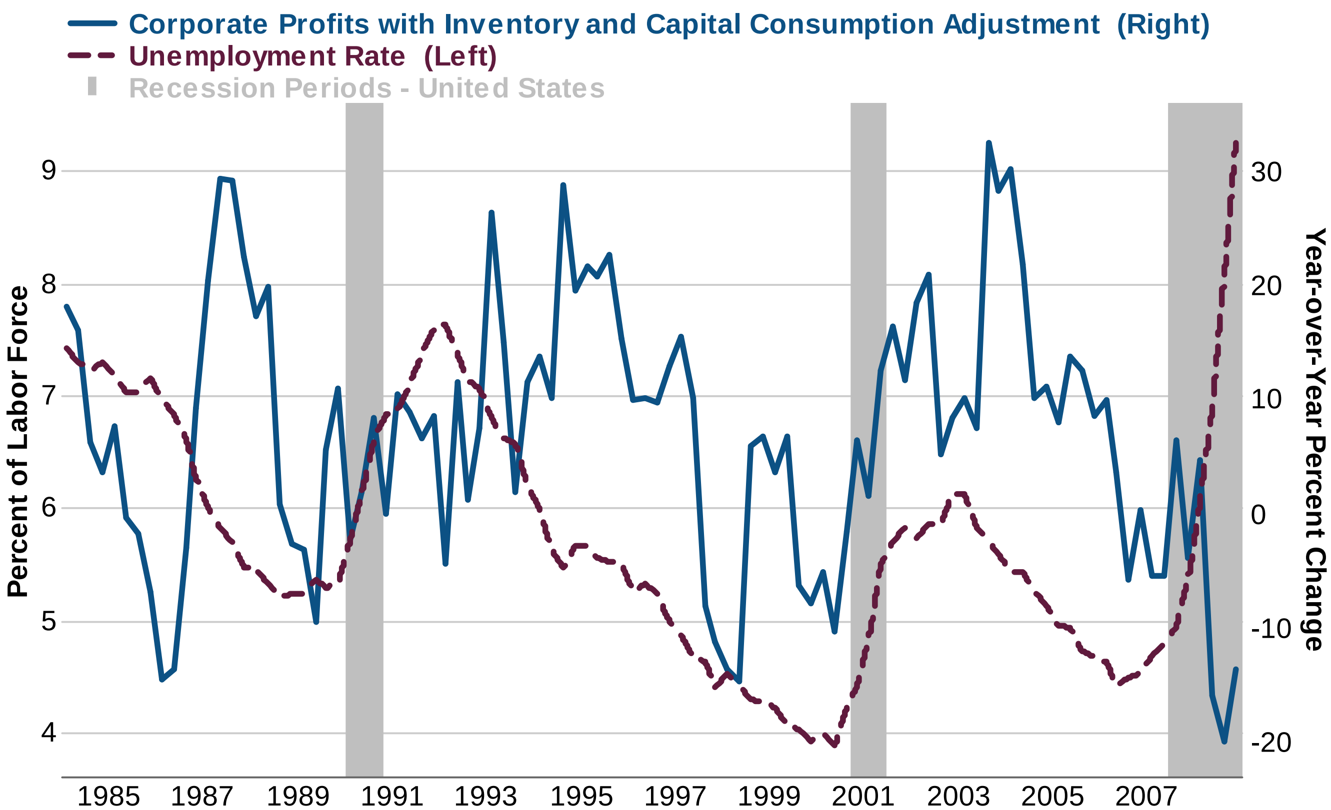


Sources: The Labor Department and the Commerce Department

The pace of job losses is slowing from an average of 556,000 per month in the first half of the year to 247,000 in July 2009. If the US economy begins growing again by the third quarter, then job growth could resume by year end. Historically, wages and salaries have begun to increase between four and six months after the economy has started generating jobs.

Corporate Cost Cutting Creates a Headache for Workers

Corporate Profits and Unemployment

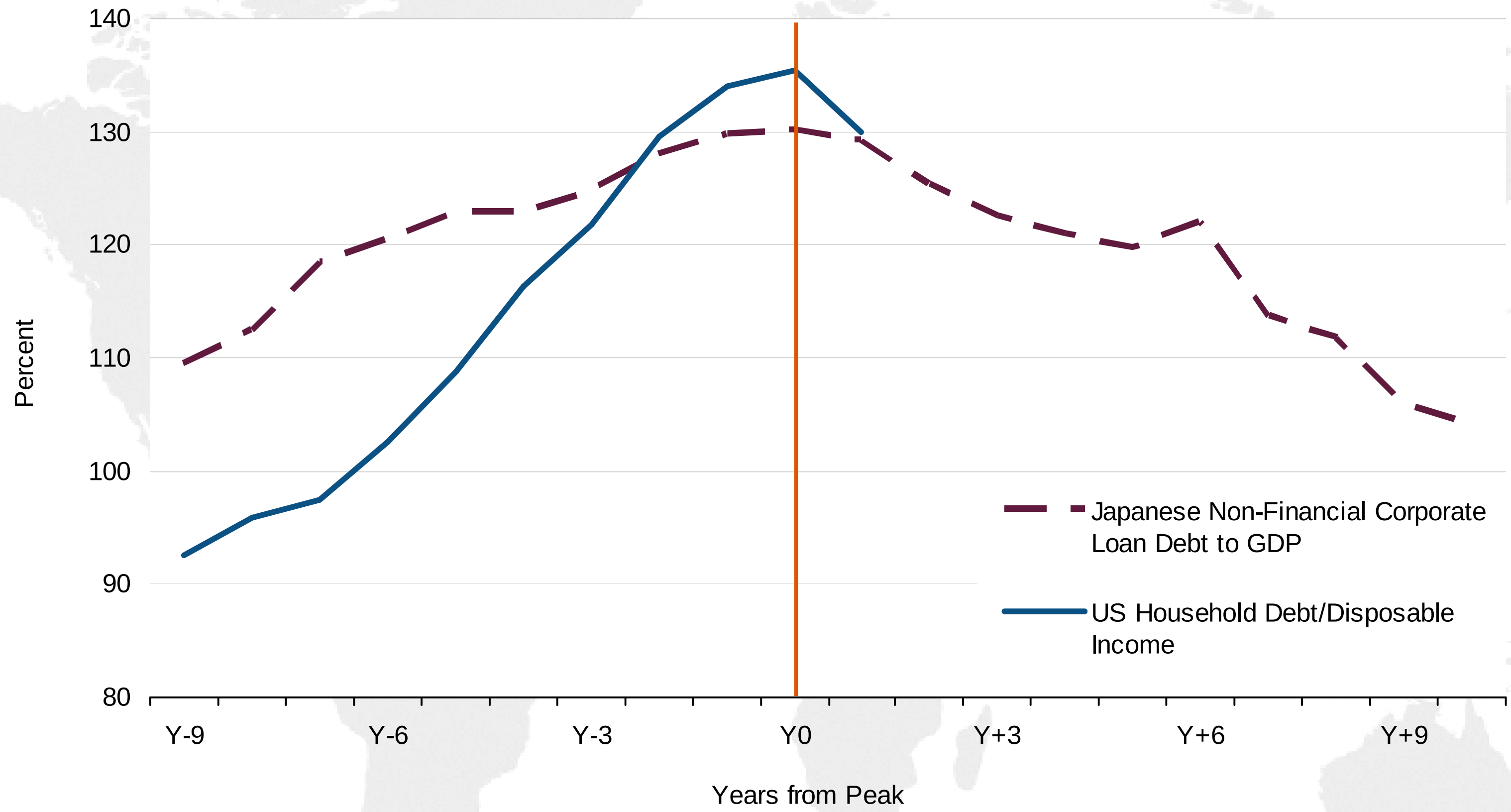


Source: The Commerce Department and the Labor Department

During recessions, corporations will often work to reduce costs as a means of improving profit margins. This implies laying off workers and slashing capital expenditures. Though corporate profits continue to decline at an alarming rate, the good news is that the number of companies reporting upside earnings surprises has risen sharply. According to Standard & Poor's, 75% of the companies in the S&P 500 stock index reported better-than-expected earnings for the second quarter.

Households Need To Purge Their Debt

US Household Debt Today and Japanese Non-Financial Corporate Debt in the 1990s

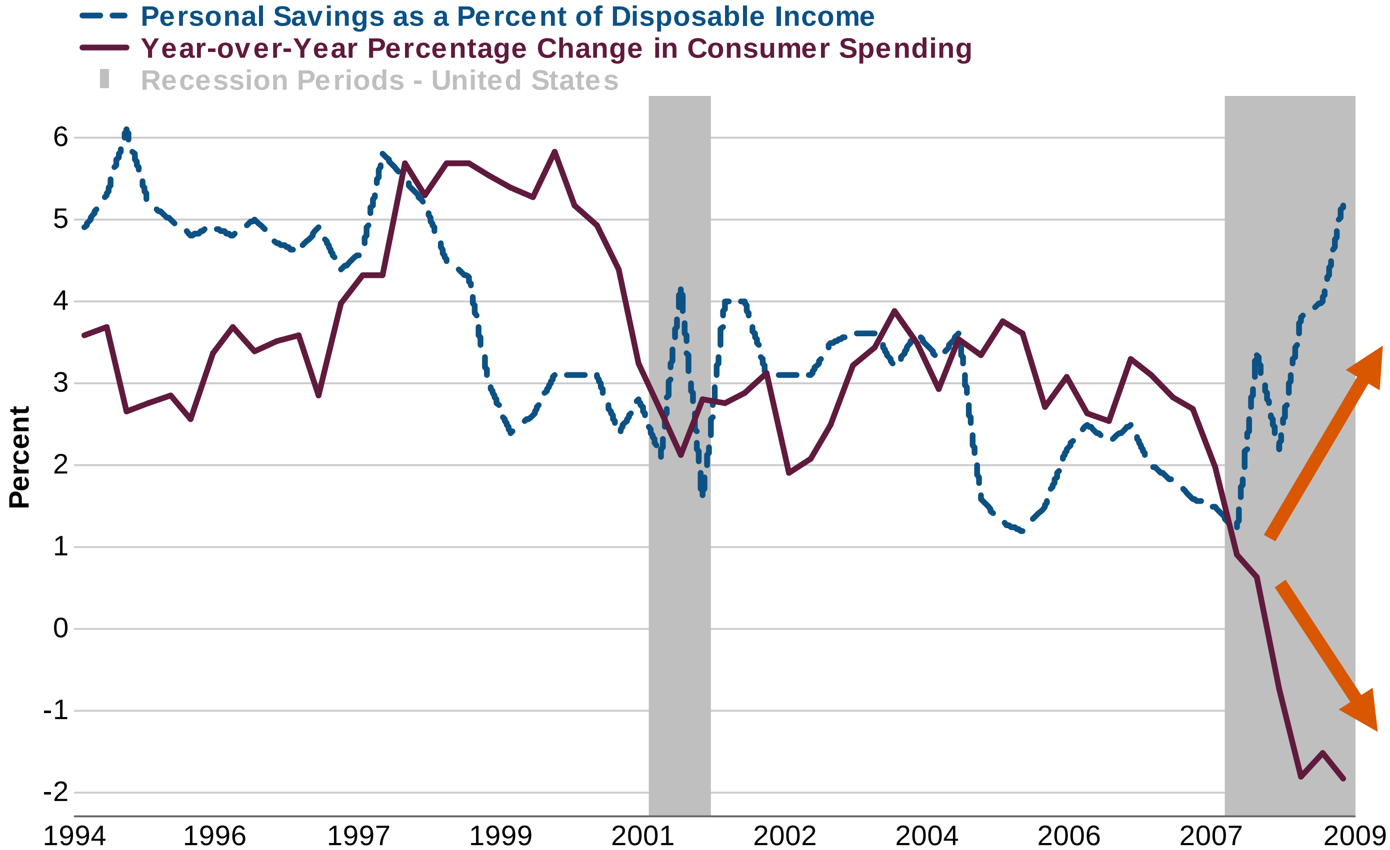


Source: San Francisco Federal Reserve

Household leverage, as measured by the ratio of debt to personal disposable income, doubled from 65% in the mid-1980s to 130% by 2008. Private nonfinancial firms in Japan managed to reduce leverage by 30 percentage points over ten years following the bursting of their bubbles in stocks and real estate in the early 1990s.

Americans Are Likely to Save More and Spend Less

Personal Savings as a Percentage of Disposable Income and Consumer Spending



Sources: The Commerce Department and the Federal Reserve

The San Francisco Fed estimates that households need to reduce their debt to income ratio from 130% to 100% over the next decade. To achieve this feat, Americans would need to increase their savings rate from 4.6% today to 10% by 2018 and 80% of those savings would have to be used debt repayment. This could shave between 0.75% and 1% from consumption growth over the next decade.

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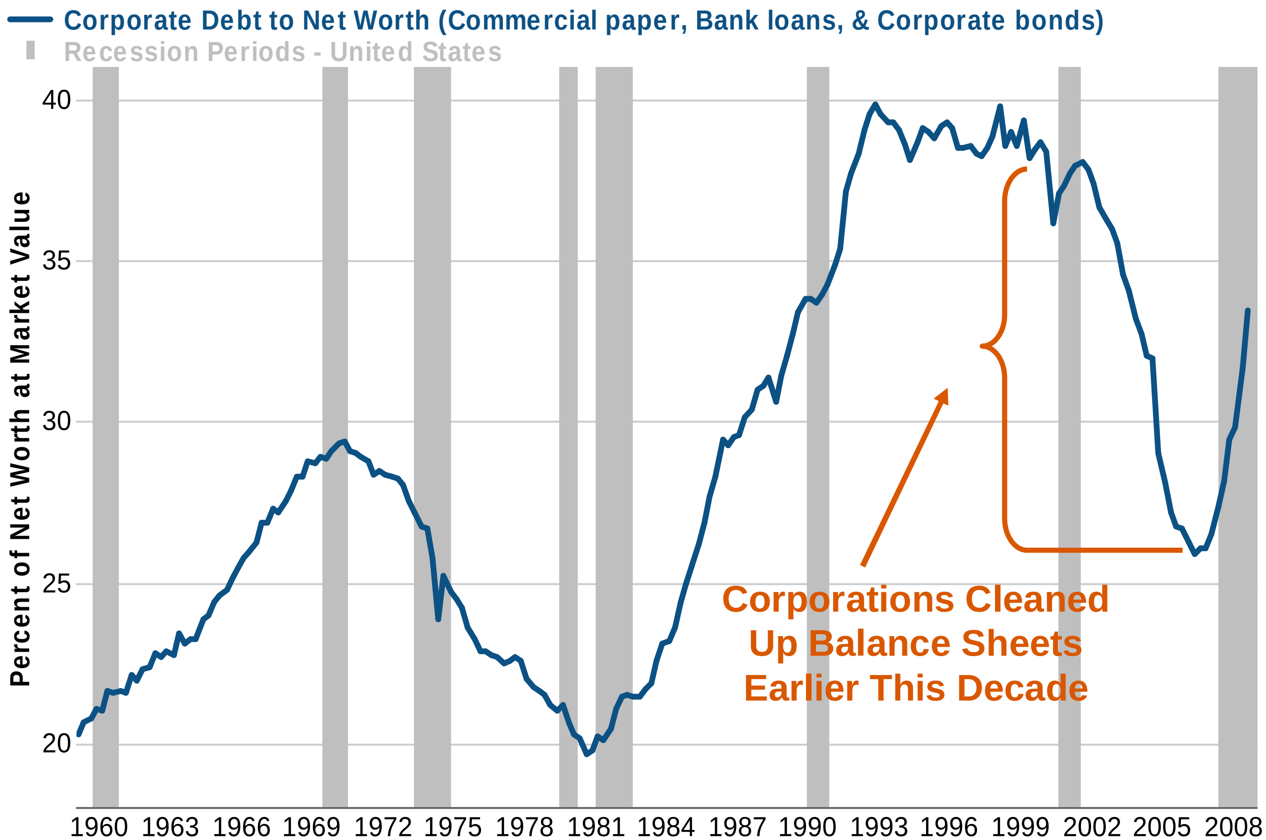
Businesses Did Not Get As Drunk On Debt As Consumers

Non-Financial Corporate Debt to Net Worth At Market Value

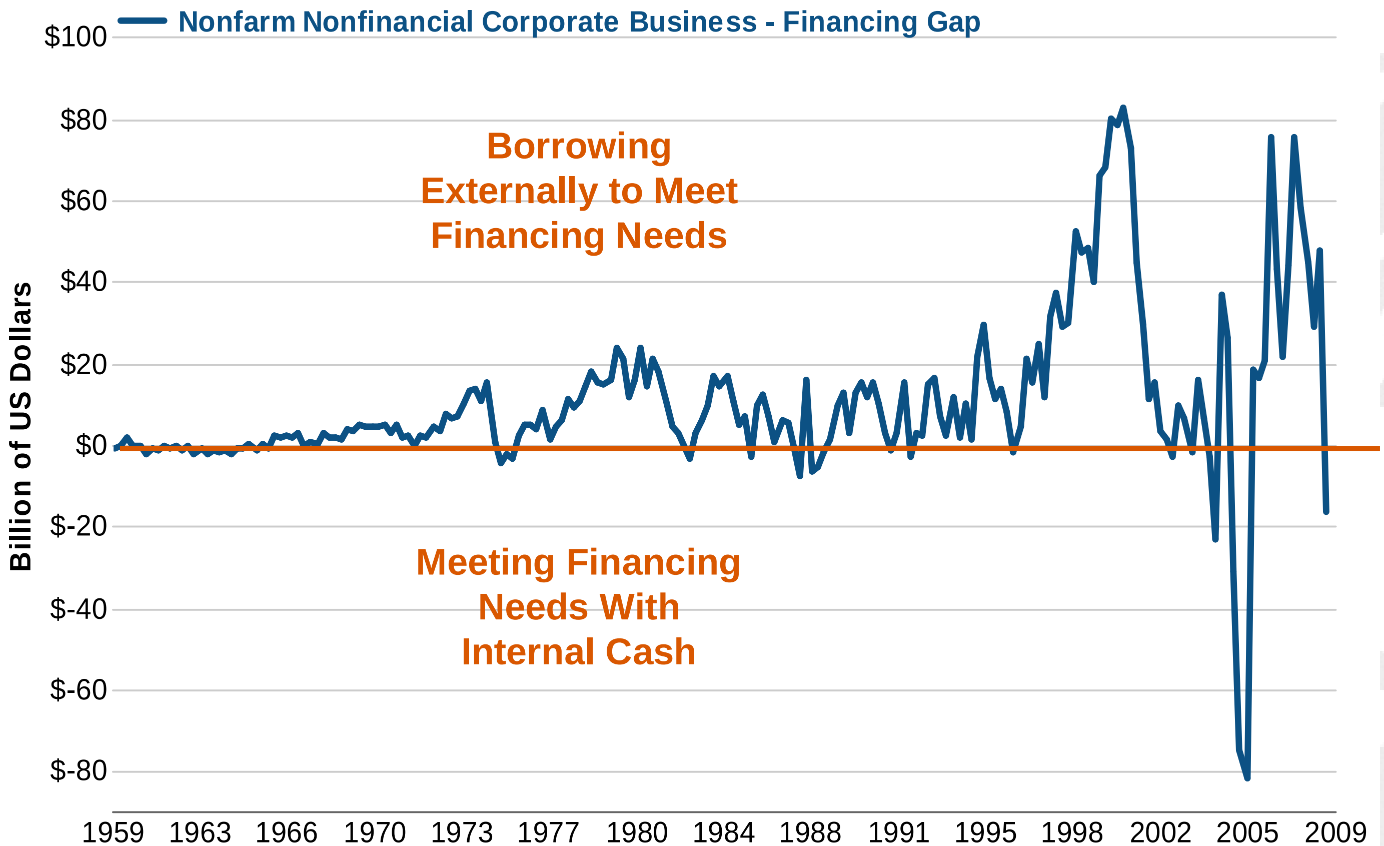


Source: Federal Reserve

The bursting of the technology bubble in the late 1990s forced the non-financial corporate sector to repair its balance sheets and reduce debt in the form of commercial paper, corporate bonds, and bank loans.

Non-Financial Corporations Have Little Need For Additional Funds

Corporate Financing Gap

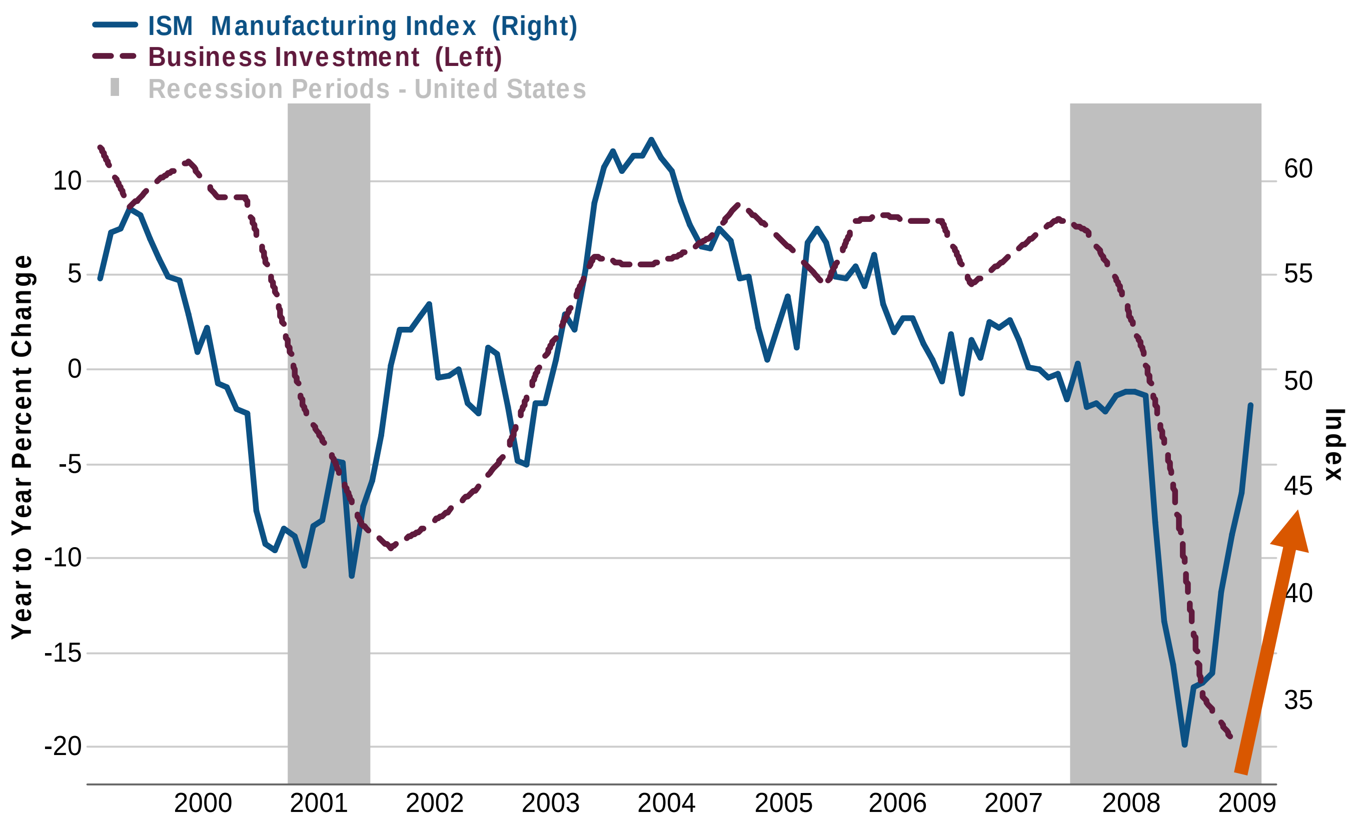


Source: Federal Reserve

The corporate financing gap is equal to capital expenditures less internal funds and inventory valuation adjustments. When this figure is negative, as it was in the first quarter of 2009, businesses have excess cash on their balance sheets.

Businesses Are Feeling Better About Their Prospects

ISM Purchasing Managers Index and Non-Residential Business Investment



Sources: Institute for Supply Management and the Commerce Department

The Institute of Supply Management's Index of Manufacturing Activity has risen dramatically since the end of last year as businesses succeed in trimming unwanted inventories and reducing their workforces to enhance future profitability.

III

The Hangover Will Last Into 2010 and Beyond

- The Debt Party Is Over: Lower Growth & Higher Unemployment
- The Tab: Higher Taxes & Higher Interest Rates

The Debt Party Is Over: Lower Economic Growth Likely

Potential output is a measure of how fast the economy can grow without generating inflation when its capital and labor resources are fully utilized.

Here is a simple formula for calculating potential GDP:

	Potential GDP	=	Output per Hour	+	Hours Worked
1990s	3.2%	=	2.7%	+	0.5%
Today	2.5%	=	2.0%	+	0.5%

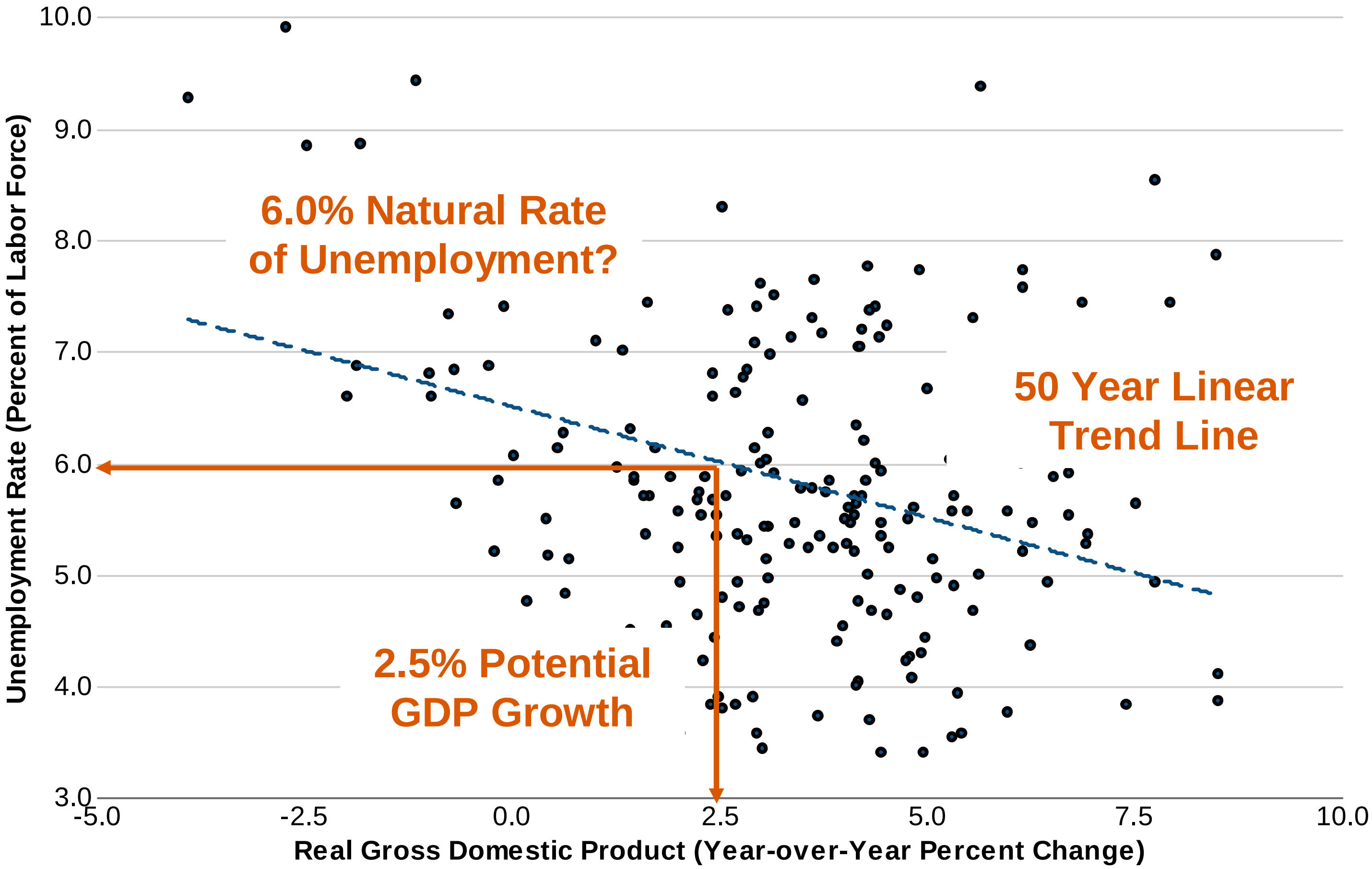
Overinvestment in housing; Underinvestment in technology

Leverage reduced in financial system from 30:1 to 20:1

Households increase savings and paying down debt

Lower Growth Potential Implies Higher Unemployment

Unemployment Rate and Real Gross Domestic Product

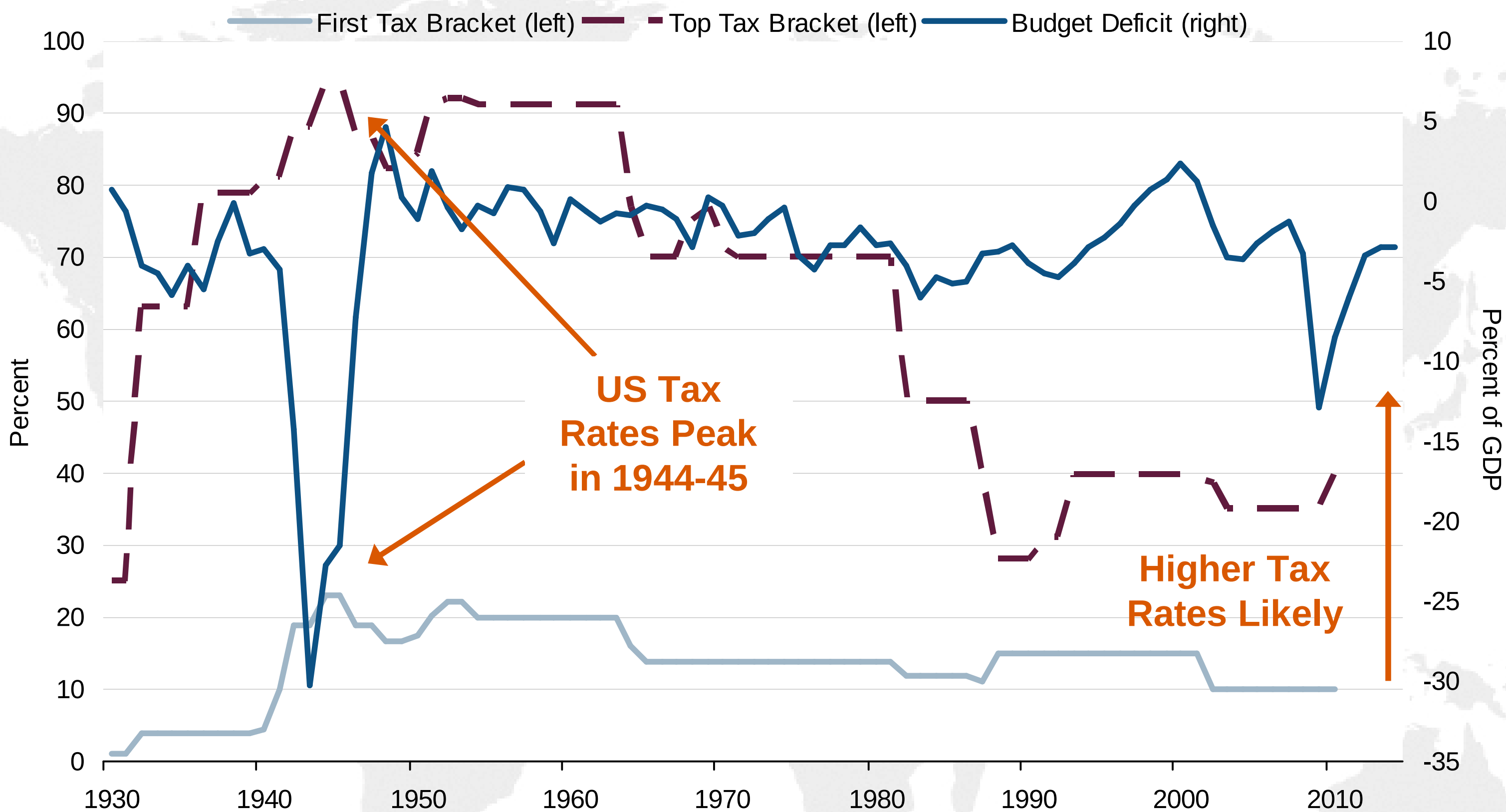


Sources: The Commerce Department and the Labor Department

The non-accelerating inflation rate of unemployment (NAIRU) is the lowest unemployment rate the economy can achieve without generating price pressures through faster wage growth. Over the past decade, many economists believed this level had fallen to 5%. However, if potential GDP growth has indeed fallen to 2.5%, the NAIRU could be much higher.

Exactly Who Is Going to Pay For All of This?

Income Tax Rates and the Budget Deficit

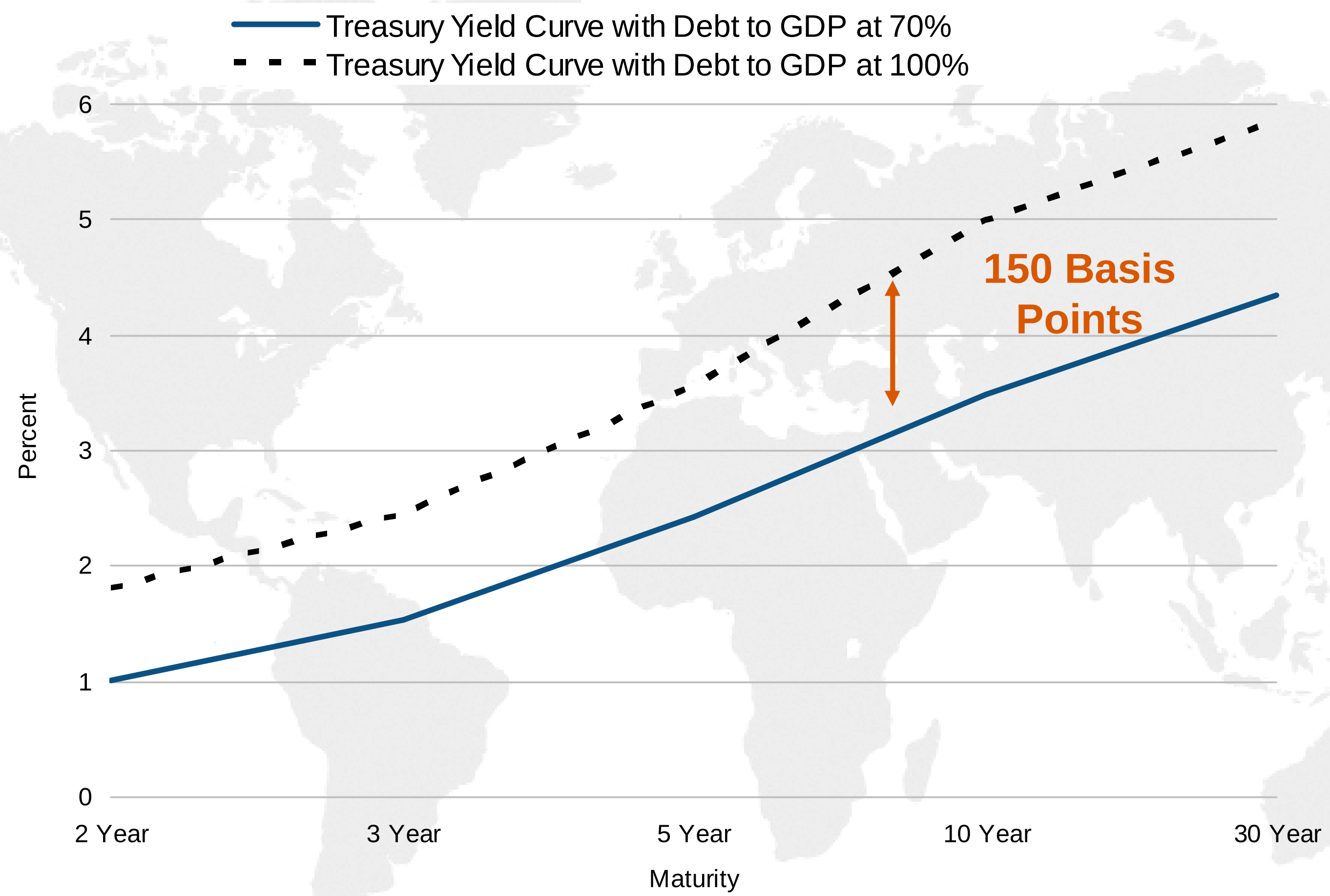


Sources: Government Accountability Office and the Tax Foundation

The 2010 fiscal year budget deficit is expected to reach $1.8 trillion or nearly 13% of GDP –the largest its been since the Second World War. Although a pick up in economic growth should lead to an increase in tax revenues in the next year, tax rates are likely to have to rise in order to pay down the budget deficit. During 1944 and 1945 the top rate reached an all-time high of 94% on incomes above $200,000 ($3 million in 2007 dollars) and the bottom rate peaked at 23%.

Higher Debt to GDP Implies Higher Long-Term Interest Rates

Treasury Yield Curve



Sources: The Federal Reserve and Payden & Rygel Estimates

The Congressional Budget Office expects the US debt to GDP ratio to increase from 70% in 2008 to 100% by the end of 2010. According to a study by the Federal Reserve, each percentage point increase in the debt to GDP ratio adds 4 to 5 basis points to long-term interest rates over a five year span. This suggests that long-term US Treasury yields could be 120 to 150 basis points higher than would otherwise be the case in equilibrium.

The Jury Is Still Out On A Recovery in Private Demand

Private Demand

Household Spending

Key Indicators	Current Signal
Consumer Confidence	Positive
Income/Employment	Negative
Household Balance Sheet	Negative

Business Spending

Key Indicators	Current Signal
Business Sentiment	Positive
Corporate Profits	Negative
Corporate Balance Sheet	Positive

US Economic Outlook

Economic Growth

The US economy shrank at an annual rate of -1.0% in Q2 2009. This was a dramatic improvement over the prior two quarters when the economy contracted at annual rates of -5.4% in Q4 2008 and -6.4% in Q1 2009.

Forecast: Real GDP growth is expected rebound strongly in Q3 as businesses move to rebuild inventories. Beyond that, the question will be whether a sustainable rebound in private demand will materialize before the impact of fiscal and monetary stimulus fade in late 2010.

Inflation

The headline consumer price index (CPI) has slipped further into negative territory, falling 1.9% on a year-over-year basis in July. Core inflation, which excludes food and energy prices, increased by 1.6% over the previous year.

Forecast: Headline inflation should turn positive again by year-end as the base effect of declining commodity prices recedes. However, core inflation will likely drift lower due to the output gap, the difference between potential and actual economic growth.

Interest Rates

The Federal Reserve left its benchmark interest rate unchanged in a range between 0% and 0.25% at the conclusion of its August meeting. In its policy statement, the Fed reiterated that economic conditions were likely to warrant a low federal funds rate for an “extended period,” despite signs that the US economy is “leveling out.”

Forecast: We expect the Fed leave its benchmark rate unchanged until the second half of 2010. However, central bank may choose to exit parts of its credit easing program sooner. For instance, the Fed has already suggested it may end its $300 billion Treasury purchase program in October.