



PRICE PERSPECTIVE

Treat SPU8 as a trading affair. Month end may be creating confusion. Despite the small bounce in the housing market, labor market conditions show deterioration and credit problems continue to fester. At the same time, the Fed will drag its feet in aiding an ailing banking sector. None-the-less, the market has been slow to respond to bearish data points and may be seeing short covering at month end. SPU8 should fail at 1275 and work toward 1260. Below 1260, the door to 1247 and 1231 will open. Above 1281, the market will be in position to test 1294 to 1300. Best guess for today's range in SPU8: 1375 to 1247.

of credit stress which could shake confidence and prolong credit stress. Going back to the last banking crisis in 1990, the Fed engineered a very steep yield curve to bolster bank profits and capital. The curve is steep, but not at a level which will create quick relief. The spread between the high yield ETF (HYG) and treasury ETF (IEF) is flirting with historically wide levels underscoring credit risk.

Support & Resistance

	SPU8	NDU8	DJU8	RRU8
R2	1282	1917	11595	737
R1	1275	1904	11475	727
S1	1260	1876	11340/285	716
S2	1247	1854	11197	711



Weekly Overview

The market will focus on issues of credit, a few profits numbers, weekly MBA and energy data, and durable good orders (please see fixed income comment for details). Credit issues remain a headwind to higher stock prices. The FDIC said that the number of troubled institutions rose to 117 in Q2 from 90 in Q1. The list could continue to grow in the coming quarters as small banks fight weakness in the commercial real estate market and higher unemployment. Moreover, the Fed said that raising capital was more difficult for banks. Large banks have better accesses to the capital markets than small banks. The Fed is also leaning hawkish given the snap shot of the FOMC minutes. The Fed's hawkish comments are occurring in the face

Profit numbers from JCG (bearish), DLTR, TLB, DY, and BGP may get a look or two. The most interesting piece of news in the consumer sector was the downward guidance from DRI in the restaurant sector. DRI cut its Q1 EPS forecast to \$.61 compared to the census of \$.75. Comp store sale growth was expected to fall 1.1%. Look for weak numbers and thus soggy housing activity in the MBA index, while energy data could be overshadowed by the path of Hurricane Gustav. The best hope for a quick rally in equity prices remains a \$10 or \$20 drop in oil prices from current levels. MFGR thinks durable good orders could show weakness relative to expectations based on the ISM new orders index from July. The durable number is a bit stale. Durable good orders are

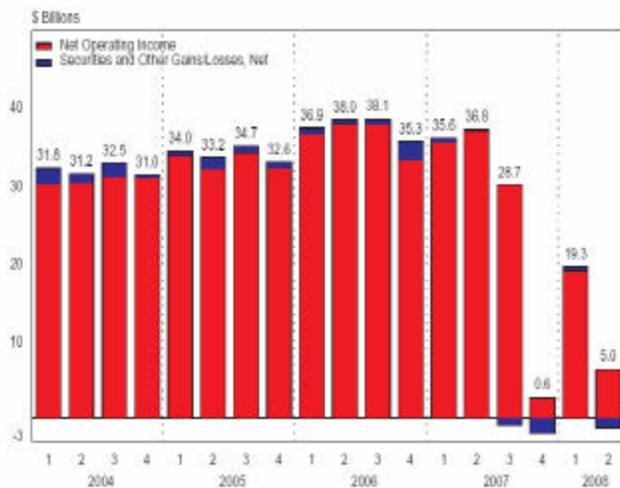
expected to be unchanged and fall 0.7% ex-transports.

A Few Thoughts on Credit and the Fed

The FOMC statements from the August 6th meeting seem to ignore the poor health of the banking system and underlying economic trends. Here are a few statements from the FOMC minutes and my comments:

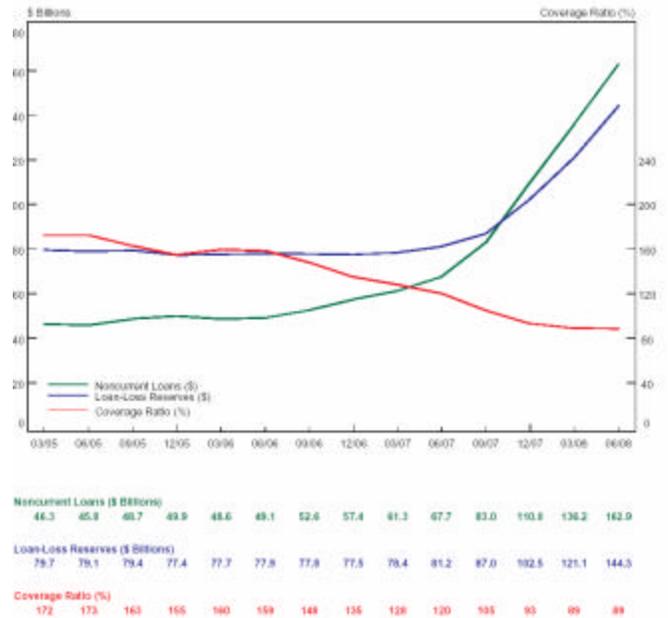
- Several officials said market risks receded – my comment – credit spreads remain very wide and show no change (see chart above).
- Generally saw next move as a rate hike.
- Many officials say market as fragile – my comment – seems to contradict risks receded.
- Some officials' worried inflation would not ease in 2009.
- Raising capital grew more difficult for banks.
- Timing and extent of rate hike depends on the data.
- Labor market, financial stress, oil, and housing to weight on economy in coming quarters.

Quarterly Net Income
2004 - 2008



Personally, I think the Fed seems to be signaling that it is done cutting rates. I'm not convinced given the economic and credit backdrop. The idea of a rate cut is also inconsistent with deteriorating health in the banking system. The graphic above display profitability and credit profiles of FDIC banks. The first graphic displays poor profitability.

Reserve Coverage Ratio*
2005-2008



The second graphic highlights the rise in non-current loans and loan loss reserves. Notice that the coverage ratio is heading downward. The fact that coverage is lagging may set the sector up for higher expenses and the need to raise capital. I'd guess that small banks are under reserved. I've only sampled a few, but there seems to be a trend consistent with the ratio of loan loss reserves to nonperforming assets falling compared to the last few years. There could create negative earnings surprises in the sector when numbers are released in mid October.

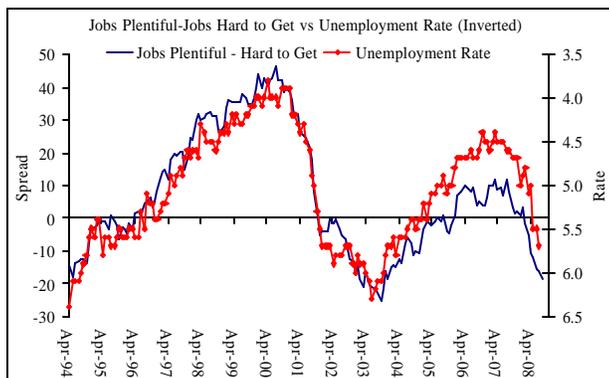
The graphic below displays the ETF of the bank index, KBE. The index looks similar to the XLF which has been widely discussed in recent weeks. The KBE made a bottom and has trended sideways. There are some signs of technical weakness, but the index really needs to fall below \$26 to destroy hopes of a bottom. Fundamentally, there are probably more write downs and it might

be tough for the market to rally in front of Q3 earnings.

The SHRM/Rutgers Leading Indicator of Economic growth indicated that labor market conditions deteriorated in September. Conditions were said to be much weaker than a year ago in both the manufacturing and service sectors. The graphic below displays the history of the survey.



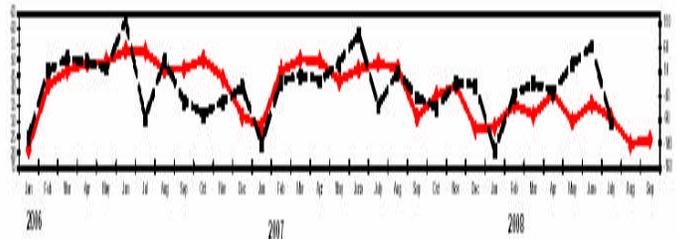
Quickly on the Labor Market



The labor market shows signs of weakening. The spread between the Conference Board's jobs plentiful and jobs hard to get indices widened to -18.9 from -16.6 in July. It's at its widest level since late 2003 and is slowly approaching the region seen during the end of the last recession. The unemployment rate should start to work over 6.0% in the coming months. Not only are businesses hiring fewer workers, but the more workers are probably looking for jobs given economic conditions. Teenagers, for example, may have to work more to pay for gas and entertainment due to the fact that families have less discretionary income because of high food and energy costs.

Monthly Change in U.S. Manufacturing Employment
January 2006 to September 2008

◆ LINE Expectations (Not Seasonally Adjusted)
● BLS Manufacturing Employment (Not Seasonally Adjusted)



Here are a few survey highlights:

- The survey said that employment expectations were down substantially. They are at their lowest levels in four years.
- Job vacancies are down substantially. Both exempt and non exempt job vacancies are at the lowest August levels in the last four years
- Recruiting difficulty down substantially. Lowest level in the last four years.