

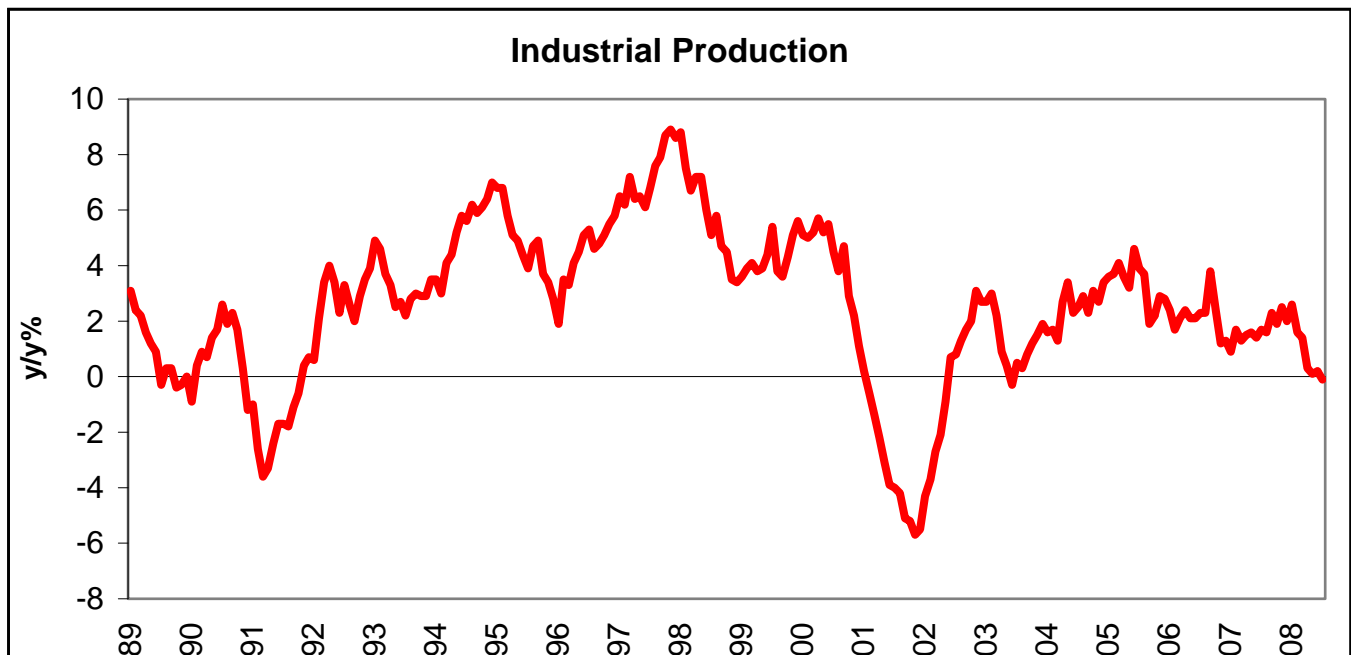
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Economics & Strategy

July Production, August Confidence & the case for Sub \$70/bbl. Crude Oil

Industrial production rose 0.2% m/m in July after having risen by a downwardly revised 0.4% m/m in June. July production was boosted by a 3.6% jump in motor vehicle and parts production. Excluding motor vehicles and parts, industrial production rose just 0.1% in July. On a year-to-year basis, which is probably best captures the underlying trend, production was essentially flat -- *falling* 0.1% from last July's level. Industrial production appears to have peaked in January 2008, which is also the first month in which payroll growth went negative. This may ultimately prove to be the peak of the business cycle.



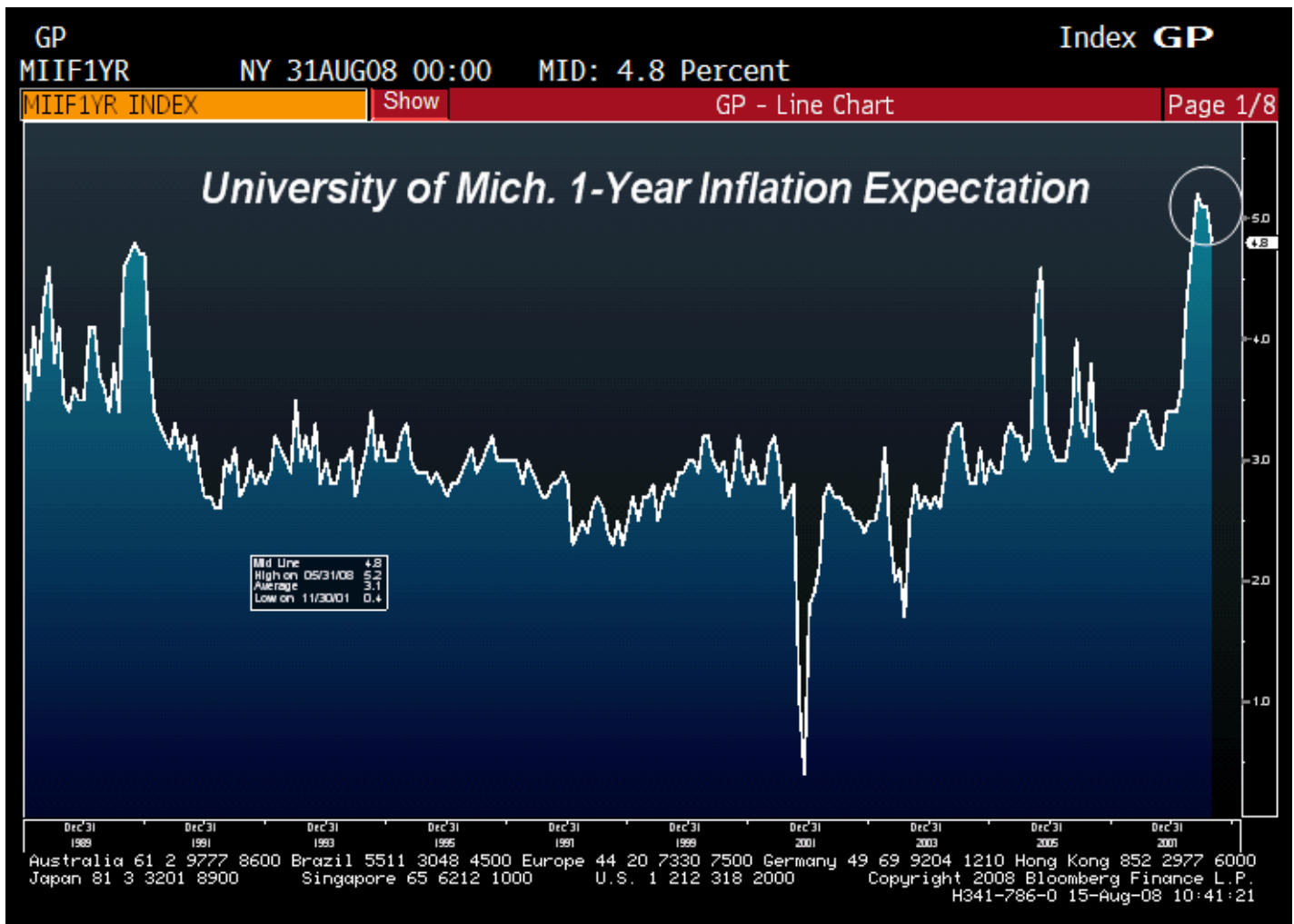
Source: Bloomberg; MKM Partners

Confidence has risen slightly from depressed levels. The University of Michigan's Consumer Sentiment Index rose to 61.7 in August from 61.2 in July. The expectations

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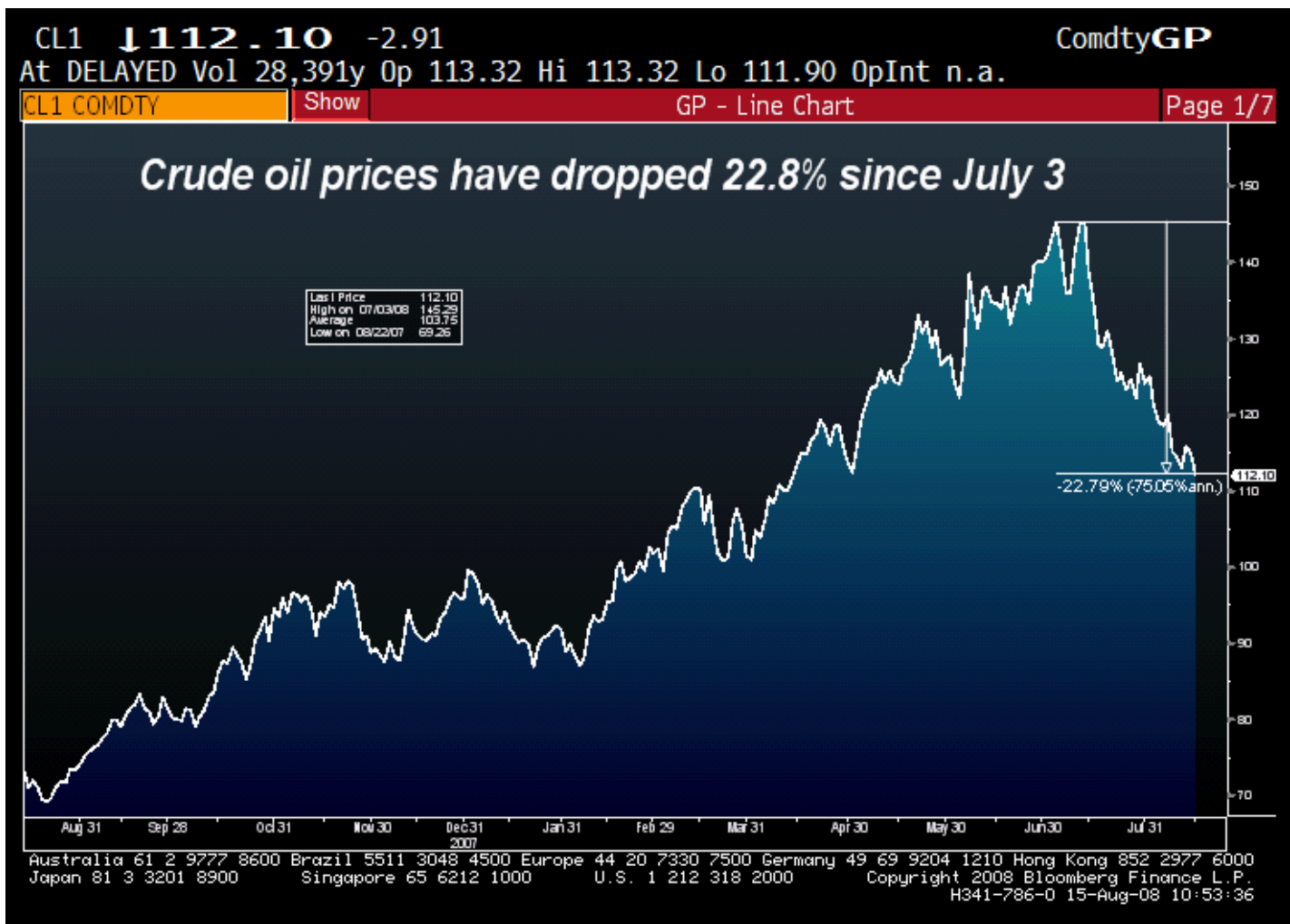
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index, which is supposed to be more forward-looking, rose to 56.8 in August from 53.5 in July. These indicators are still meandering around the lowest levels seen since the 1990-1991 recession. Year-ahead inflation expectations from the Michigan Survey pulled back to a still-high 4.8% from 5.1% in July and a 26-year high of 5.2% reached in May. As we noted yesterday, crude oil prices fell more than 50% from peak-to-trough during the last two recessions. A similar decline today would put crude oil *below* \$70/bbl. If that occurs, year-ahead inflation expectations almost surely have seen their highs (and the headline CPI likely is close to peaking). Longer-term inflation expectations remained somewhat elevated at 3.2% in August, the same reading seen in July and slightly above the 10-year average of 2.9%.



We think crude oil could fall below \$70/bbl. Crude oil prices dropped 56% from peak-to-trough during the 1990-1991 downturn and 53% during the 2001 recession. Applying the same logic to the current environment would take crude oil down to \$66/bbl. over the course of the next 6-12 months from the peak of \$145.29/bbl. seen in July. We believe this is still a fairly conservative call because crude oil was much more expensive relative to non-energy commodities at this year's peak than it was during the peaks before the last two recessions. In any event, this would be welcome relief on the

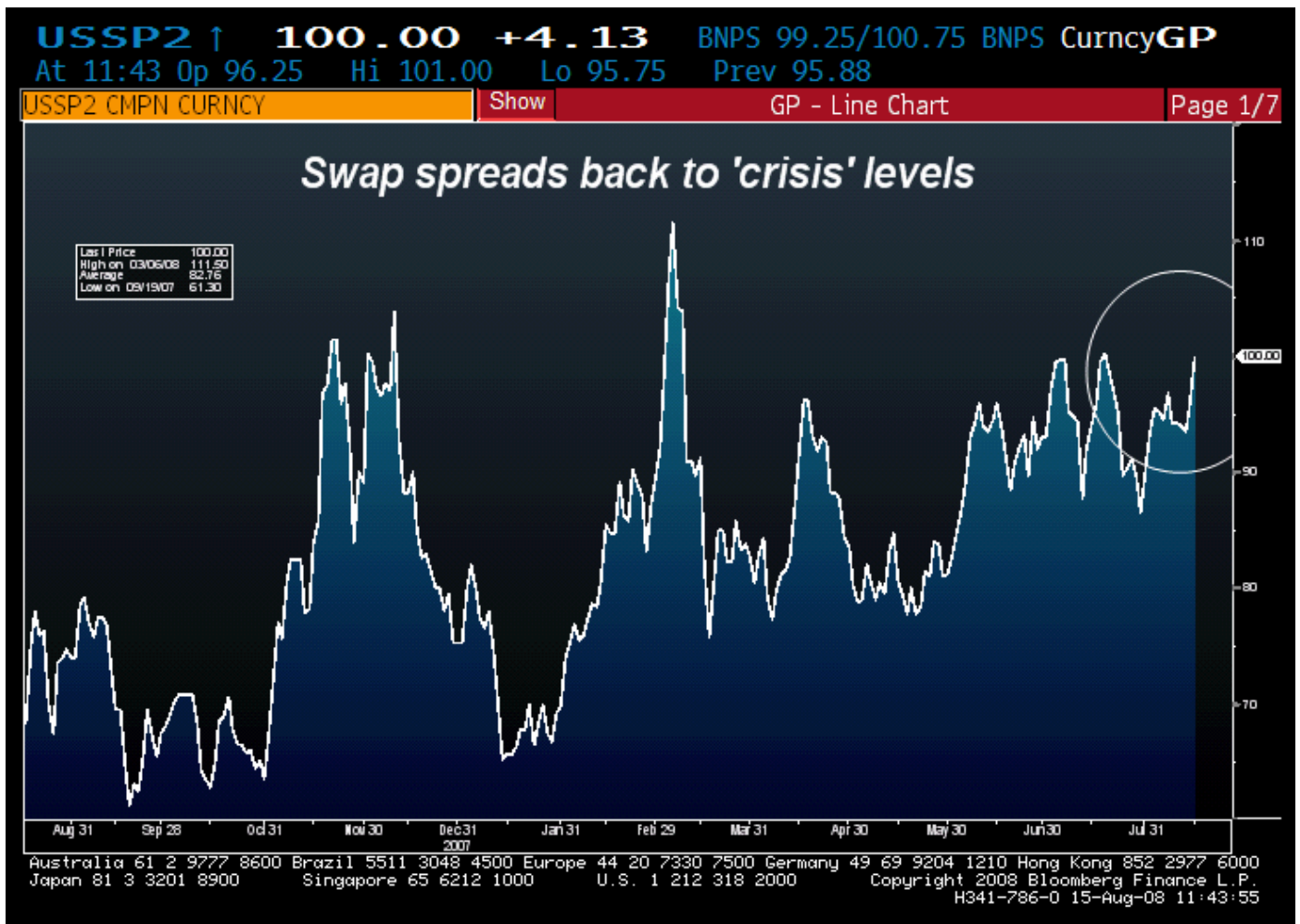
inflation and inflation expectations front, and also serve to take some pressure off concerns that have had margins squeezed by high oil prices. However, if falling crude is in large part *the result* of two-thirds of the global economy sinking into recession, it's hardly an "all clear" for the economy, especially with the labor market weak and credit conditions tightening. As such, we'd be more interested in consumer staples companies than the consumer discretionary sector, which is likely to face stiff headwinds for some time.



Conclusion: Industrial production rose 0.2% m/m in July after having risen by a downwardly revised 0.4% m/m in June. On a year-to-year basis, industrial production is down 0.1% and appears to have peaked in January, along with payrolls. With the second half outlook weak, January may ultimately prove to be the peak of the business cycle. Nonetheless, the retreat in energy prices seems to be having *some* positive impact on household confidence. The University of Michigan's Consumer Sentiment Index rose for the second consecutive month in August (although it remains in a zone not seen since the 1990-1991 recession). The retreat in crude oil prices also seems to be pulling down near-term inflation expectations, with the University of Michigan

Survey's year-ahead inflation expectations measure falling to 4.8% in August -- down from a 26-year high of 5.2% in May.

Investment Implications: Important coincident economic indicators such as industrial production and payrolls peaked in January, which probably marked the end of the expansion that began in late 2001. Crude oil prices *dropped* 56% from peak-to-trough during the 1990-1991 downturn and 53% during the 2001 recession. Applying the same logic to the current environment would take crude oil down to \$66/bbl. However, if falling crude oil is in large part *the result* of two-thirds of the global economy sinking into recession, it's hardly an "all clear" for the economy, especially with the labor market weak and credit conditions tightening. As such, we'd be more interested in consumer staples companies than the consumer discretionary sector, which is likely to face stiff headwinds for some time. Indeed, key leading indicators of credit are sending a "crisis alert" that investors can ignore only at their own peril.



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