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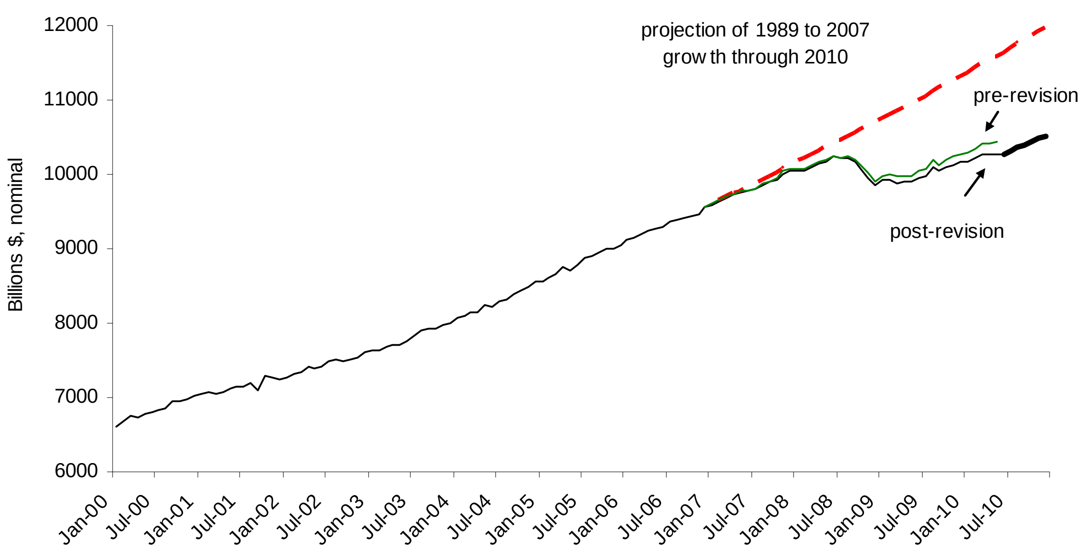
Income Stagnation

While personal income grew slightly in June from May, some key main street indicators fell. Wages and salaries were down 0.1% while proprietors' income, a measure of small business activity, fell 0.4%. Transfer payments made up for the losses, leaving personal income up slightly.

Consumption was down small in nominal terms and up small in real terms. We think moderate consumption growth will resume after the second-quarter soft-patch as Washington sustains its transfer payments (including the retroactive payments for unemployment insurance) and the labor environment improves gradually. Auto sales in July were above expectation, a positive trend we think will continue in the second half.

- Personal consumption in June fell $2.9 billion (less than 0.1%) to $10.275 trillion (nominal, annual rate). In the benchmark revision, PCE was revised lower by $156.1 billion. Current consumption trends leave consumption $1 trillion (annual rate) below the pre-Lehman trend.

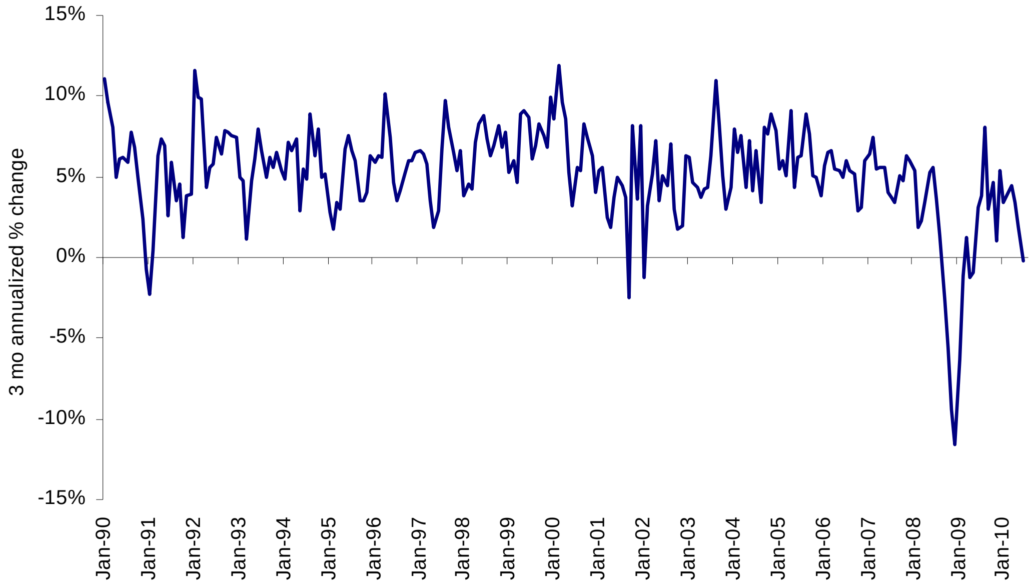
Nominal PCE (last obs. June 2010, broad line projects through Dec 2010)



Source: Bureau of Economic Analysis; Encima Global

- Consumption fell 0.0% in June from May in nominal terms, versus 0.1% growth in May and -0.1% in April. Three-month annualized growth is -0.2% nominal

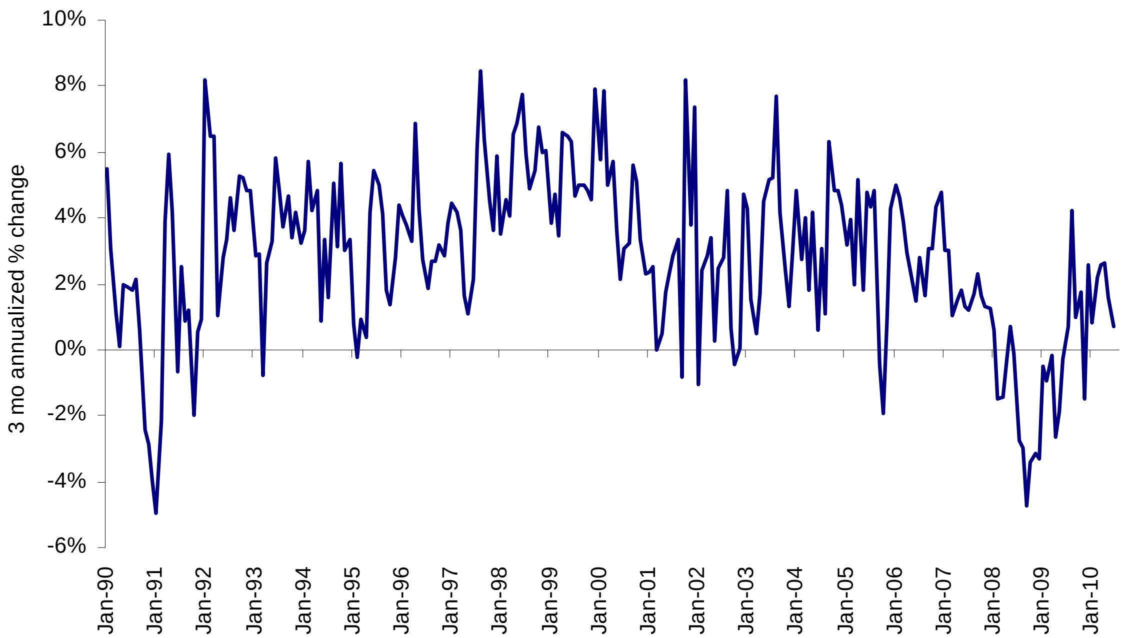
Nominal PCE (3 mo % change annualized, last obs. June 2010)



Source: Bureau of Economic Analysis; Encima Global

- Real PCE rose 0.1% in June from May and rose 0.7% annualized for the three months ending in June, well below expectations and below the growth at similar stages in previous recoveries.

Real PCE (3 mo % change annualized, last obs. June 2010)



Source: Bureau of Economic Analysis; Encima Global

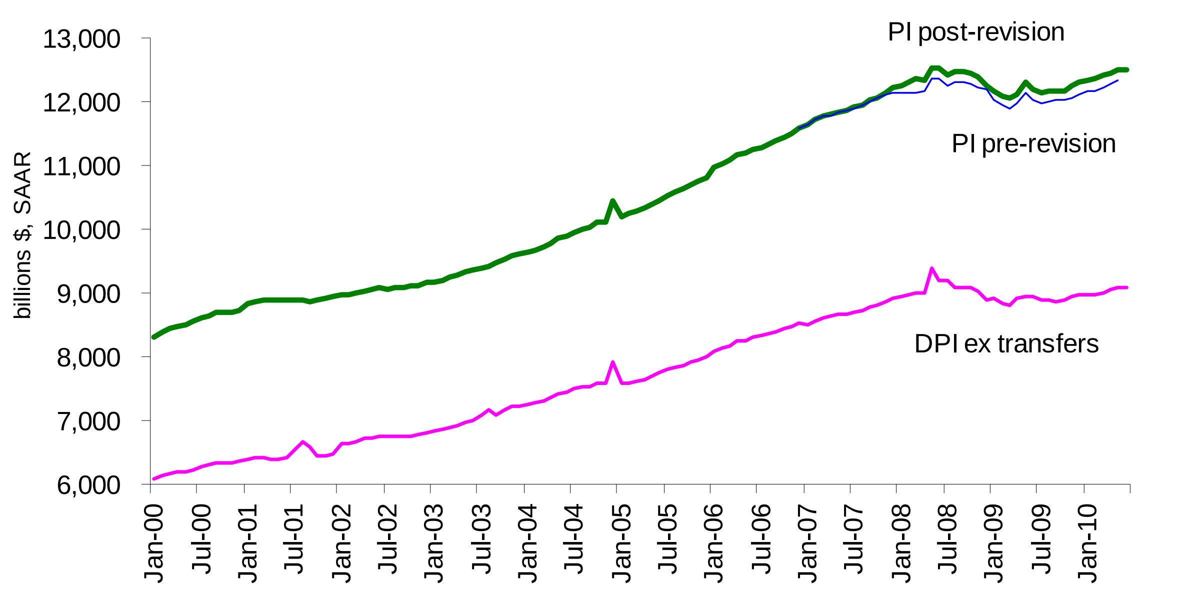
- We continue to expect “moderate growth from a lower base”. This is not a V-shaped recovery and leaves many businesses and governments underwater unless growth strengthens. Most recent indicators for small businesses, housing and the consumer continue to point to weakness, waiting for a better environment for small businesses in terms of bank lending, taxes and other Washington policies.

Personal Income

In June, personal income grew a mere $3.0 billion (less than 0.1%) to a $12.5 trillion annual rate. The benchmark revisions to the data added $160.7 billion but still leave personal income below the June 2008 peak (all data nominal terms) while consumption expenditures are above their previous peak.

- Personal income growth remains a weak spot in the transition from recovery to expansion, and has been disappointing especially given the massive federal transfers propping it up. We think weakness in small-business hiring, optimism and access to credit is a key part of the problem. The upward revision to the personal income data was largely due to a $160.6 billion increase in personal dividend income.
- Disposable personal income excluding transfers fell $2.1 billion in June and remains $317 billion below its 2008 peak.

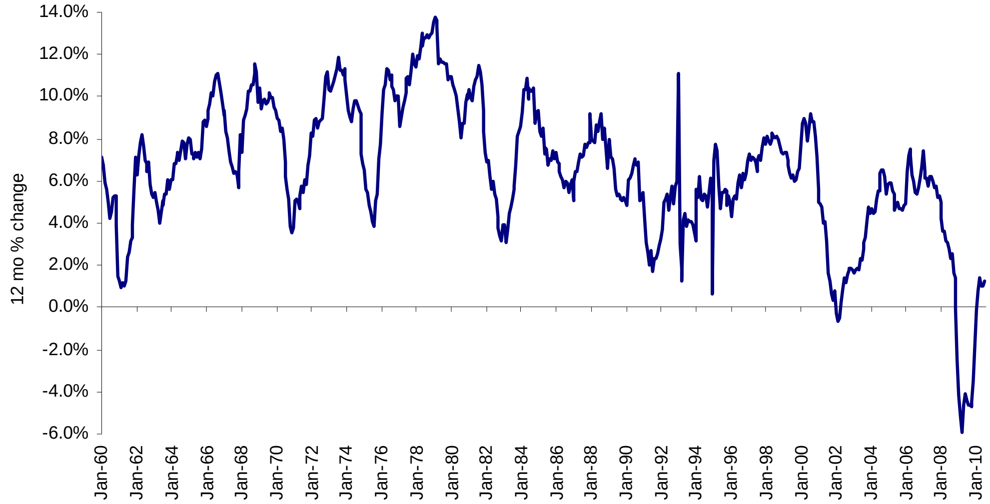
Personal Income and DPI ex Transfers (last obs. June 2010)



Source: Bureau of Economic Analysis; Encima Global

- The June data showed that income from wages and salaries (which don’t include transfer payments) fell 0.1% to $6.36 trillion annual rate. On a year over year basis, wage and salary income is now up 1.2%, having suffered a much deeper decline than in previous recessions. The stabilization in the year-over-year data reflects an improving employment situation from a reduced base, consistent with our outlook for a moderate expansion from the economy’s lower base.

Wages & Salaries (y/y change, last obs. June 2010)

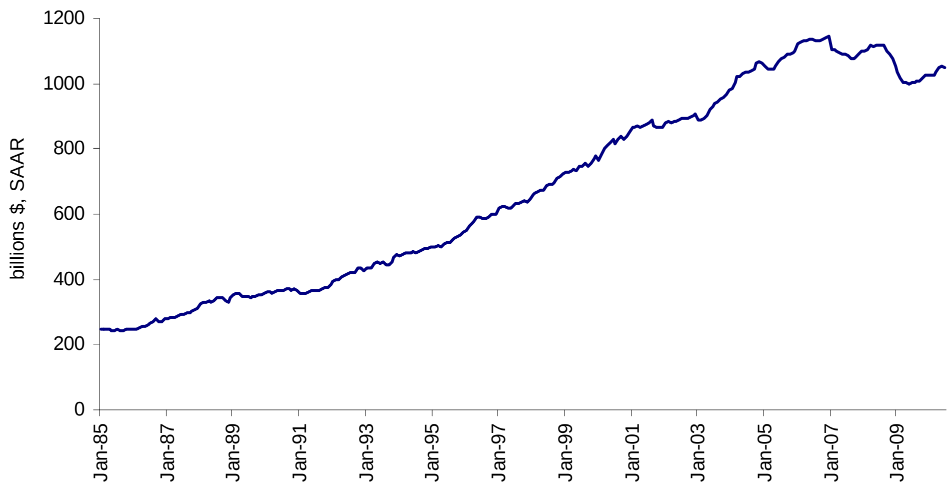


Source: Bureau of Economic Analysis; Encima Global

Small Business Income Fell and Was Revised Down

- Proprietors' income fell $4.4 billion or 0.4% to $1.05 trillion in June from May. On a year over year basis, it's up 4.6% but it is still down 8.7% from the peak in December 2006. Proprietors' income was revised downward by $36.0 billion in the benchmark revision (whereas the overall personal income data was revised up).

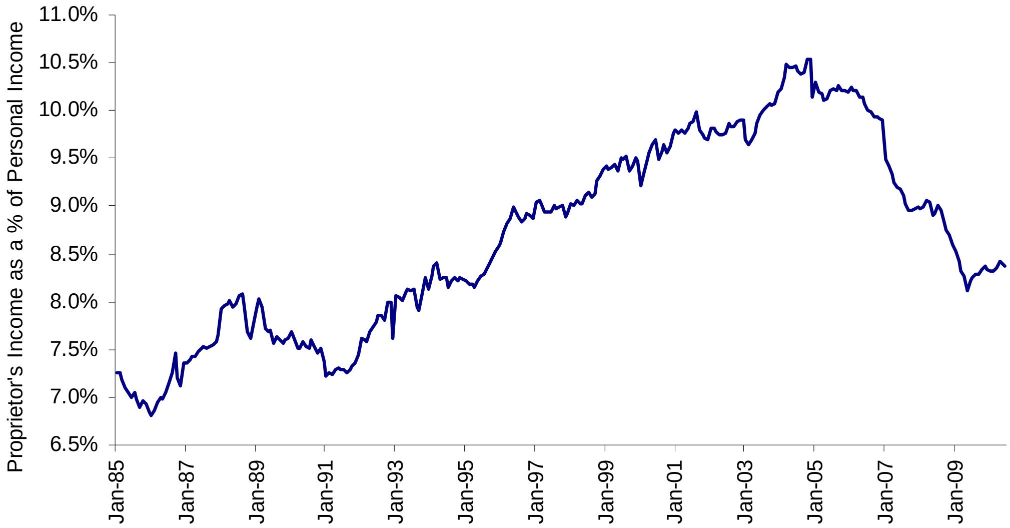
Proprietors' Income with IVA and CCAdj (billions, last obs. June 2010)



Source: Bureau of Economic Analysis; Encima Global

- While governments, big corporations and banks are doing well, small businesses have lost a major part of their share in the economy. As a percentage of personal income, proprietors' income stood at 8.4% in June, about the same proportion as in the 1990s. It had peaked in November 2005 at 10.5%. With the economy less dynamic as the federal government expands into new businesses, we expect a sustained expansion, but not enough strength to rapidly lower unemployment.

Proprietors' Income as a share of Personal Income (last obs. June 2010)

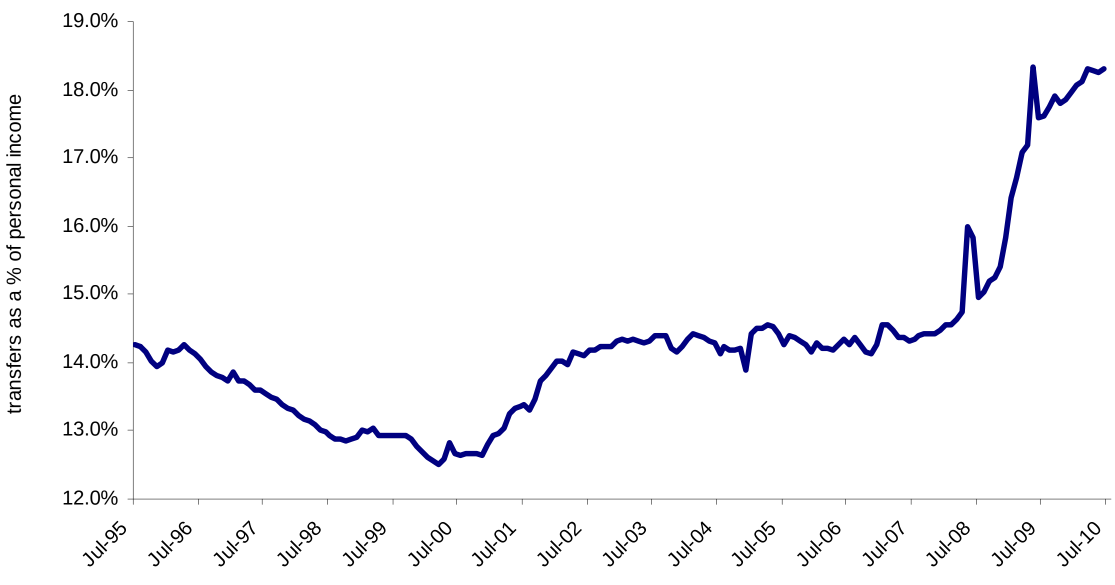


Source: Bureau of Economic Analysis; Encima Global

Transfers Support Personal Income and Savings

In June, transfers supplied $2.3 trillion (annual rate) or 18.3% of total personal income, matching the peak for this measure.

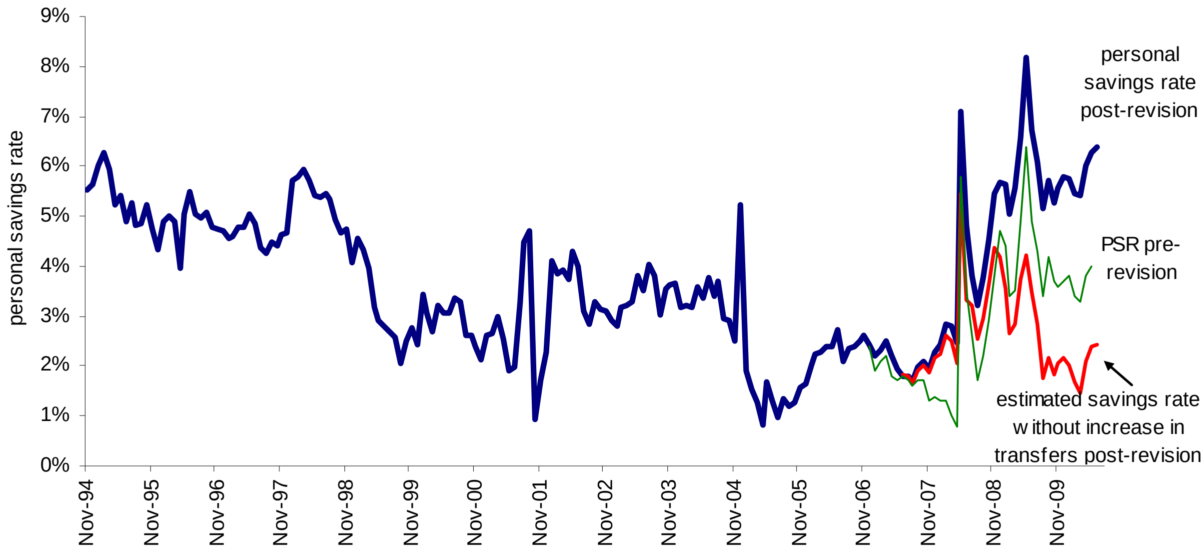
Transfers as a percentage of Personal Income (last obs. June 2010)



Source: Bureau of Economic Analysis; Encima Global

Before the revisions, the personal savings rate stood at 4.0% in May. With income revised upwards and consumption revised downwards, the personal savings rate was revised to 6.3% in May and rose to 6.4% in June. Without the increase in federal transfer payments since the end of 2007, however, we estimate the PSR in June would have been 2.4% using the revised benchmark.

Personal savings rate, excluding increase in transfers (last obs. June 2010)



Source: Bureau of Economic Analysis; Encima Global

- The upward revision to the dividend income (which helped the overall personal income figure and the savings rate) highlights one of the problems with the PSR calculation. The amount of private sector savings is the same whether the dividend is retained or paid out, but the personal savings rate is altered materially.
- As discussed in detail in our previous pieces, we note other problems with the PSR which make it unusable for economic purposes: it doesn't reflect the flow into savings nor can it be reconciled to the stock of savings (which the Fed correctly tracks in its savings data); it doesn't help predict consumption; it derives savings using a cash-basis measure of consumption (outlays from any source) and a narrower measure of income (excludes realized and unrealized capital gains and the inside buildup in pensions and 401ks.)
- We don't think the change in the official measure of the personal savings rate has significance in the outlook. It won't be picked up in the Fed's measures of actual savings and doesn't by itself point to a change in consumption trends (though the unemployment rate will have an impact.)
- Bottom line: income and consumption were weak in June, waiting for more jobs.