Picking a theme for these monthly meditations is usually straightforward. Out of the maelstrom of monthly news there usually emerges one dominant story – say gasoline prices, or Federal Reserve policy, or advances in space-based solar power (great progress with the advanced extension cords, but the issue of which independent system operator to join is a bear) – that sticks out as potentially most impactful on the economy and energy markets. Or is easiest to mock, either one. This month, however, it's like wading through the buffet at the Bellagio – so many choices, so little room to stuff it all in. In a normal month the budget deal and its implications would be the clear lead, but this month that story has to compete for top billing with the European financial crisis spinning out of control, the severe downshift in domestic economic growth and the implications of the recent S&P downgrade. We might not even have room to discuss an issue that most months would merit at least a paragraph; the prospect of Albert Haynesworth and Chad Ochocinco orbiting the sun (although inhabiting their own individual galaxies) as members of same team. But this month we'll just have to take a pass to discuss matters of greater import.

The budget deal that emerged from the last six months of Sturm und Drang brings to mind our favorite Winston Churchill quote: "Never have so many labored so mightily for such squat". The politicos did reach a tortured compromise that raises the debt ceiling by $2.1 trillion and cuts spending by $2.4 trillion over ten years. It comes in two installments: the first amounts to roughly $900 billion in cuts and debt ceiling increases that is designed to get us through November. By then, a bipartisan "supercomittee" (their word, not ours) has to come to agreement on the rest of the $1.5 billion in additional reductions or automatic, across the board budget cuts are triggered. Oh goody, another bipartisan commission to study the budget. The last bipartisan committee, the Simpson-Bowles Commission brought into being by President Obama, actually came up with a credible long-term plan to address the budget crisis through tax reform and measured spending reductions. But that was obviously too sensible a set of ideas and was promptly ignored by everybody, including the President. Instead, we now have a "supercommittee", which (it is rumored) will deliver its final report backed by a band playing the Mighty Mouse theme song ("Here we come to save the day…"). Washington may lack for competence, but hubris they've got by the boatload.

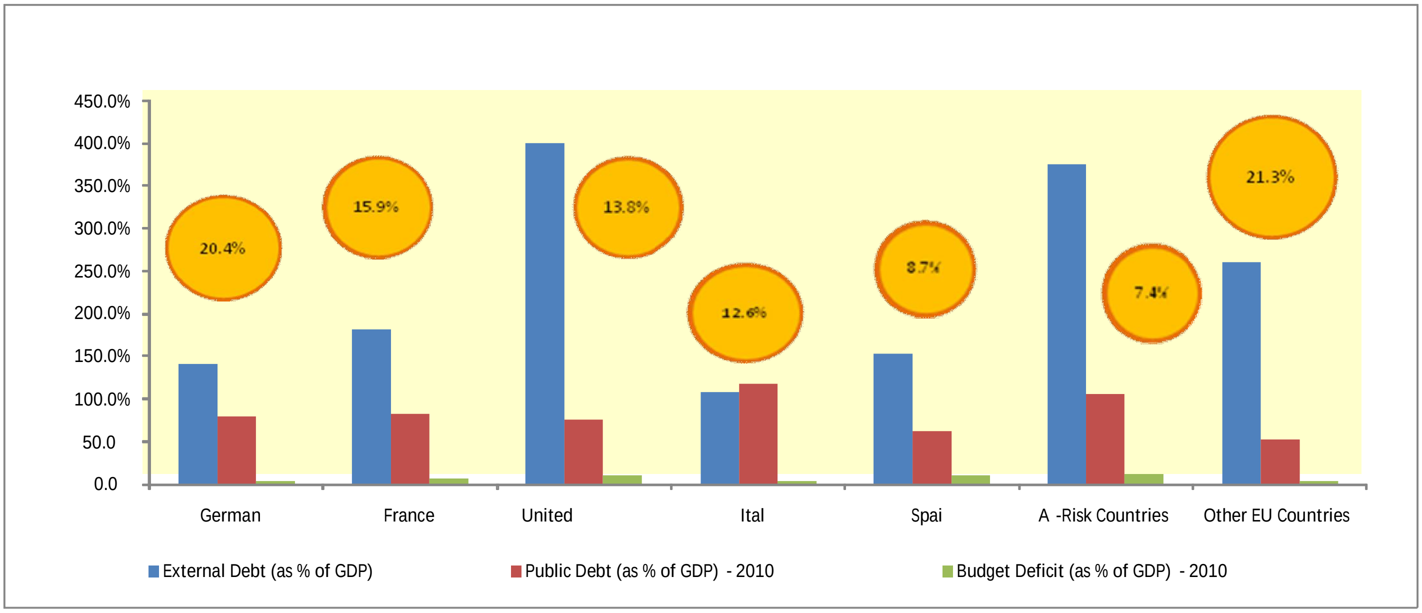
The deal averted the immediate dreaded specter of default (which nobody bought anyway), but does little to solve our long-term budget problems. It's not big enough and doesn't address the two elephants in the room: revenue shortfalls and the looming entitlements crisis. It is back loaded as all get out, with only $25 billion in spending cuts through 2012. This is not entirely a bad idea, because short-term spending cuts larger than that would impose additional fiscal drag on an economy that currently is exhibiting all the vigor of Abe Vigoda in a Snickers commercial. But unless structural reforms are made to programs and tax regimes it will be the easiest of things for future Congresses to ignore this budget blueprint. The tone in Washington has shifted, but we continue to await substance.

The budget deal obviously didn't impress the ratings agency S&P which quickly, and historically, reduced its rating on U.S. government debt for the first time from its vaunted AAA rating to AA+. The immediate practical impact of this move hasn't been substantive. The other two major ratings agencies, Moody's and Fitch, retained their AAA ratings. And everybody keeps treating U.S. debt as though it is the safest investment in the world, partly because it still is and partly because the alternative – complete financial chaos that would make 2008 look like a stroll in the park – isn't all that attractive. Interest rates were supposed to edge up a bit to reflect the increased perceived risk of U.S. assets, but exactly the opposite has occurred, as S&P's opinion has been trumped by more immediate fears about Europe's finances and the possibility of another global recession.

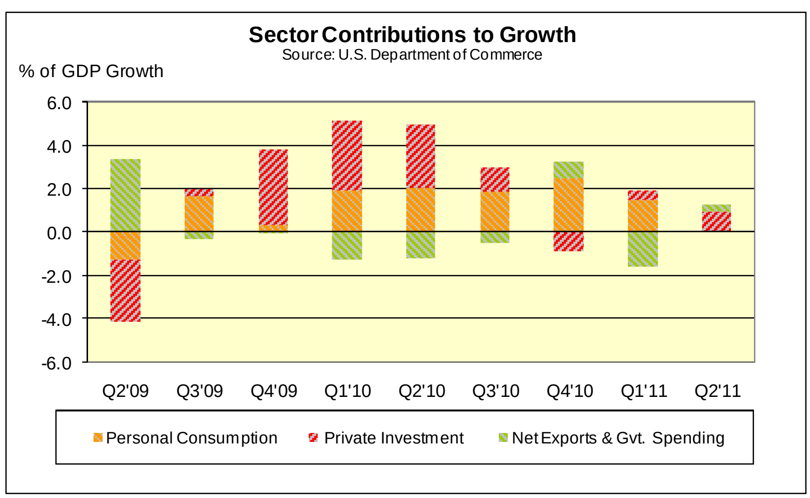
S&P has received a lot of flak for their decision, some of it deserved, some of it political nonsense. The reasoning behind the move was sound, though arguable – they wanted $4 trillion in cuts from the budget deal, which most analysts believe is the reduction necessary to bring the deficit down to "sustainable levels", i.e., deficits grow no faster than the long-term growth rate in the economy. And they did warn the warring parties of their intent to downgrade without a credible long-term deficit reduction plan being in place. This one clearly wasn't it, hence the downgrade, but the timing was dreadful. At the least they should have waited to make such a momentous decision until after the supercommittee has a chance to save the day (as the other two major rating agencies will). We think S&P was so stung by criticism that they were too slow to recognize risks in the sub-prime mortgage market during the last crisis that they decided it was better to get out ahead of the curve on this one. Time will tell if that was a prudent move, but right now it looks precipitate. S&P rushes in where Moody's fears to tread, so to speak. They also made a math error in their calculations which the Treasury Department caught before the final release. Now, if you are going to make a decision of this magnitude, don't you think somebody could have checked the math first? Anyone? Bueller?

If all this wasn't bad enough, the European debt crisis has popped back up in the continuing game of global financial crisis whack-a-mole. To update you, Greece has transitioned from being a problem child to a potential microcosm. The EU and the European Central Bank keep trotting out programs to help Greece successfully roll its debt, which helps paper over short-term liquidity problems but does nothing to solve long-term solvency concerns. Greece doesn't have the ability to manage its debt load no matter how many austerity programs are imposed, so continually piling on more debt hasn't been a long-term winning strategy. The EU finally did get a stabilization program in place to handle Greece and the other two problem children (Portugal and Ireland) that does include haircuts for creditors and more substantial subsidies from the adult countries in the EU. But the problem is not ending there, unfortunately, since the problem children represent the leading edge of an EU-wide set of structural problems. The EU as a whole has total external debt of around 260% of GDP, contrasting to the U.S. ratio of around 95%, although their annual government deficits are more under control (4.5% of GDP compared to the U.S. federal ratio of around 9%). Europe also has less room to address their budget deficit through tax hikes (our rates are lower) and defense spending (which they've already gutted). And unlike U.S. banks, which go into a potential crisis cycle well capitalized, European banks are generally thought to be short of the capital needed to weather rolling sovereign debt crises. Because individual countries no longer have control over their currency, it also hamstrings their flexibility in responding to regional crises. Greece would love to have solved their problems by trashing their currency but, alas, couldn't. This lack of flexibility aggravates regional tensions and eventually will likely need to be resolved, maybe through the demise of the Euro, maybe through closer fiscal union.

We know that's a lot of background blah blah, but here's the point: one of these days pretty soon the rolling financial crisis will impact a country or two that is large enough to matter and which is too large to bail out. When this occurs in earnest, look out below. What's spooking financial markets so much recently is the fear that we might be closer to that point than previously thought. In the week leading up to the S&P downgrade Spanish and Italian 10-year government bond yields were threatening to breech 6%, which is generally considered the point where real troubles begin for a country. U.S. ten-year bonds, in contrast, are currently yielding an almost unfathomable 2%. And Spain and Italy are big enough to matter, accounting for over 20% of the EU economy. (The bubbles in the following chart represent the relative sizes of the various national economies). The European Central Bank intervened to knock yields down by buying bonds in the open market, averting a reckoning for the moment. But it was into this rattled market that S&P dropped its bomb, accounting for much of the ensuing hullaballoo. Fund managers usually reflexively flee to U.S. treasury bonds in times of trouble as a safe haven, but those bonds had just been downgraded, so what to do? Buy them anyway, since there is only so much gold in the world, and both commodities and stocks are being hammered by fears of a global recession. Expect more volatility as this gets sorted out.

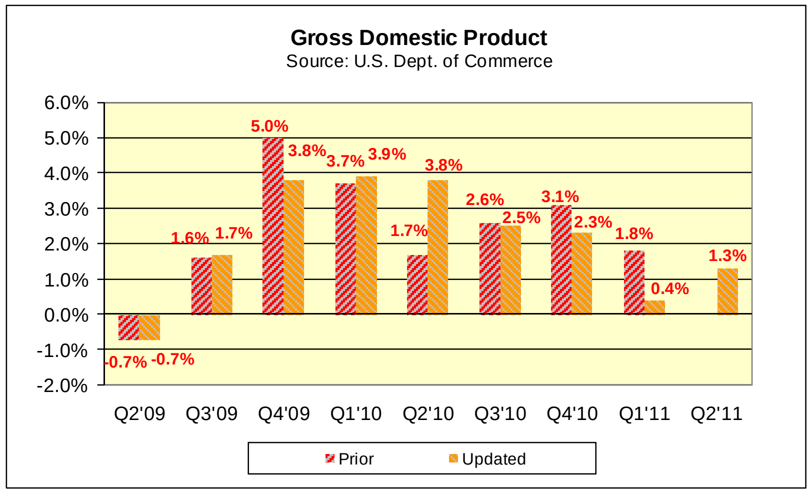


Even before all this financial excitement the U.S. economy's "soft patch" was threatening to morph into something conspicuously looking like another recession. The first read on Q2 gross domestic product growth, for example, arrived right about the time the budget circus was in full swing. Growth was predictably soft, at a 1.3% annual rate, but the report served as a serious confidence rattler for financial markets principally due to the unfortunate circumstances surrounding its birth, and also partly to suspicions that the 1.3% will eventually be revised lower. As we discussed last month, consumers battled



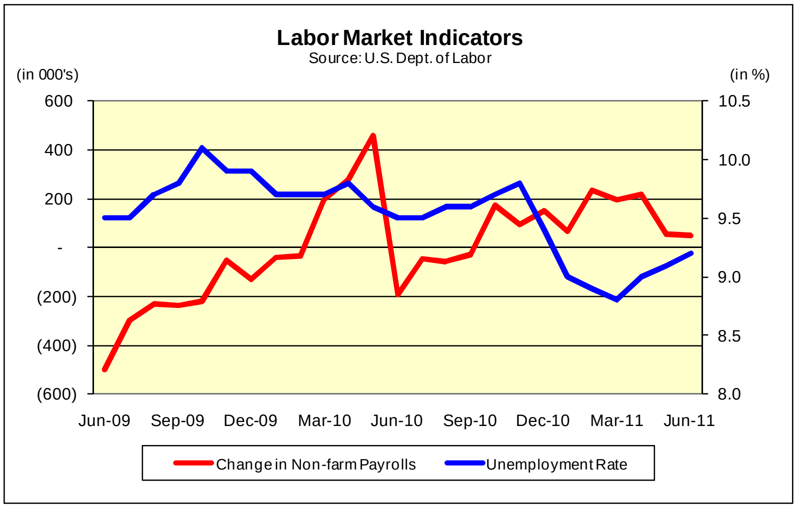
increases in food and energy prices during the quarter, as well as weak labor markets and doubts about the sanity of their elected leadership. So it wasn't a huge shock that personal consumption was essentially flat with prior quarter. Most elements of private investment continued to grow modestly during the quarter, but barely fast enough to overcome the sluggishness on the consumer side. Results also would have been a whole lot worse if we hadn't seen a large improvement in government spending from Q1 – the trend was still negative in Q2, mind you, just not quite as negative as the prior quarter.

July is also the month that the Bureau of Economic Analysis chooses to roll out its benchmark revisions to previous GDP reports. We believe that they choose July in hopes that everyone is on vacation and won't notice all the oopsies. But they weren't able to slip this one past anybody, and the results resulted in yet another bit of a tizzy. Probably more of a tizzy than justified by the magnitude of the changes, but folks are understandably in the mood for a tizzy these days.

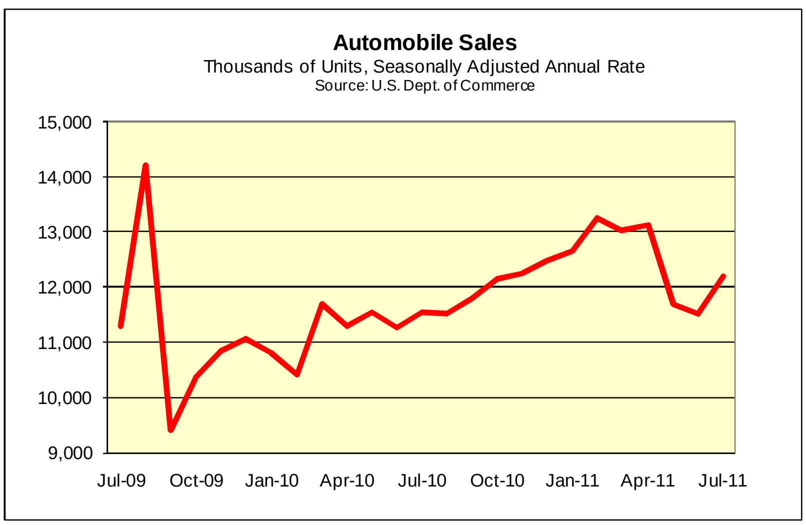


Growth during Q1, for example, was revised sharply downwards from a previously reported 1.8% growth to just 0.4%, implying that the big Spring slowdown in growth started earlier than originally thought. Nearly all of the decrease from the prior estimate, however, was the result of a large reduction in estimated inventories. So, in other words, businesses reacted quickly to signs of weakness in consumption by cutting both hiring and inventories, which isn't exactly breaking news. The drop in economic output during the depth of the financial crisis was also larger than first thought, about 1% deeper in 2009. Again, you wouldn't need a large feather to knock us over on that one. What was kind of interesting, however, was that growth during the first half of 2010 was more vigorous than previously thought, at just under 4%. This might have been useful news to the Federal Reserve at the time, because that was when they launched their grand plan to stimulate the economy with large scale bond purchases. Only instead of about 1.7% growth, which was the data they had available when making the decision, we actually were percolating along at close to 4%. This might explain why QE 2 didn't work so well: they were fighting a long-term structural problem – sluggish employment growth – with tools that are designed to solve short-term cyclical problems, and doing it at a time when the economy was actually growing relatively healthily. So all that additional cash ended up stoking inflation in food and commodities, eventually harming consumption growth instead of aiding it. The classic unintended consequence.

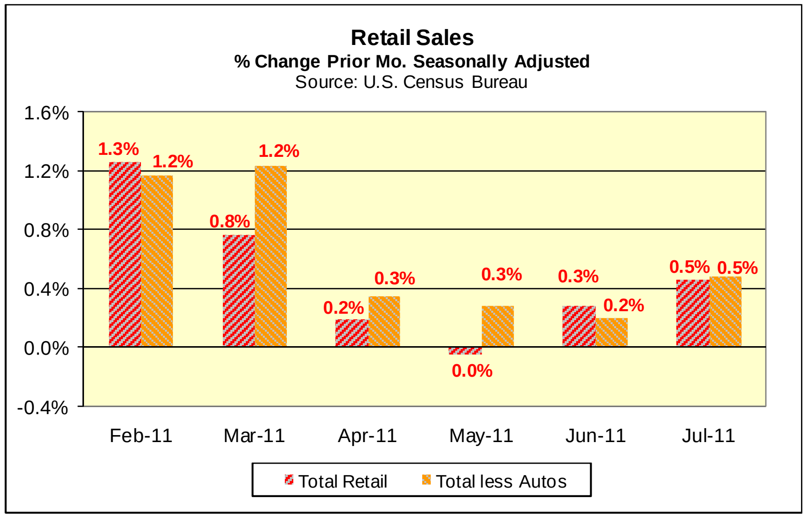
As good news goes, the latest monthly employment report is small beer. But compared to last month's disaster, and following on the depressing GDP report, we'll take it. Employment rose by 117,000 and the unemployment rate declined to 9.1%. Private sector employment increased by 154,000, offsetting continued travails in government, and the two prior months' job counts were revised upwards by a combined 56,000. The overall picture is of a labor market that has slowed to a crawl but has not stalled completely. This doesn't represent great progress, but does at least temporarily relieve fears that we are already in a recession. Sort of. One of the problems with the report is that the increase in jobs was entirely due to seasonal adjustment factors. This time of year we usually see a decline in employment as the traditional school year ends (teachers aren't counted as employed over the summer) and because auto and other durable goods factories typically furlough workers for summer maintenance turnarounds. There weren't as many teacher layoffs this year, however, because so many teachers were let go earlier in the year due to budget cuts. And many auto factories are cancelling their planned shutdowns because they shut down involuntarily earlier in the year due to parts shortages resulting from the Japanese natural disaster. As a result, the seasonal adjustments likely exaggerated labor market weakness in May and June and tempered it in July. Manufacturing employment, for example, rose from June to July by 35,000, seasonally adjusted, nearly all due to durable goods manufacturing. Non-seasonally adjusted, however, those numbers were essentially flat. We may see more of the same in August. Whether this amounts to any real progress in hiring, however, remains to be seen.



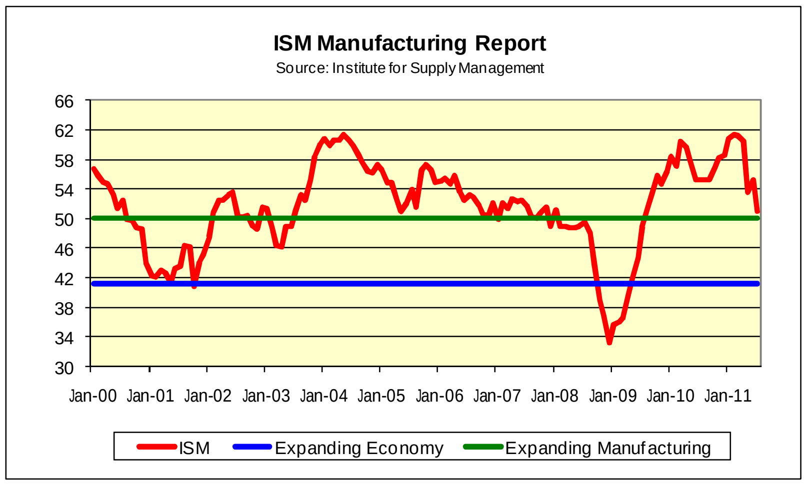
July retail and car sales also fall into the not bad, considering category. The annualized sales rate for cars popped 6% from June to a 12.2 million unit rate. Results at Toyota and Honda continue to be considerably hobbled by production disruptions following the Japanese disaster but should be back in gear within the next several months. Most of the other manufacturers posted decent results, but unit rates were still held down somewhat by low inventories and scaled back incentives. Retail sales generally benefited from lower gasoline prices (a trend that should continue in coming months) and rampant retailer discounting. A return to a more normal sales environment is likely to provide a significant boost to the overall economy by the end of



Q3 and into Q4, providing hope that we have managed to skip through the worst of the soft patch without actually having a recession.



The other piece of economic news that was a market mover (in a month chock full of them) was the Institute for Supply Management's manufacturing survey, which notched another month of sharp decline. This time the drop was from 55.3 to 50.9. Although still in growth territory, the manufacturing sector has clearly slowed from the solid gains seen early in the recovery, and does beggar the question of what sector will take the lead now. We do expect this index to improve in coming months, but we aren't likely to see a return to boisterous growth without some improvement in consumer demand, particularly for cars and housing. So it really all comes down to whether the consumer can rebound.



Interestingly, all this is coming down almost exactly a year after the Fed unveiled QE2 at its annual gathering of economic Pooh-Bahs in Jackson Hole Wyoming. How they are going to respond after this year's gabfest is the question of the day. Likely they will sit on their hands, because even ardent admirers of Fed action admit that another round of easy money isn't likely to do much good at present. But they also will be facing tremendous pressure to do something, anything by folks who are still having trouble grasping that policymakers in general are out of magic bullets, "supercommittee" notwithstanding. We'll just have to read about it in the press, like everyone else because, inexplicably, our invitation was lost in the mail *again*. Since we live in Texas, we figure it was in the same mail bag as Rick Perry's and Ron Paul's invitations.