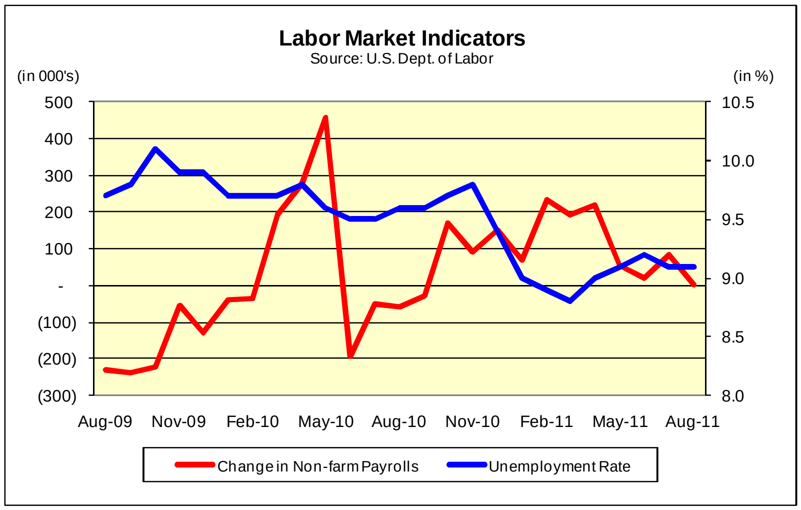
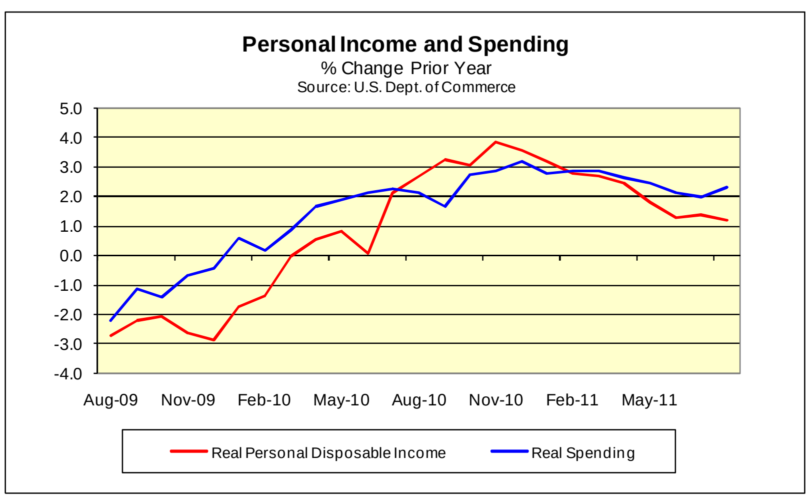
Entergy's Economic Trends Analysis – September 2011

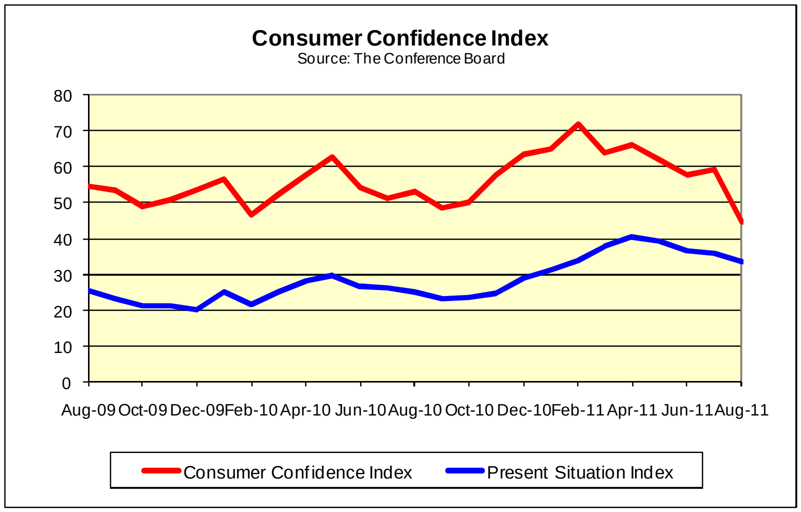
The economy continues flailing. On the positive side, the sundry "temporary" issues that started the economy on the road to perdition this spring – the spike in gas prices, the Japanese natural disaster, etc. – have largely abated, leading to stabilization in key economic indicators. On the other hand, stabilization at current levels isn't all that great an accomplishment. The Titanic, for example, did eventually stabilize after hitting the iceberg, but it was on the floor of the Atlantic Ocean by the time things settled down. We're not quite at that stage yet, but given the economy's current enfeebled condition it won't take much of a metaphorical iceberg to get there. There is just no cushion at all for any more nasty surprises. Unfortunately, the next nasty surprise is already looming in the form of the European debt crisis, which is transitioning to the "not if, but when" stage. If the Europeans can avoid a total train wreck, then it's possible that we'll be able to pull out of our stall and resume a more normal recovery. But the probability of another recession occurring over the next six to 12 months is clearly increasing – maybe as high as 50% – due primarily to Europe and secondarily to our own structural problems.

One of the most visible signs of the painfully slow pace of recovery has been the glacial rebound in jobs. August brought more so-so news on that score, with non-farm payrolls being unchanged from July. The government's fiscal crisis drove another big decrease in public sector positions, about 17,000, balanced by gains of the same magnitude in the private sector. There were a couple of mitigating factors, however, one being a strike at Verizon Communications that temporarily reduced employment by 45,000. Adding those workers back in, the gain in employment would have been in the same range as over the past several months, i.e., slow but positive. The second factor is that the other two surveys of employment that people look at – the "household" survey that is used to calculate the unemployment rate (which stayed constant at 9.1%) and the private sector ADP survey – were both considerably more positive than the "official" count. At any rate, we aren't seeing broad decreases in employment consistent with a recession as of yet, just little growth.

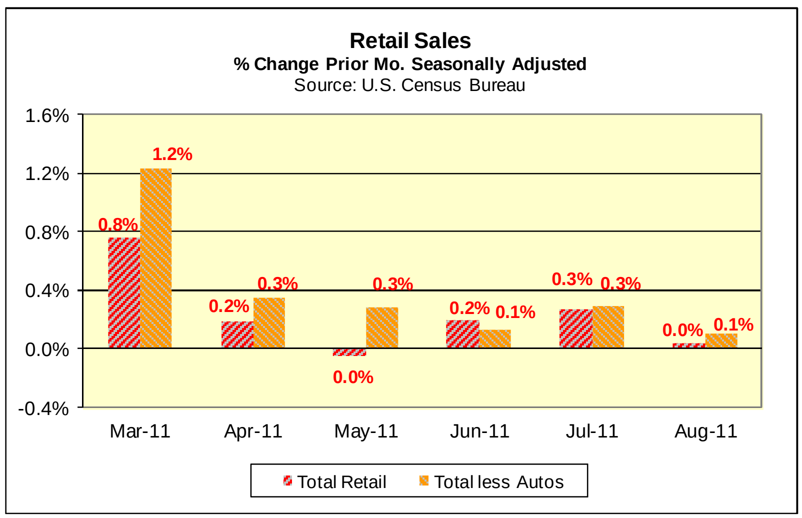




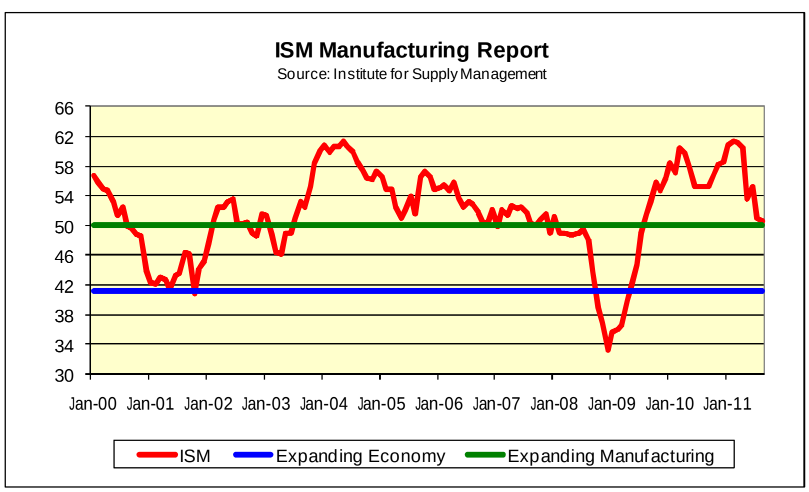
The sluggish job and income growth combined with higher food and energy prices earlier in the year to slow personal consumption growth to essentially a standstill from April to June. In July, however, real (inflation adjusted) consumption bounced 0.5% from prior month, partly due to the beginnings of a recovery in auto sales and partly due to a decent beginning to the back to school season (for retailers – not so much if you are a laid-off teacher). Whether this can be sustained is the question, especially in light of the damage that the debt ceiling debacle inflicted on consumer psyches. Consumer confidence, as measured by the Conference Board, plunged sharply in August to the lowest levels since the dark days of early 2009. We hope that would serve as a cautionary tale for the nimrods in D.C. to mind their manners as the economic policy debates continue, but that's probably a bit much to ask.



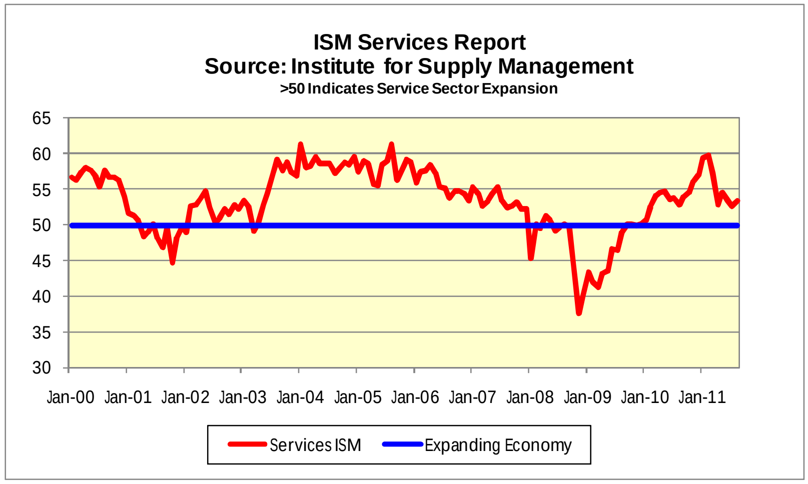
If consumers can shake those bad images from their minds (easy to say, hard to do – like trying to forget a car accident) it does seem like the worst of the damage wrought by the food and energy price surge is behind us and that consumption should improve as we head into the holiday season. That auto sales are doing better is encouraging given the continued (though lessening) inventory problems at Toyota and Honda. On the other side of the coin, the early retail sales report for August indicated a scant 0.1% increase in core (less autos) retail sales in nominal terms. Inflation adjusted, that's a decline. At least in August, consumers put their money where their mouth is and pulled back again on spending.



The latest Institute for Supply Management surveys indicate a continuation of slow growth. The manufacturing ISM dropped again in August from July, but (somewhat surprisingly) stayed north of the 50 mark indicating expansion in the sector. Similar declines in ISM indices are being reported around the globe from virtually all our major trading partners, including



heretofore booming India and China, signaling that the long-running export boom for U.S. manufacturers may soon decelerate. In another surprise, the service sector ISM actually rose in August and has been higher than the manufacturing ISM each of the past two months. We'd try to convince you that this heralds the long-awaited passing of the growth torch from the manufacturing to the much larger services sector, but we don't like to insult your intelligence. Let's just say that it is good news they both are still over 50 and leave it at that.

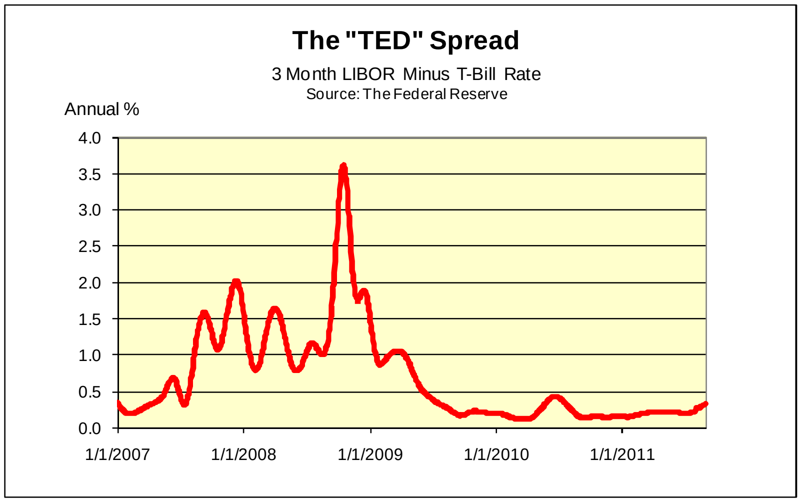


On to Europe. The Greek bailout that was the centerpiece of the European plan to postpone cleaning the financial skeletons out of the Euro zone closet until a more propitious time (i.e., when the current crop of politicians are out of office long enough so they can claim it wasn't their fault) is in trouble again. This time it's because Finland, one of the tidy, well-run but slightly self-righteous countries from the northern tier insisted on getting more collateral before they would chip in for their share of the bailout funds. Two things about this turn of events: 1) who knew Finland had that much clout? It'd like finding out that Vanderbilt is calling the shots in the SEC, and 2) much as we empathize with the desire of the Finns not to get stiffed (the Greeks don't always keep the promises they make when these rescue packages are announced) we'd like to humbly point out that if the Greeks had the collateral in the first place they wouldn't need the stinking bailout. The Greek economy is in such bad shape that they actually import a large percentage of their baklava (a key food staple) from Turkey, a country with which they've had some words down through the years. To put it in perspective, that would be like the U.S. having to import all its clothing from a Communist country. Okay, maybe that's not a great analogy but the point is that Greece is in a world of hurt and it's not getting better with time.

As investors look more closely at Europe's financial situation in general, especially the capital adequacy of the banking system as larger problem children like Spain, Italy and now, believe it or not, France, inch closer to crisis, the less they like what they see. The latest chapter in the long running saga had the Federal Reserve and the central banks of Europe announcing a joint plan to provide dollar liquidity to European banks that are having trouble accessing U.S. money markets. European banks do a lot of lending in dollars to multi-nationals and they generally fund these operations through U.S. financial institutions. The fact that these institutions are refusing to lend to the European banks is frighteningly reminiscent of the beginning stages of the 2008 financial crisis, just substitute "BNP Paribas" for "Bear Stearns" and "Greek debt" for "mortgage backed securities" and the stories are already written. And, just like 2007 and 2008, the policy response has been to slap on a series of band aids and hope the problem goes away. Didn't work then, won't work now.

As we discussed last month, there are three ways out of this mess: 1) the Euro zone moves to more closely integrate their economies and government fiscal policies to create a sort of United States of

Europe, 2) some of the weaker sisters are ejected from the Euro zone, but the core remains intact, or 3) the whole thing blows up and each country goes back to having its own currency. The first alternative is infinitely preferable to either the second or the third, but there does not appear to be any political consensus for getting it done. And it doesn't look like we can avoid a calamity of some kind at this point anyway; it's just a matter of how big and how soon. Until recently, it seemed that the break point was far into the future. Now it's looking imminent. Funny about history – it tends to happen when you least expect it. The fall of the Berlin Wall, for example, was triggered by an off-hand remark by a mid-level East German government flunky who said at a press conference that he thought the border crossings in Berlin were open. Well, they were, permanently, after he opened his yap. Similarly, this crisis has been moving along faster and more unpredictably than most observers thought possible even a few months ago.



For right now, most of the damage has been confined to the equity markets. Bond yields have actually been stable or decreasing due to flight to quality buying of U.S. government treasuries, despite the recent S&P downgrade. Risk spreads of other instruments such as corporate bonds and mortgages have also been stable, we think because liquidity remains ample due to continuing central bank accommodation. The Federal Reserve is pondering its next move domestically if conditions continue to deteriorate, although another big bond buying binge is not likely. What they may try to do instead is to purchase bonds of longer durations while selling bonds at the shorter end, in an attempt to influence market-based rates for business and mortgage loans lower without providing any new net stimulus. We aren't going to go into a long dissertation on why we think this is nuts other than to say that it's been tried once, back in the 1960's. They called it Operation Twist, we believe to reflect the status of their knickers at the time. Didn't work then, won't work now. Fundamentally, does anybody think that mortgage rates that are currently a little over 4% are really our biggest problem? The fact they are considering pulling out a failed, obscure strategy is indicative of how desperate policymakers are becoming over the continued malaise. Operation Twist indeed.