

February 9, 2010

MONTHLY SUMMARY FOR JANUARY¹
JOB LOSSES EVEN GREATER THAN REPORTED;
BUT WE ARE BEGINNING TO CLIMB OUT OF THE HOLE

First the bad news. That 7.2 million lost jobs during the recession was really 8.4 million. Worse news is that the error was caused by estimates on the births and deaths of corporations. (Employment is based upon a sample except for one month, when a full counting is done. Because failed companies no longer report while new companies do not need to report until the end of their first year, responses naturally fall during the year. It is necessary for the Department of Labor to guess what is happening to the births and deaths of firms to make their estimates. During such dramatic liquidity constraints as the economy currently is suffering, fewer firms are birthing, so the estimating technique over-compensates for those failing and no longer reporting. When the full count is made, the errors are rectified, so that is why such large revisions sometimes occur.) The reason why this is worse is because we may still be overstating jobs. Thus, another downward revision is likely when we make the full count for this year (which will be released early next year).

However, the recent rates of change in jobs are less likely to be seriously in error, at least for recent reports. Thus, the employment growth in November may persist and the small decline in January may stay a small decline. Still, we might eventually discover that this Great Recession destroyed 9 million jobs before the counting is finalized.

So where is the good news? Job destruction is virtually over. We did lose another 20k jobs in January, but that was because weather (and some financial strain) destroyed another 75k jobs in construction. Manufacturing jobs rose, though most of that was in auto assembly. We did have 9,000 Census workers hired during the month. That number will surge to nearly a quarter million by April before causing declines until Census jobs are near zero by the end of the year. As these workers probably are temporarily re-entering

the workforce, the impact of the Census upon unemployment may be minimal. However, the psychological impact of reporting job growth could be substantial.

Even the construction cutbacks are nearing an end. Some further declines are likely, but the greatest financial constraint upon that sector already is upon us. Commercial and industrial loans continue to decline, but more banks are beginning to make offers for loan business at reasonable rates and conditions. (However, a large number of loans remain subject to downward appraisals that lead to classification of performing loans. Those loans continue to suffer from refinancing lock out.)

Of course, auto assembly cannot carry manufacturing every month (they added 23k this past month). More sectors are shedding jobs than adding them, but the diffusion index is 46.8 percent, the same level as in November, when jobs increased. Employment agency jobs grew a solid 52k while the workweek increased. The manufacturing workweek extended by 0.3 hours, which will add to the leading indicators. In short, the underlying employment indicators were strong with hours worked rising and wages growing sufficiently to suggest that real earnings will rise in January.

I am not suggesting that these gains in purchasing power will be quickly spent. The savings rate in December was 4.8%, still not sufficient to provide enough asset growth to sustain current spending patterns. The nearly 6% drop in stock values since the year began probably justifies savings rates approaching 7% before balance can be achieved. Indeed, the drop in auto sales (mostly because of the Toyota recall) probably means that little growth occurred in consumer expenditures despite the gains in real income. Nevertheless, that would push savings rates to just over

¹ The Monthly Summary is prepared by Dr. Donald Ratajczak, PhD., Morgan Keegan's Consulting Economist. Additionally, this report is a transcript of comments made by Dr. Ratajczak and should be read in that context. Additional Information Is Available Upon Request.

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5%, which is not yet sufficient to restore historical rates of consumer growth.

Notice, however, that any near term weakness is now the result of weather and auto recalls, not liquidity constraints and job losses. When those problems vanish, growth will be sufficient to create some jobs. The technology industry already is reporting a substantial increase in job openings. Some of the business and health services also are beginning to seek more employees. There is not yet a rush of new job openings, but the labor climate clearly is improving.

Not all problems have been resolved. While the contributions to loan provisions appear to have peaked, many banks still are not internally adding to capital. Two problems still overhang the financial markets: commercial real estate and sovereign debt. Neither is as large as the housing debacle, but both need to be resolved. Furthermore, substantial credit default swaps have been written against the sovereign debts, which might mean another round of asset selling if defaults surface. (There are far fewer credit default swaps against commercial real estate, so the transmission mechanism for spreading and intensifying financial sickness is not that substantial for that real estate.)

While sovereign debt has the greatest potential for financial damage, temporary solution patches are readily available if anyone wishes to use them. As we are seeing in Greece, the deficits can only be brought down to reasonable rates through budget trimming. Yet, such trimming has serious political impact. Clearly, some external bully (shall we say the IMF, or what euroland's discipline equivalent to the IMF can be) needs to intervene. The carrot would be low cost loans to moderate the external fund raising of Greece. The stick would be removal from the euro and loan default if certain budget goals are not attained. Thus, the surging interest burden that Greece (and other countries) currently faces can be alleviated while the politicians can point to the external bully for the necessary budgetary discipline.

Because of the capital raising done by many financial institutions, the default of any individual country's sovereign debt should not bring about another financial crisis. Of course, if all the weak links in euroland collapse (Portugal, Italy, Ireland and Spain along with Greece) the reverberations would be dramatic.

At the same time, the BRIC countries have suffered large equity declines while the sovereign debt issue has swirled. Certainly, Brazil is tied to Portugal, but Brazil's debt was recently elevated in credit worthiness. Nevertheless, a full blown correction has developed in those equities. China and India to a lesser extent also have suffered from the sovereign debt problem. Indeed, investors seem to believe that bad financial

stewardship is likely. (Is that another indictment of Trichet's management of the ECB?) I would not make the same assumption, but I cannot rule out the worst from happening on sovereign debt.

I believe I can dismiss the worries about commercial real estate. Of course, job losses will not fill workplaces. Inventory cutbacks do not require warehouses. Consumer restraint requires very little growth in retail space. An extra 1.5 million vacant houses do not support more apartment construction. Though businesses are beginning to spend again, that 13.3% annualized gain in equipment and software spending in the fourth quarter was impressive, even hotel occupancy will take some time to increase enough to support higher room rates. In short, virtually every appraisal of existing property will be slashed from what previous appraisals showed.

Regulators still are concerned about collateral (the problem that got us into this mess and now is keeping us from getting out of it). The appraisals raise the LTVs (loan to value) of commercial loans. However, many of these properties have sufficient cash flow to meet their notes. By classifying such loans because of lower collateral values, loans become too expensive to support commercial real estate transactions except at deep discounts. This might provide opportunity for vulture investors, but it does not help to improve the health of commercial real estate.

So why am I not so worried about commercial real estate. Nearly all those loans have been reappraised and regulators already have decided whether classifications are appropriate. This explains the continuing large provisions to the loan loss reserves. However, even with such regulatory scrutiny, those loan loss provisions appear to be moderating. No one is saying that some downside surprises will not emerge, but the recapitalization, which was required with the mortgage fiasco, is much less likely with commercial real estate.

Indeed, the financial stress has shifted from U.S. banks to European banks. On the surface, their exposure to sovereign debt is manageable. However, credit default swap payouts might undermine other asset values (including those held by U.S. banks), leading to another asset selloff. As I stated, such defaults do not need to happen and should not be allowed to happen in this environment. But we also know that Lehman should not have been permitted to fail, but it did; and the job losses, that probably would have been no higher than 3 million, ballooned to almost 9 million as I expect will be shown when the next employment revision is made.

CREDIT MARKETS

Because of the problems with some euroland countries, the dollar once again has become the default currency. In about six weeks, the dollar has gained almost 10% against the Euro and Pound. It has gained very little against the Yen, but has increased about 3% against the loonie. Talk about removing the dollar as a reserve currency has virtually died. Even the Chinese have become quiet when they learned that about a third of last year's gains in foreign exchange were caused by dollar related capital gains. Not surprisingly, international investors are more willing to send their savings to the U.S. at the very low interest rates that we currently offer. I am expecting the dollar to begin losing value in the spring, but not as much as originally expected. While some dollar slippage is likely if European policy turns more restrictive before we do, the euro problem may prevent early adjustments by their central banks.

Thus, strong international flows at prevailing rates are likely through the summer and then only grudging withdrawals are expected into next year. This is a change from previous assessments and means that longer term rates can remain relatively low well into next year.

The biggest shift will be in the corporate sector, as corporations will begin adding inventories even as profit margins show only moderate increases. In the past year, corporations have added about \$300 billion to their cash positions, but already show signs of wanting to invest some of those funds in their businesses. The surge in equipment and software spending in the fourth quarters suggests that some spending increases are likely even without considering the shift from liquidation to restocking in inventories.

Of course, I expect profit growth to remain relatively strong, though probably at a somewhat slower rate of growth than in recent quarters. Thus, with stronger gains in spending and slower growth in internally generated cash flow, corporations will not provide anywhere near the same amount to credit markets this year. They may actually be a net user of credit by the middle of next year. Thus, a shift from a \$300 billion contributor to a user of funds by the middle of next year will have a significant impact upon interest rates.

To be sure, the international flows could intensify and compensate for that reduction. I believe, however, that international flows are currently very strong and will ease, unless our trade deficits narrow significantly. Unfortunately, that is not likely, as the dollar now is stronger than had been anticipated against most countries. Therefore, the benefits from export will be less dramatic than expected a few months ago, though some benefits clearly will persist. (We remain very competitive in Japan, but have lost about half the

competitive edge in Europe that we had as the year began.)

Certainly, the household sector could make up the difference that will be vacated by the corporate sector, but if too much is provided by households, we will not have the spending growth needed to encourage corporate spending. My guess is that the savings rate will rise to 6-7% sometime next year. At the upper end, that would provide whatever the corporate sector is shedding. My guess is that slightly less than that will be provided, leading to upward pressures on interest rates.

Then there is the government. State and local governments have exhausted their "rainy day" funds. Their revenues have not yet improved. Thus, further cutbacks are likely. Moreover, the revenue problems are so severe that even matching programs with the federal government may be under-funded. I see no relief until the next fiscal year (second half of next year). By spending little more than the inflow of cash, state and local governments will be using fewer funds than they have in the past year or so, but only about \$50 billion less.

The federal government continues to estimate that they will use more funds, about a quarter trillion more, than last year. Unless those international flows remain strong, rates will rise late this year and well into next year. Of course, the policy rate will rise early next year, which will relieve some of the steepness of the yield curve. In the meantime, the yield curve could easily climb to 320 basis points for treasuries (between the 2 and 10 year issues). When policy rates begin rising, the pressure on that curve will ease. While I expect the long rate to continue rising, I might be overstating the rate of increase in the absence of rising inflationary pressures. (Notice that I have put some additional inflation into the forecast, but much of that is the result of higher commodity prices when the dollar finally stabilizes. Any significant gains in core inflation are not likely until capacity utilization is significantly higher than the current 72%.)

EQUITY MARKETS

After a dramatic surge in values, including an additional 2.4% in the first week of the new year, stock values have been clobbered by sovereign debt concerns and disappointment with some technology companies (Apple and Motorola come to mind). At this writing, a nearly 10% correction has been achieved from that initial week's peak. Emerging markets have corrected between 15 and 20% while technology also has corrected by more than 10%. In short, the typical range of a correction during a bull market has been exceeded.

Of course, nothing is truly typical in stock market performances. If the sovereign debt problem is a greater threat to financial structures than I expect, a

more serious decline is possible. Of course, that would mean my forecasted recovery could not happen. I am not yet willing to rule out this result, but continue to believe it is relatively unlikely.

After that initial week, every major sector of the S&P declined. Telecommunications services showed the largest weakness, continuing a string of monthly underperformances. Investors clearly believe that the near monopoly conditions enjoyed by these services are being undermined by new technology. If so, this group may not recover. Jobs continued to decline in this segment and few companies were ordering additional equipment.

The next greatest weakness by sector was materials. This was one of the hot sectors last year as investors believed China would again exhaust available stocks of materials. The deep recession and China's decision to slow its growth undermined that belief. Also, the dollar's rally meant that commodities, which are priced in dollars, already are becoming more expensive in most of the world.

Information technology, which led the upturn, stumbled badly early in the correction. The announced hiring needs partially moderated their sell-off and I still believe they will regain leadership. However, the sector is almost 19% of the S&P by value and must have limited upside (they account for less than 5% of earnings at this time).

While no sector experienced gains, healthcare and industrials showed minimal declines. Uncertainty has restrained healthcare values for much of the last few months. The worst fears of that sector have been eased with the election in Massachusetts and I would expect some leadership to develop in this sector.

The industrials suggest that the upturn remains likely. This is one of the indicators that suggest this is a correction rather than an end to the bull run (which now would be in a continuing bear market). At some point, the industrials will fade (they normally lead up and down soon after cyclical changes if not before). Until they do, I will expect further gains in the overall market even if corrections become more noticeable.

While small caps have lagged in this correction (they normally do), I would expect them to grow strongly when the upturn resumes. Notice that my model continues to maintain a significant valuation gap. This means the upside potential is greater than the downside risk at prevailing values (if my forecasts are correct). I am assuming that such favorable conditions will change, especially after policy interest rates begin to climb, but they will not prevent further strong gains from being achieved in stock market values. I actually raised

my projections for next year because of the stronger profits that I now anticipate for the corporate sector.

In summary, this is a correction that is nearing an end, unless the sovereign debt issue is terribly mismanaged. Anything that provides a temporary solution to those debt issues would provide a forceful rallying point for the markets.

MORGAN KEEGAN UNIVERSE

As the correction unfolded, small cap stocks were put on the shelf and large stocks received more attention. The Dow Jones did less bad than the S&P, which was falling more slowly than NASDAQ. Not surprisingly, real estate fell harder than other sectors.

Very few of the MK segments were able to sustain increasing values early in February. However, the double digit gains for regional banks largely were preserved. Communications components actually added slightly to their January gains as did restaurants. No other sectors were ahead for the year to date.

Transportation was uniformly weak, though air freight nearly matched the average losses for the MK universe. LTL trucking showed the largest declines, as the anticipated removal of some capacity through bankruptcy did not occur. Railroads also were weak, which should have been expected because of falling commodity prices. Given the rocky start to transportation, most of these issues are fairly priced, though the LTL may have over-adjusted to the disappointing capacity news. Just as I found some solace in the small declines in industrials, I am a bit concerned about the failure of transportation to show gains.

Our technology was more mixed than in the overall market and some of the group, such as the communications equipment and technology and the system area networks nearly held their value. Semiconductors were slammed and transaction processing also lagged. None of our technology segments appear to be overpriced based upon our earnings projections.

The REITs were slightly less than market performers, which is where I believe they will stay, whether medical or traditional, for much of the year.

Our industrials did not do quite as well as in the overall market, but our profit projections suggest that opportunities may exist in some of these companies. I still believe residential building products are do for some advance despite their January weakness.

Security and safety did better than the market and are expected to show modest earnings growth. This is a

market performing sector, but with some potential in a few issues.

With the struggles in Obamacare, the previously favored technology in healthcare have lost luster (and are overpriced as a group in my opinion) while the services are bargains if earnings continue improving, as we anticipate. Medical devices also appear to be reasonably priced and should not be included in the information technology that has lost support so far this year.

The regional banks had a great January, but gave back some of those gains early in February. Our profit projections are discouraging, but I must believe they will earn more than we anticipate. If not, the selloff was justified.

The lowest priced earnings we offer are in specialty services. Unfortunately, the expected erosion of profits suggests that some discounting is justified (though I think the discounts are overdone).

Oil is now trading at the low end of its trading range. I believe it will recover modestly as floating inventory

continues to decline. Also, weather conditions have removed some of the excess storage of natural gas. This could open opportunities for oil service companies later in the year. However, a strong dollar and speculative holdings suggest that little upside is likely until we see what the summer weather is.

Finally, our consumer stocks are not expected to show strong profit gains, except in our special situations. If those profits materialize, the special situations could provide some significant gains. Our profit estimates suggest that specialty retailing will be a market performer, although there always are some outliers in this group. While the earnings for restaurants are stabilizing, they are not growing. Until jobs materialize, they will be marginal performers (but jobs are beginning to materialize).

Until the correction ends, the MK universe will underperform the market. However, if we are nearing an end to this correction, as I believe, then the MK universe will be the place to be. Prudence says wait until we have built a solid foundation for a leap ahead.

Current forecasts for several key economic variables are shown below (they reflect the chain weighted measures of GDP):

	2009		2010				2011				Ann.	Ann.	Ann.	Ann.
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2008	2009	2010	2011
Real GDP	2.2	5.7	3.1	2.8	1.5	3.2	4.1	4.3	4.7	4.3	0.4	-2.4	2.6	3.8
GDP Deflator	0.4	0.6	1.7	1.9	1.8	2.3	2.4	2.5	2.5	2.6	2.1	1.2	1.6	2.3
Nominal GDP	2.6	6.4	4.8	4.7	4.0	5.0	6.2	6.8	7.4	7.2	2.6	-1.3	4.4	6.3
CPI-U (annual rate)	3.6	3.5	2.5	2.8	2.6	2.7	3.0	2.9	3.1	3.3	3.8	-0.4	3.0	3.1
91-Day Bills	0.2	0.0	0.1	0.1	0.1	0.3	0.7	1.2	1.6	2.1	1.5	0.2	0.2	1.4
Prime Rate	3.3	3.3	3.3	3.3	3.3	3.5	4.2	4.9	5.3	5.5	5.1	3.3	3.3	5.0
Federal Funds	0.2	0.1	0.1	0.1	0.2	0.5	1.2	1.9	2.3	2.5	1.9	0.2	0.2	2.0
2-Yr Note	1.0	0.9	0.9	0.8	0.9	1.1	1.7	2.1	2.5	2.8	1.9	1.0	0.9	2.3
5-Yr Note	2.5	2.3	2.5	2.3	2.4	2.6	2.8	3.3	3.5	3.9	2.8	2.2	2.5	3.4
10-Yr Note	3.5	3.4	3.7	3.7	3.8	4.0	4.4	4.6	4.8	5.0	3.7	3.3	3.8	4.7
LT-Average	4.3	4.4	4.6	4.6	4.7	4.9	5.2	5.4	5.6	5.8	4.3	4.1	4.7	5.5
Aaa	5.3	5.2	5.3	5.4	5.5	5.8	6.0	6.3	6.5	6.7	5.6	5.3	5.5	6.4
Baa	6.7	6.4	6.3	6.4	6.6	6.8	7.0	7.3	7.4	7.7	7.5	7.3	6.5	7.4
Corporate Profits (\$bil)	1174	1259	1298	1334	1358	1408	1451	1502	1551	1611	1171	1111	1350	1529
Operating Profits Adjusted (\$bil)	1038	1109	1147	1180	1199	1246	1295	1340	1392	1440	1068	996	1193	1367
S&P 500	997	1086	1098	1150	1214	1284	1367	1414	1431	1456	1220	948	1187	1417
S&P 500 Equil.*	1207	1333	1401	1418	1398	1410	1424	1413	1447	1439	1220	1112	1407	1430
Value Gap (%)	-17	-19	-21	-19	-13	-9	-4	0	-1	+1	0	-15	-16	-1
Dow Jones	9230	10325	10453	10974	11533	12238	12953	13346	13420	13691	11253	8876	11300	13352
NASDAQ	1985	2140	2193	2327	2468	2609	2781	2913	2982	3057	2162	1845	2400	2933
Trade Weighted Dollar	102.8	100.9	104.6	103.7	103.2	103.6	102.2	102.9	103.5	103.4	100.7	105.6	103.8	103.0
<p><i>*This is an equilibrium value based upon discounted cash flows related to current earnings and discounted by Baa rates and adjusted for additional share supply for existing companies. I have recalibrated the estimates based upon trend peaks in stock market values.</i></p> <p style="text-align: right;"><i>Updated February 9, 2010</i></p>														