



Friday, July 17, 2009

Signs Remain Mixed, but Positive on Balance

Signs of a turn in the economy continued to mount this week with perhaps more compelling evidence than we have seen far. Stock investors were pleased on Wednesday as they drove the averages up 3% on news of improving earnings from leaders like J&J, Intel, and Goldman Sachs. Key economic indicators in the manufacturing sector also added fuel. The Dow Jones racked up the largest point gain since March 23rd and the fifth largest point gain year, according to the Wall Street Journal.

We are in the very early stages of the second quarter's earnings cycle, but the trend appears good so far. Intel Corp reported on Wednesday that their third quarter sales will be up to 13% higher than analysts expect. Intel's CEO described the company's Q2 growth as the best since 1988. Also on Wednesday the former investment banking giant Goldman Sacs posted record earnings – this less than a year after taking \$10 billion in rescue funds from the US Treasury.

Intel's report is promising for technology companies and for the global economy as well. The company reported that consumer demand for computers, especially in Asia was responsible for their gains and would propel future gains. It is increasingly apparent that consumers in emerging economies rather than in the US are likely to lead the world out of the worst recession since the Great Depression. IT companies stand to benefit hugely from the rapidly growing demand for cell phones, netbooks, and flat screen TVs.

Analysts are raising projected corporate earnings for seven of ten economic sectors, but valuations, until Wednesday were falling. According to Ed Yardeni, forward earnings remain sharply down for all 10 sectors from their record highs in 2007-2008. Roughly 10% of S&P 500 companies have reported so far, suggesting that the companies on-balance will beat analysts' estimates as they did last quarter. This trend is supportive of stock prices. Prior to the first quarter of this year we experiences six quarters in a row of negative surprises.

Treasury Secretary Timothy Geithner added confidence when he said "we're seeing durable signs of greater confidence" in markets. At the same time, he warned that withdrawing stimulus too soon would "weaken the basic fabric of the economy," and "that's not something we can afford to do." Mr. Geithner was interviewed in Paris by Bloomberg. Another market mover, Nouriel Roubini, who accurately predicted the severity of the current recession, said the worst of the financial crisis is over and the recession will end this year.

The American consumer, roughly 75% of the US economy, is likely to remain subdued, but he will eventually increase spending. The government reported on Tuesday that retail sales in June came in a little stronger than expected on increases gasoline and motor vehicle sales. Credit card issuers reported new data that showed delinquency rates falling throughout the industry in June. It is apparent that the consumer will be considerably more frugal and careful in his spending than in the last couple of decades. Weighing heavily on the consumer is the continuing bad news of unemployment and falling housing. However, on the job front, we saw some improvement this week. Initial jobless claims fell 47,000 to a lower-than-expected 522,000 in the July 11th week. But the Labor Department is warning that results for both initial and continuing claims are being affected by prior layoffs in the manufacturing sector.

Earlier in the week it looked like the expected recovery in housing would prove an even longer wait as MBA's purchase index fell this week by a heavy 9.4%. Weak job conditions and tight credit continue to limit home buying despite falling prices and low rates. Rates were lower but are falling again. At 5.05% for 30-year loans, mortgages have fallen nearly 30 points this week.

Today, the Commerce Department brought good news that housing starts rose in June as construction of single-family dwellings jumped by 14%, the most since December 2004, signaling the market may be stabilizing. The 3.6% increase brought starts to an annual rate of 582,000, the highest level since November and followed a 562,000 pace in May, higher than previously estimated. Building permits, a sign of future construction, rose the most in a year.

Rates of manufacturing decline are also showing signs of slowing decisively, suggesting a near-term bottoming in the sector. The Empire State general business conditions index was only slightly negative in the July. A leveling in the manufacturing sector would broaden the base of the economic recovery and be welcome news to employees of that sector.

Capacity utilization in manufacturing (the extent to which plants are in production) in June dropped to another record low, declining to 68.0% in June from 68.2% in May. Prior to the current recession, the low over the history of this series, which begins in 1967, was 70.9% in December 1982. With inventories reaching extraordinarily low levels, it is reasonable to expect a turn in these measures soon.

Prices of goods and services are showing signs of life too, though not sufficiently to raise inflation fears among many as the primary causes were temporary. Producer price inflation in June jumped sharply at the headline level due to higher energy costs. The core also was high and largely due to higher motor vehicle prices. The overall PPI spiked 1.8% in June (well over the .8% expected), after increasing 0.2% in May.

While the economy anemically mends, the Democrats in the House Ways and Means Committee are slapping themselves on the back today after approving with no republican support the biggest overhaul of the US health-care system in four decades. "We're very, very proud of what we've done," Chairman Charles Rangel of New York said after the panel debated the measure for 15 hours. "We're one-third of this tripod. I think we carried our weight."

Unfortunately they can't pay for it, according to the General Accounting Office's report (non-political government agency) released yesterday. Even with a surtax of as much as 5.4% on the nation's wealthiest households, spending will far outstrip revenues. Mr. Rangel, raising taxes during such economic weakness is akin to taking two or three pints of blood from Lance Armstrong and then asking him to finish the second half of the Tour de France. Mr. Rangle, that is not good physical or fiscal policy. We hope reason prevails.

Recovery is underway, both at home and particularly in the emerging markets. The US's role will likely be decidedly weaker than in past recoveries, but will likely continue if events unfold as appears likely now. But, the high chance of increasing taxes virtually across the board and the eventual removal of stimulus measures makes long term recovery less certain than in the past. This ole economy can take a beating and come back stronger than before. We sincerely hope and pray that our government will not press the *American experiment* to its breaking point. We'll be watching.