



Friday, February 12, 2010

Washington and US Digging Out While Europe Braces for Worse

Signs of recovery in the US are mounting as more areas of the economy point to improvement. However the story in Europe is considerably different as Greece teeters on insolvency, Spain and Portugal worry, and now Germany reports its economy stagnated in the fourth quarter. From a year earlier, euro-area GDP declined a seasonally adjusted 2.1% in the fourth quarter. For the full year, the economy contracted 4%.

European governments face a similar problem to the US; how to safely reduce their mounting debts from stimulus without imperiling their anemic recoveries. But Greece's deficit problems exacerbate Europe's challenges. Economists and investors warn that inadequate measures from those governments would be met with swift and painful reaction in the bond markets.

Europe, like the US faces unemployment of 10%, but unlike the US its recovery may be stalling. Bloomberg reports that expansion in service and manufacturing industries slowed in January and investor confidence fell for the first time in seven months in February. Today's report that Germany, its largest economy was stagnating, was unwelcome news in a difficult period.

As Europe pines for growth, China is putting on the brakes of its own. For the second time in a month China has ordered banks to increase deposits held as reserves in an effort to damp accelerating loan growth. The reserve requirement will increase 50 basis points, or 0.5%. The current level is 16% for big banks and 14% for smaller ones. Global stocks were down on the news as investors fear that a slowing Chinese economy will weaken the global recovery.

Here at home, there is sufficient evidence that our economy is gaining momentum that Fed Chairman Ben Bernanke is openly discussing his plans to begin removing the unprecedented economic stimulus measures employed since 2008 to avert financial collapse. While saying that low rates are warranted "for an extended period" he added that the Fed may also temporarily replace the federal funds rate (rate on overnight loans between banks) as a policy guide with interest it pays on banks' deposits should fed funds become a "less reliable indicator than usual." He added that "before long, we expect to consider a modest increase in the spread between the discount rate (rate charged on money borrowed from the Fed) and the target federal funds rate."

Bernanke said that "one possible sequence" of his exit strategy might be to first test the tools for draining reserves "on a limited basis." As the time for the removal of policy accommodation drew near, the operations would be scaled up to begin the "actual firming of policy" process of raising the interest rate on bank reserves. Markets should be well-prepared for and accepting of the tightening process by the time the process is underway.

The consumer, responsible for over 70% of the US economy, is showing some signs of coming back. Today the Commerce Department announced that sales at US retailers climbed in January

for the third time in four months. Strength into the new year following the Christmas selling season is encouraging. Also encouraging is that the .5% increase was larger than expected and follows a .1% drop in December which was smaller than previously estimated. Consumer spending grew at an average 2.4% pace in the last six months of the year. For all of 2009, household purchases dropped 0.6%, the worst performance since 1974.

The Business Council reported that chief executive officers in the US are more confident that the economy is recovering bringing stability to the job market and raising business investment. Their confidence gauge increased to 64.7 this month, the highest level in at least four years. Readings greater than 50 signal economic growth.

Almost 70% of the executives surveyed said employment at their companies is likely to remain stable this year, a bad sign that the 8.4 million jobs lost since the recession began will not be coming back soon. Respondents were skeptical that the administration's stimulus program enacted last February would boost growth or employment. JP Morgan CEO Jamie Dimon said that "business looks to be getting back into business -- though there remains much to be cautious about."

Job growth will be slow for several reasons. Bloomberg reported yesterday that a majority of companies in the Standard & Poor's 500 stock index increased cash to a combined \$1.18 trillion by reducing their spending on jobs and investment. Major companies have aggressively cut capital spending by as much as 43% which will keep job creation stalled. Companies say they will rely on unused capacity and productivity increases to meet any growth.

Yesterday, the government reported that the number of applications for US jobless benefits dropped more than anticipated by 43,000 last week to 440,000. Unfortunately they qualified the good news. The Labor Department attributed the entire drop not to economic improvement, but to the end of the holiday backlog that inflated levels in prior weeks. The four-week average is a better measure and fell for the first time in four weeks, though only by 1,000 to 468,500. It is little changed from mid-December before the backlogs started to build.

The best hope for job recovery remains in the hands of small business. Small businesses represent more than 99% of all US employers and have created 64% of all new jobs in the past 15 years, according to the US Small Business Administration. The National Federation of Independent Business reported this week that their gauge of small business confidence climbed to 89.3 in January, the highest level in 16 months, from 88 in December. The advance left the measure close to the 2009 low of 81 reached in March, which was second only to a 1980 reading as the lowest on record.

President Obama started the week by reminding his detractors that he and his administration have pursued a "fundamentally business-friendly" agenda and "fierce advocates" for the free market. He said that he had made "modifications" to his proposals on taxing multinational corporations in response to criticism.

Last week the President announced that he will back a temporary increase in Small Business Administration loans to \$1 million from \$350,000 to encourage hiring. He has previously endorsed \$33 billion in small business tax cuts and incentives for hiring as well as a plan to use \$30 billion of bailout money paid back by Wall Street financial institutions to help community banks make loans to small businesses.

While ample credit is important, small business managers know that their top problem is weak demand. Until the consumer comes back, all the credit in the world is not going to revive their business and hence, job growth. And the consumer is not coming back meaningfully until he feels that his job, his home, and his savings are solid.

The best thing the government can do for small business is to get out of the way of the economy. In an interview with Business Week and Bloomberg on Monday the President said “Our real problem is not the spike in spending last year, or even the lost revenues last year, as significant as those are, the real problem has to do with the fact that there is a just a mismatch between the amount of money coming in and the amount of money going out. And that is going to require some big, tough choices that, so far, the political system has been unable to deal with.” He said he is willing to put it all on the table including entitlement spending.

Most of every tax dollar that leaves the productive side of the economy as taxes is lost for good. Most of every dollar that remains in the private sector compounds on itself in the form of new investments, jobs, and innovation. As the government grows, the private economy’s ability to support the government declines at an increasing rate because profit margins evaporate due to higher taxes and reduced spending by consumers also paying higher taxes.

Excessive regulations can have the same crippling effect as taxes, but there was reason for hope this week on that front. Banking reform got new life this week when Republican Senator Bob Corker’s agreed to work with Senate Banking Committee Chairman Christopher Dodd to speed passage of a bill. Corker and other Republicans condition their cooperation and ultimate support at the expense of President Barack Obama’s biggest goal: a standalone Consumer Financial Protection Agency. Progress on the legislation was halted earlier in the month when talks between Dodd and Senator Richard Shelby, the banking panel’s top Republican, collapsed when Dodd was urged by the President to push for the independent regulator.

Stability and reason are returning. Perhaps the government’s week-long recess brought about by Washington’s ‘big chill’ will prove helpful in cooling lawmakers’ tempers enough to work together to clear the road for the economy.

Information provided in this Brief has been prepared from sources believed to be reliable, but it is not guaranteed by Beacon Investment Management and is not a complete summary or statement of all available data necessary for making an investment decision. Past performance does not guarantee future results. Information provided is intended only to inform and does not constitute a recommendation to buy or sell.

The opinions expressed reflect the judgment of the author as of this date and are subject to change without notice. All email sent to or from Beacon Investment Management's corporate e-mail system is subject to archival, monitoring and/or review by Beacon personnel and regulatory authorities.