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Economy Fools Government, Economists, and Consumers

Today's news from the government comes as welcome relief after a week of sub-par economic reports. The economy's fourth quarter expansion of 5.9%, higher than initially reported, ranks as the best performance in six years, according to the Department of Commerce. The government's initial estimate last month was 5.7%, where economists pegged the quarter's growth. But the group most surprised is undoubtedly the US consumer whose sour mood unsettled investors earlier this week.

Economic growth of such magnitude is encouraging on the heels of the worst single-year economic performance since 1946. The core of growth in the fourth quarter came from capital spending as total business investment grew 6.2%. Purchases of equipment and software rose 18.2%.

The months-long trend of declining inventories slowed last quarter as production to replace them began to take hold. The report showed that stockpiles dropped at a \$16.9 billion annual pace compared to a \$139.2 billion decline the previous three months. Inventories declined at a record \$160.2 billion pace in the second quarter.

Consumer spending which represents 70% of our economy rose by 1.7%. But given the weight of unemployment and housing, the consumer is not expected to be as important to this recovery as he has been in past expansions. Spending added just 1.23% to the fourth quarter GDP.

Earlier in the week, the Conference Board's Consumer Confidence Index jarred investors and economists as it dropped a surprising 10 points to 46.0 in February from January revised 56.5. Expectations, the index's leading component, fell more than 13 points to 63.8 reflecting a sweeping sentiment downturn in income, employment, and business conditions. As an interesting aside, Bespoke Investment Group reminds us that in the five prior periods where a drop of this magnitude occurred, the S&P 500 posted an average gain of 23.0% over the following 12 months; a reminder to avoid emotions when investing.

The Reuter's/University of Michigan's Consumer sentiment index released today, showed a more modest retreat, edging down .7 to 73.7. Their assessment of current conditions actually rose in the period but was offset by a dip in expectations which is the leading component for the report, as reported by Bloomberg.

The struggling jobs market is likely to keep the brakes on recovery for a while. The government reported this week that payrolls fell by 20,000 last month after a 150,000 drop in December. The US economy has lost 8.4 million jobs since the recession began in December 2007. That's the worst job loss of any slowdown in the post-World War II era, according to Bloomberg. Unemployment is projected to end the year at 9.5% according to economists.

Consumers are also worried by declining home prices. Case-Shiller reported this week a second straight month decline of minus 0.2 points for both December and November. The results reverse earlier signs of a housing recovery. In the New Home Sales report the government said that home prices fell with the median down 5.6% in January to \$203,500 for another year-on-year decline, now at minus 2.4%. Inventory jumped to 9.1 months, reversing eight months of incremental improvement. Existing Home Sales in December plunged 16.7% for the largest monthly decline in data going back to 1968 (Bloomberg). December's annualized sales rate of 5.45 million was up 15.0% on a year-ago basis. Supply rose from 6.5 months in November to 7.2 months in December.

So, What Will Drive Our Economy?

The US economy, while weakened, is still by far the world's leading economy. It is as large as the next four countries Japan, China, Germany, and France combined. It is more complex, more diversified, innovative, and resource-rich than any other country on the planet. Growth can and will come from areas we can predict and from areas we cannot. While we have lost much of our manufacturing base, the US is generally regarded as a world leader in technology, research and advanced education.

We can look for growth to come from a wide variety of areas. As the world develops and grows the basic necessities such as food, shelter, and clothing will be in increasing demand and potential short supply presenting huge opportunities for US companies. To facilitate their growth, communication, transportation, and information processing will become increasingly vital. The US is a primary innovator and supplier in these areas.

Strong and vital relationships exist between universities, governments and industry in the area of research and development. Seventeen of the 30 fastest-growing occupations in the US are related to medical research or health care according to the Bureau of Labor Statistics. About two-thirds of new jobs in the US are created by new and young firms (1 to 5 years old) according to the Kauffman Foundation. Research is the foundation of innovation and entrepreneurship. It will fuel growth in areas and by amounts impossible to predict.

As the basics are satisfied, emerging market consumers will demand more entertainment, gadgets, restaurants and services that are near saturation in the developed markets. Companies such as Disney, Starbucks, McDonalds, Cargill, Apple, Google, to name a few, stand to see huge growth.

The government has a significant role in the economy's expansion too. As George Will explains: "A mature capitalist economy is a government project. A properly functioning free market system does not spring spontaneously from society's soils as dandelions spring from suburban lawns. Rather, it is a complex creation of laws and mores." Our government chooses technologies and projects to fund (rightly or wrongly) but nevertheless, it has billions to invest and those billions impact the economy.

The largest areas of the economy impacted in the coming years by government spending will likely be infrastructure rebuild, including highways and bridges, mass transportation, green initiatives such as enhanced nuclear power production and energy self-reliance. The latter will have huge impact on stemming the flow of billions of dollars out of US control into the hands of oil-rich nations with unfriendly agendas.

There is indeed much reason to be optimistic. As this morning's GDP demonstrates, the US economy is far from out of the race. It is still capable of making it to the medal stand, though it will be a team effort. Parts of the economy will continue to drag for some time, but a growing part of the team is showing renewed vigor. While significant hurdles remain, it would be a mistake to count out the world's most diversified and powerful economy. The US will earn its way back to unquestionable global leadership.

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