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Economy Gaining Strength

The US economy continues to blaze new paths to recovery. The week's economic reports demonstrate how the world's largest economy can grow even in the face of enduring impediments. With unemployment near 10%, housing prices in decline for the first time in recent memory, and confidence near all-time lows, the consumer is showing signs of life. The manufacturing and non-manufacturing sectors of the economy are coming back with improving signs of strength. Recovery is young and weak, but difficult to deny.

Businesses are squeezing more work out of their employees and profits from their plants as demonstrated by this month's revision of the fourth quarter's productivity and costs report. Nonfarm business productivity was revised up a strong 6.9% from an initial estimate of 6.2% and unit labor costs fell an annualized 5.9%, compared to an initial estimate of 4.4%. The report further showed that output was up by 7.6%. The Personal Income and Outlays report showed that those pulling the weight for leaner companies did better in January. Wages and salaries were up 0.4% for the month. However, it will remain tough for the unemployed as companies are unlikely to hire until demand improves significantly.

February's ISM report supports consensus for a slow recovery in employment, but it does offer some hope. The report showed moderate growth for the manufacturing sector, improving hiring, and the indication that spare capacity is being used up. Factory orders rose 1.7% in January with transportation equipment leading the way. Orders for non-durable goods rose 0.9%. Durable goods orders were revised slightly down, but still show strong growth of 2.6%.

The ISM's non-manufacturing index rose 2.5 points signaling growth for the majority of the US economy. Employment measured in this report jumped 4 points to 48.6, the best reading since April 2008. While a reading below 50 indicates contraction, the significance of the improvement is welcome indeed.

Today, the government announced that the nation's unemployment rate remained at 9.7% for February with 36,000 jobs lost during the month, less than projected. The underemployment rate (part-time workers who'd prefer a full-time position and people who want work but have given up looking) didn't fare as well, rising from 16.5% to 16.8%. However, it is likely that February's severe weather only delayed what may be the beginning of a hiring upswing.

Companies cut the fewest jobs in two years, according to ADP Employer Services. Similarly, employers last month announced the fewest job cuts (42,000) in more than three years, according to the job-placement firm Challenger, Gray & Christmas. For comparison, layoffs in January were 71,482 and were 186,350 in February of last year.

Despite last week's dire warnings from sentiment surveys, the consumer appears to be coming back as chain stores did very well in February (despite the weather). Stores reported increasing rates of growth compared to January with rising traffic and higher transactions.

Car and truck sales remained strong despite bad weather as well. Preliminary totals point to a 7.6 million annual rate for domestic produced vehicles versus January's 7.9. Bloomberg reports that even Toyota's sales improved for the month. New car sales make up about 70% of the motor vehicle component which comprises about 20% of total retail sales.

After what looked like an upturn in the industry for several months, housing seems to have resumed its decline. This week the National Association of Realtors announced that their pending home sales index dropped a surprising 7.6% to 90.4. The trade group blamed the weather, but it likely has more to do with the expiration of the government's first round of incentives. Perhaps a second round, due to expire in April, will re-ignite demand.

The Federal Reserve continues to signal that they will remain accommodative for recovery keeping interest rates at historical lows. Yesterday, Chicago Fed President Charles Evans said that he needs to see signs of "highly sustainable" growth before supporting steps toward tighter monetary policy. Chairman Ben S. Bernanke said last week the US economy is in a "nascent" recovery that still requires low interest rates to spur demand by consumers and businesses once federal stimulus wanes. But, don't forget, they raised the discount rate two weeks ago. Was the action taken to eliminate distortions created by quantitative easing, or was it a veiled warning?

The Fed believes it has time to soak up the excess liquidity in the markets from its various stimulus measures, before economic growth creates inflationary pressures. The bond market seems to concur. As the most sensitive barometer of inflationary pressures, long-term bond yields are closely watched for signs of the economy's direction. The 30-year Treasury yield currently stands at 4.65%, up from its October 2009 lows of 3.95%. However, for now, yields appear to be trading in a range between 4.5% and 4.77% with no strength to the upside.

The stock market, which generally takes a six-month look ahead, seems to point toward continued recovery, though without much conviction in the way of volume. But that pattern has persisted all year. After a 5% pause in February, the S&P has risen somewhat persistently toward its recent high of January 19th.

Corporate profits have sustained the rally thus far, but they must represent more than cost savings and productivity gains to be sustainable. Corporate earnings from the first quarter will provide early indicators of the vitality of this global recovery. While the banking industry faces continued pressures, companies in general are showing promise of delivering the goods.

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