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## Where From Here?

The 'green shoots' of economic recovery characterized by Ben Bernanke in mid 2009 are withering as the housing slump drags on, unemployment remains chronically high, consumer spending remains stagnant, Europe's debt crisis eludes resolution, state governments grow increasingly insolvent, and the economic and ecological catastrophe in the Gulf grows worse by the day. For the second time, the government revised downward their estimate of US gross domestic product from 3.2% to 2.7%. The first estimate was 3.2%, followed by a correction to 3.0%. Year over year real GDP (inflation adjusted) is up 2.4%, compared to up .1% for the fourth quarter.

The consumer, the engine of most recoveries is of little help this time. Worried about high unemployment, declining home prices, tight credit, two wars, the Gulf tragedy, lack of confidence in the general direction of the economy and of government, it's clear to see why he remains cautious. Consumer spending for the first quarter was revised downward from 3.5% to 3%. It was up on only 1.6% in the fourth quarter. And the trend of increases may be leveling off for a while. A report last month showed purchases in April were unchanged from the previous month.

Data are showing that consumer spending, particularly on the large items, such as houses and cars is heavily dependent on government incentives. There have been huge disruptions in markets as the programs expire, from cash to clunkers to homes. Yesterday, the government reported that new home sales plunged 33% in May to an annual rate of 300,000, the lowest rate on record going back to 1963. Downward revisions to the stimulus-fed months of April and March added further reductions totaling 108,000.

Bloomberg reported that new home supply, due to the drop in sales, surged to 8.5 months from April's 5.8 months, which is certain to slow construction and related jobs. Prices are also in line for further declines. In this report they dropped 1.0% to a median \$200,900. Year-on-year prices are down 9.6% at the median.

In the consumer's absence America's businesses have taken up the charge. The results have been admirable, but one has to wonder how long business can grow without more increasing consumption. Much of the initial surge in Manufacturing came from inventory re-build and exports. Both are showing signs of abating. Today's report of non-durable sales showed the headline number slipping in May from an April spike. New factory orders for durable goods in May declined 1.1% after jumping a revised 3.0% in April. Overall new orders for durables were worse than the market forecast for a 0.5% dip. However, excluding the volatile transportation component, new durables orders rebounded 0.9%, following a 0.8% decrease in April.

The government also reported today that corporate profits after taxes jumped 44.8% in the first quarter to an annualized \$1.424 trillion. Profits in the fourth quarter were up an annualized 58.0%, following a 37.0% gain the prior quarter.

Today's GDP report also showed that inflation is unlikely to be a problem for some time to come. It was revised at 1.1% annualized for the first quarter, compared to the prior estimate of 1.0% annualized. The price index for gross domestic purchases increased 1.7% in the first quarter, down

from 2.0% in the fourth quarter. Excluding more volatile food and energy prices, the price index for gross domestic purchases increased 1.2% in the first quarter, compared with an increase of 1.5% in the fourth.

Some worry about the possibility of deflation. Credit Suisse's Andrew Garthwaite points out that deflation requires falling wages (which account for 70% of inflation) – yet, wage growth is still positive in almost all major developed regions. He says that there is no deflation in emerging markets (47% of global GDP). Indeed, Emerging market wage growth and core inflation are rising and China is now exporting inflation. In Garthwaite's view, "deflation historically has been the result of policy mistakes often owing to the wrong macro-economic theory (e.g. neoclassical theory of savings and gold standard). In the 1990s in Japan and early 1930s in the US real rates were abnormally high – now they are negative."

What about a "double dip" recession? Some are beginning to worry that problems in Europe and the potential of problems in China might pull the US economy back into recession. Most economists argue against such a scenario and are confident the possibility is next to nil. Throughout history double dips are exceptionally rare. Recent economic data from Europe and the US mostly point to a soft landing at worst. Emerging markets which represent 47% of the world economy are growing.

Difficult times such as these tend to provide a fertile mix for extreme scenarios. While double dip and deflation are unlikely, it appears that the recovery has been slowed and perhaps extended. Government stimulus attempts have largely failed to produce sustainable results on any front. In fact, the large deficits they have created are having the opposite effect on consumers and small businesses who are working hard to get their financial houses in order. They are increasingly calling on the federal government to do the same. As David Brooks points out, "deficit spending doesn't induce small businesspeople to hire and expand. It scares them because they conclude the growth isn't real and they know big tax increases are on the horizon. It doesn't make political leaders feel better either. Lacking faith that they can wisely cut the debt in some magically virtuous future, they see their nations careening to fiscal ruin."

Will we see fiscal responsibility return to Washington? Polls and early primaries all point to an electorate that is fed up with the direction of the current Congress. Numerous professional politicians have announced they will not run for re-election as they see their records as out of favor.

We will have to wait until November and beyond to learn what impact Congressional changes will have on deficit cutting. But it seems increasingly clear that this recovery is integrally tied to fiscal responsibility in the private home, the state house, and our federal government. By all indications so far, the electorate will speak loudly and convincingly in November. The result will be a new Congress with a clear mandate do a most unnatural thing – to reduce the size and grip of government and to return to balanced budgets. The economy will eventually recover with or without government fiscal responsibility, but oh how much faster and stronger would it flourish if we knew that the foundation of our future rested on rock and not sand?

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