Lavery Consulting Group

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Some Momentum Going Into 2010

Looking at the economy in the rear-view mirror is not especially productive, except as a precursor of what lies ahead. Last week, 3Q:'09 real GDP was revised from growth of 2.8% annualized to 2.2%. The most substantive downward revisions were in commercial construction and in inventories. The downward revision in inventories in 3Q:'09 will likely contribute to real GDP in 4Q:'09 growing at a 5% annual rate, fueled by a dramatically reduced rate of inventory liquidation in the current quarter. The first official estimate of 4Q:'09 real GDP growth is released by the Bureau of Economic Analysis on January 29, 2010. The steeper yield curve, the widening spread between the two year and the ten year note, signals a better recovery ahead.

As the consumer moves toward the end of 2009, the ABC Consumer Comfort Index moved higher in the week ending December 20. The consumer is not euphoric, as evidenced by the December 22 release of the ICSC-GS Chain Store Sales index. The index bounced up 0.6% in the week ending December 19 from the prior week, but the same ICSC-GS Index is only up 0.4% y/y.

The final level of the Reuters/University of Michigan Consumer Sentiment Index was 72.5 in December. This was below market expectations, and weaker than the December preliminary report of 73.4. But, at 72.5, the December measure remained well above the November reading of 67.4.

Personal income rose 0.4% in November, and personal consumption expenditures (PCE) advanced 0.5%. Both readings were weaker than market expectations. The good news is that disposable personal income is up 3.1% y/y, and private sector wages and salaries rose for the seventh time in eight months, and have grown faster than inflation over the eight months ending November. This leads to our above consensus call on the December Conference Board measure of consumer confidence to be released on December 29. See the forthcoming indicators section later in this report.

Support for the consumer is beginning to evolve in the labor market data getting decidedly less negative. Initial unemployment claims fell 28,000 in the week ending December 19 to the smallest level since early September 2008. Labor market data also show a surge in the hiring of temporary workers, a precursor of an increase in the hiring of "permanent" workers. And, the mass layoffs data for November showed a substantial lessening, a 23% decline y/y.

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In the housing sphere, existing home sales in November increased 7.4% m/m, well above consensus expectations, and were up 44.1% y/y. The Federal Housing Finance Agency (FHFA) reported on December 22 its purchase-only house price index rose 0.6% in October, stronger than the consensus expectation of a 0.2% rise. The October advance was the first since July, and leaves prices 1.9% below October 2008.

In contrast to existing home sales in November, new home sales were weaker than market expectations, falling 11.3% in November. At the November sales pace, the supply of unsold new homes widened to 7.9 months. Physical inventories of unsold new homes declined, however, to 235,000 in November, a drop of roundly 59% from the high in the middle of 2006. Physical units of unsold new homes are the smallest since 1971. On balance, the residential housing market, existing and new homes, has a positive outlook, albeit with government tax credits and subdued prices attracting home buyers.

In manufacturing, the December Richmond Fed index faltered for the third consecutive month. New orders have fallen for five straight months to the lowest level since March 2009. The Richmond Fed survey, however, showed heightened optimism for shipments and orders over the next six months.

New orders for durable goods increased 0.2% in November, below consensus expectations of a 0.5% gain. But, durable goods orders, ex transportation orders, rose 2%, stronger than market expectations of a 1.1% increase. Over the six month period ending in November, new orders for durable goods have grown at an annualized pace of 5.2%. Excluding transportation, orders have advanced at an annual rate of more than 13% over the same period.

The next FOMC meeting is scheduled for January 26, 27. While the FOMC will discuss when an exit strategy from the extraordinary policy of a 0% to 0.25% federal funds rate can be gradually implemented, Chairman Bernanke remains concerned about deflationary threats. Our belief is that with the fiscal stimuli already in the system and the still extraordinary easy money posture of the Fed, real GDP growth of 3.0% to 3.5% is likely in the first half of 2010. That should generate, following the 5% real growth we see for 4Q:'09, enough recovery in the labor market and in industrial activity to warrant the Fed allowing short rates to increase beginning in 3Q:'10. That would trigger bank lending and further recovery through at least 2010. The risk is that the Fed may not tighten in 2010, validating fears of some inflation escalation beginning in the latter months of 2010. This will generate an increase in longer-term interest rates, forcing the Fed to push short rates higher. The recovery could slow or stall in 2011.

Economic Indicators in the Week Ahead:

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Tuesday, Dec. 29 9:00a.m. Oct. Case-Shiller Home Price Index

We expect the Case-Shiller Composite of the 20 Largest Cities/Metro Areas likely fell 0.3% in October m/m for the first month of decline since April. Seasonal weakness and incremental foreclosure supply lead to the downward pressure on prices. Still, on a y/y basis the price decline continues to moderate. Prices for the October Composite 20 will likely be released as down 7.6% y/y. Prices were declining 9.4% y/y in September and 11.3% y/y in August. The market consensus currently expects a 7.3% y/y decline in October.

Tuesday, December 29 10:00a.m. Dec. Consumer Confidence

We believe the December Consumer Confidence Index from the Conference Board will rise to 55.0 from 49.5 in November and 48.7 in October. If our expectation is realized, the **market consensus**, which sees a more subdued rise in confidence to 52.9, **will be surprised on the upside.** The upside surge in the December ABC News Consumer Comfort Index, the slowing trend in jobless claims, and higher equity prices all support our stronger than consensus view.

Wednesday, Dec. 30 9:45a.m. Dec. Chicago PMI Index

The Chicago Purchasing Managers Association report of the December Purchasing Managers Index (**PMI**) will likely show the sixth rise in the past seven months to 57.5, driven by strong seasonal adjustment factors and the lessening in jobless claims. **Our expectation of 57.5 is well above the market consensus of 55.3, and would be another upside surprise for the equity market.**

Thursday, December 31 8:30a.m. Weekly Jobless Claims

We anticipate that weekly jobless claims for the week ending December 26 will edge higher to 465,000 from 452,000 the prior week. The slight rise in initial claims should not be viewed as an incremental worsening of the labor market. The trend of a lessening of initial claims is still intact. Continuing claims will recede further, but this remains due not to any strengthening in the labor market, but rather is a function of a still escalating number of workers exhausting state unemployment insurance benefits and rolling onto extended federal benefits.

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