Lavery Consulting Group

January 24, 2010

Investor Worries

January 20th through January 22nd was a short period of time. Yet, in those three trading sessions the DJIA dropped 552.45 points, a 5.2% decline. That's the largest relative decline in stock prices since March 2009, just prior to the bear market bottom. Corporate bonds faltered as well.

Three concerns have amplified investor uncertainty. China has made preliminary monetary policy moves that suggest a directional tightening. The Obama administration has talked of tougher regulation of banks, both in terms of constraining bank size and risk taking. And, increased opposition has arisen in the Senate to Fed Chairman Ben Bernanke's confirmation for a second term as Fed Chairman.

China's policy moves are to contain the unsustainable growth in bank lending which doubled in 2009, a troubling escalation of inflation in December, and surging prices in real estate. We see the policy moves as constructive in both managing massive flows of liquidity into China and in seeking to prevent an overheating economy.

The Obama administration talk of Wall Street reform is, in part, political theatre and does not suggest knee-jerk implementation of specific regulatory change. Some regard this as capitalism vs. Big Government, a multi-year debate. We see it a positive in Paul Volcker getting some of Mr. Obama's ear. And, we see the results of the Massachusetts runoff election to succeed the late Senator Ted Kennedy as stunning, and as evidence of the checks and balances so prudently envisioned by the architects of our Constitution. It is also constructive that President Obama now wants a bi-partisan fiscal commission to address U.S. fiscal imbalances with constraints on federal spending as part of the solution. Protectionist policy is, however, wrong and harmful to growth.

As for Fed Chair Bernanke, it is our assessment that he will be reconfirmed as Fed Chairman. President Obama has secured the overall votes to get this done. This will remove an uncertainty overhanging the market. Investors have also been focused on whether or not the Fed's program of purchasing mortgage-backed securities will end on March 31 as scheduled. Chairman Bernanke will not jeopardize the sustainability of the economic recovery, but he may underscore prudence in curtailing an area of governmental largesse.

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Economic Indicators in the Week Ahead:

Monday, January 25 10:00a.m. December Existing Home Sales

We expect existing home sales fell 9.0% in December to 5.95 million units annualized from 6.54 million in November. The market consensus expects a decline to 5.90 million in December. The weakness in December follows three successive months of strong existing home sales, helped greatly by the first-time homebuyer tax credit. That government tax credit was due to expire November 30th, but was extended and expanded. Over the September through November period, existing home sales surged 28.5%. November's reading was up 44.1% y/y. The drop in December existing home sales is partly a function of the 16% plunge in the November Pending Home Sales Index from the National Association of Realtors. December's anticipated decline in existing home sales does not mean any truncation of the housing recovery.

Tuesday, January 26 9:00a.m. Nov. Case-Shiller Home Price Index

The Case-Shiller home price index for the 20 largest metro areas likely advanced 0.4% in November. This would reduce the y/y measure of home price deflation to 5.0%, in line with consensus, and less than the 7.3% y/y decline in the October data. Foreclosures will act to keep downside pressure on home prices. But, the Mortgage Bankers Association mortgage application index rose 9.1% in the week ended January 15th, atop a 14.3% increase the prior week. This suggests renewed strength in home sales going forward, providing a demand side limitation on home prices.

Tuesday, January 26 10:00a.m. January Consumer Confidence

We believe the Conference Board Consumer Confidence Index will rise to 55.0 in January, stronger than consensus expectations. This serves to reinforce the Reuters/University of Michigan preliminary January reading of Consumer Sentiment which was higher than December.

Wednesday, January 27 10:00a.m. December New Home Sales

New home sales likely rose 2.8% in December to 365,000 units at an annual rate, up from 355,000 in November. Our December expectation is below the market consensus. The National Association of Home Builders (NAHB) has had subdued readings in builder confidence re sales expectations. Foreclosures and declines in existing home prices suggest incremental builder concessions to stimulate new home sales. While the inventory of unsold new homes has improved, i.e., declined, the number of months from completion to final sale is nearly 14 months, high by historical standards.

Thursday, January 28 8:30a.m. December Durable Goods Orders

Durable goods orders likely rose 1.5% in December, stronger than the 0.2% November increase, but less than consensus expectations of a 2.0% rise. A firming in aircraft orders contributes to the December rise. Non-defense capital goods orders excluding aircraft increased by about 1.3% last month, following a 2.2% increase in November.

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Thursday, January 28 8:30a.m. Weekly Jobless Claims
In the week ending January 23rd, initial jobless claims likely dropped to 435,000, following the increase of the prior week to 482,000. The Labor Department attributes the prior weekly jump to an administrative backlog in claims relating to staffing at state unemployment offices. Continuing claims, reported with a one week lag, likely fell, but that is due to the number of long-term unemployed exhausting state benefits. The extended federal benefits program is swelling.

Thursday, January 28 8:30a.m. December Chicago Fed NAI
We see the Chicago Fed National Activity Index (CFNAI) in December to remaining flat with the November reading.

Friday, January 29 8:30a.m. Fourth Quarter Real GDP
We expect the "Advance" report from the Bureau of Economic Analysis on real GDP in 4Q:'09 to show an annualized growth of 5.0% over the third quarter, which grew at an annual pace of 2.2% over 2Q:'09. Our expectation of 4Q:'09 real GDP is stronger than the consensus forecast of a 4.5% annualized rate of advance. The gain in 4Q:'09 is, however, due principally to a dramatically reduced rate of inventory liquidation. Real final demand grew about 1.5% annualized with the consumer, residential investment, exports, and federal government spending contributing to growth, while commercial real estate investment was the principal drag.
Inflation, as measured by the GDP deflator, likely rose 0.8%, slower than the consensus call of 1.3%.

Friday, January 29 8:30a.m. Fourth Qtr. Employment Cost Index
We expect the employment cost index (ECI) to be up 0.4% q/q in the final quarter of 2009, and up only 1.4% y/y. This is a broad measure of labor costs, incorporating wages and salaries and employer paid benefit costs. Given the tremendous slack in the labor market, we see employment costs under very little upward pressure in 2010.

Friday, January 29 9:45a.m. January Purchasing Managers Index
We see the Chicago Purchasing Managers Association as reporting the January PMI at 58.0. While down from the December level of 58.7, our expectation is above the consensus forecast of 57.2. The new orders component is likely to reach 66.0 in January from 64.4 in December.

Friday, January 29 10:00a.m. January Consumer Sentiment
The final January report from the Reuters/University of Michigan Index of Consumer Sentiment is likely to be unchanged at 72.8 as in the preliminary January report, slightly above the December level of 72.5.

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