Lavery Consulting Group

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Major Potholes in the Path of an Enduring Recovery

The recovery is intact for the time being. Fourth quarter real GDP advanced at a 5.7% annual rate, but roundly 61% of that advance was fueled by a reduced rate of inventory liquidation. Real final demand advanced only 2.2%. We expect a still further lessening in inventory liquidation will benefit the first quarter of 2010, and inventory restocking and associated production will keep the economy in recovery going through 2010. But, that is simply our most likely scenario, our base case. Major risks abound.

Consumer sentiment, as measured by the Reuters/University of Michigan survey rose to 74.4 in its final January reading, up from its preliminary January call of 72.8. The 74.4 reading, while not high in an absolute sense, is the best consumer sentiment reading since January 2008. Both the current conditions assessment and the expectations six months forward improved in January. The ICSC-GS chain store sales index dropped 2.3% in the week ending January 23rd. This is notable, but should not be over-reacted to, as it is a volatile weekly series, and had risen 2% in the prior week.

The Chicago Purchasing Managers Index (PMI) hit 61.5 in January, its best performance since November 2005. The Dallas Fed's Texas manufacturing index showed broad-based gains in its second straight rise, following a long decline that started in January 2007. In contrast, the Richmond Fed showed disappointing results in manufacturing in both December and January. The Philadelphia Fed measure slipped a bit in January, but has remained in positive territory for five straight months.

Both existing home sales and new home sales fell in December. The existing home sales drop was expected after three very strong months, but the new home sales decline was the 2nd monthly decline in succession, and fell back near its January 2009 low. Inventories of unsold homes have been declining, but foreclosures and distressed sales keep downside pressure on prices, despite the better readings from Case-Shiller. We see housing as at risk to increased foreclosures, widening negative net worth (where the value of the home is less than the

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outstanding mortgage. Mortgage resets of adjustable rate mortgages in the period ahead could add to downside pressure.

A risk to the economy beyond 2010 is that the Fed's exit strategy from quantitative easing will be too slow, as Bernanke wants to avoid at all costs the deflationary risks he rightly sees. The extraordinary growth in excess reserves and evolving pressures to increase bank lending could fuel upward pressure on inflation in 2011.

On January 26th the Philadelphia Fed revealed its coincident indices for all 50 states for December 2009. Only three states improved, seven remained unchanged, and fully forty showed weakness. This was a significant deterioration in breadth, and the weakest reading since August 2009.

The forward momentum in the economy could weaken later in 2010 as the effects of monetary and fiscal stimuli are lessened. There is still a massive federal debt hangover. The non-US investor could demand higher nominal returns, i.e., higher interest rates on dollar denominated assets. The debt reduction needed in parts of the developed world, e.g., the U.S. and the U.K., has really not begun. And, the problems of high levels of long-term unemployment threaten growth.

The risks cited in the last two paragraphs are precisely the reasons why a less independent Fed, especially with a Chairman worried about deflation, will keep the economy moving forward by overstaying the period of incredibly low short-term interest rates. This is fine for 2010, but it will tend to eventually create bubbles, which could ultimately culminate in the last stretch of the rubber band, i.e., a renewed shock globally in 2011 or 2012 that imperils sustained growth beyond 2010.

Economic Indicators in the Week Ahead:

Monday, February 1 8:30a.m. December Personal Income and PCE

Personal Income (PI) likely advanced 0.3% m/m, a slowing from the 0.4% increase in November. This would mark the 6th consecutive monthly rise in PI. Transfer payments will be an important contributor. We believe the core wage and salary component could disappoint with only a 0.2% increase over November. Personal consumption expenditures (**PCE**) are **likely to be flat. The consensus sees a 0.3% rise in PCE. Anything less will be a disappointment to the market consensus.** The savings rate likely rose from 4.4% in November to 5.1% in December. The overall PCE deflator likely rose 0.2% in January. Core prices likely inched up by 0.1%, but the y/y rate would be up 1.5% from the 1.4% y/y level of October and November.

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Monday, February 1 10:00a.m. January ISM Manufacturing Index
We believe the Institute for Supply Management (ISM) manufacturing survey will hit 56.6, **stronger than the consensus estimate** of 55.6. The index was 53.7 in November and 54.9 in December. Our January reading would be the sixth consecutive reading above 50.0 for this series.

Monday, February 1 10:00a.m. December Construction Spending
We look for December construction spending to be reported as falling 0.7%, atop a downward revision to November. This is **appreciably weaker than the consensus expectation** of December construction spending being down only 0.4%. The biggest declines are likely in multi-family housing and nonresidential construction. Tighter credit conditions and escalating vacancy rates are important drags. Government stimulus related construction will boost public construction.

Wednesday, February 3 8:15a.m. January ADP Employment
The Automatic Data Processing (ADP) report will likely show a modest decline of 30,000 in private sector non-farm payrolls. This would be a distinct improvement from the 145K and 84K declines of November and December respectively. This 30K decline would be a harbinger of relatively flat non-farm payrolls to be released on Friday. Declining layoffs data and job gains in the service sector drive the reduced decline in the ADP data.

Wednesday, Feb. 3 10:00a.m. Jan. ISM Non-Manufacturing Index
We see the non-manufacturing Institute for Supply Management (ISM) survey being 49.9 in January, relative to a December reading of 49.8, which had first been reported at 50.1, and a November level of 48.4. Our estimate is **weaker than the consensus call of 51.0**. We see the non-manufacturing survey staying just south of the 50.0 level for the 3rd straight month, as the consumer remains sluggish and as the Richmond Fed service sector index fell in January.

Thursday, February 4 8:30a.m. 4Q:'09 Productivity and ULC
We expect a 6.8% annualized surge in 4Q:'09 output per hour, based on a reported 7.2% rise in 4Q non-farm business gross value and a 0.3% advance in nonfarm, private sector hours worked. Our 4Q:'09 forecast productivity gain, coupled with a 2% annualized rise in labor compensation, results in a 4.8% annualized fall in 4Q:'09 unit labor costs (ULC). Our **productivity estimate is well above the consensus call of 5.3%, and our forecast 4.8% annualized drop in ULC is dramatically better, i.e. a bigger decline in ULC, than the consensus estimate of a drop of 2.1%.**

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Thursday, February 4 8:30a.m. Weekly Unemployment Claims
We expect initial jobless claims for the week ending January 30th will show a 30,000 reduction in claims to 440K from 470K the prior week. The backlog in processing claims in California made initial claims higher than otherwise would have been the case in the past 2 weeks. Continuing claims (reported with a one week lag) likely remain near 4.6 million. The federal extended benefits and the EUC should move above 5.6 million.

Thursday, February 4 10:00a.m. December Factory Orders
Factory orders likely rose 0.7% in December, **moderately slower than the 0.9% rise expected by the consensus.** Durable goods orders rose 0.3%, and actually 0.9% excluding transportation. We currently have a 1.3% increase in non-defense capital goods orders ex aircraft in December. While real non-residential construction plunges at roundly a 12% annual rate in 1Q:'10, in our estimation, the capital equipment and software component rises close to 10% annualized in the first quarter of next year in our view.

Friday, February 5 8:30a.m. January Employment Situation Report
The January employment report will also contain the annual benchmark revision, (employment could be revised lower by 824,000),ll and corrected data on Average Hourly Earnings, the Index of Hours Worked, and the length of the workweek. There will be specific detail on female workers as well. We anticipate that non-farm payrolls will rise by 27,000 workers in January, slightly **stronger than the consensus** rise of 20K. The gain we see is fueled heavily by temporary census staffing by the federal government. Hiring in health care is also a plus. We expect the unemployment rate will stay at 10.0%.

Friday, Feb. 5 3:00p.m. December Consumer Credit Outstanding
We expect consumer credit outstanding (CCI) will drop $9 billion, a 4% decline y/y. November showed a $17.5 billion fall in CCI. A decline in the December data would be the 11th consecutive drop in CCI. This is driven on the demand for credit side by the consumer sector's intention to cut debt, and on the supply side by tighter lending standards by banks and via reductions in credit limits.

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