Lavery Consulting Group

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The Challenges in Europe; Tightening by China

On Friday, the People's Bank of China (PBOC) moved again to elevate the reserve requirement ratio on banks half a percentage point to 16.5%. The latest announcement will take effect on February 25th. (The PBOC previously announced an increase in reserve requirements on January 12th.) Nervous investors saw a heightened threat to the global economy via less growth prospectively from China, a key driver of the global economy. This announcement came on a day when the European Union reported a virtual stall in its overall economic growth in the fourth quarter of 2009. This further raised concerns about the global economy.

Taking these issues separately, we do not regard China's monetary action as cause for alarm. The People's Bank of China is merely practicing responsible monetary policy. Their action follows enormous increases in bank lending and a huge surge in electric power demand that challenges China's infrastructure. Some tightening at this stage is not going to stall the China recovery. It may modestly pare China's substantial growth rate, but lessens the risk of creating asset bubble expansions, the bursting of which would be far more painful. We even expect that the Chinese monetary authorities may tighten twice further in the months ahead, ultimately bringing the reserve requirement ratio to 17.5%. The pace of China's growth in bank lending has been very strong, and must be tempered somewhat.

The stalling in the economic growth of Europe in the final quarter of 2008 is, however, a valid concern. Europe's major economies, especially Germany, are standing tall to forestall potential debt default by Greece. Support for Greece contains requirements on the part of Greek public policy to trim the deficit as a share of GDP by four percentage points this year. Fiscal austerity is certainly not something traditionally practiced by Greek public policymakers. It will be extremely difficult, if not impossible, for Greece to accomplish its pledged austerity in light of rather tepid economic growth.

This problem is not going away. Credit risks exist in Spain and Portugal as well. We expect the developed world economies, many loaded with debt themselves, will effectively print money so that defaults don't occur in Greece, Spain, Portugal, etc. The deflationary consequences of default are likely viewed as far worse than somewhat stoking the fires of inflation.

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The United States federal debt situation is another problem. The growing depth of the "Red Sea" in Washington D.C. has prompted Moody's Investors Service to "warn" that Washington's credit rating could be vulnerable to a downgrade at some point, if its fiscal finances don't show some indication of directional improvement.

It is in this climate that we doubt Chairman Bernanke will move to implement any real tightening until 2011. The global landscape is viewed by Bernanke as characterized by several deflationary risks. Public policymakers seem to prefer trying to get another expansionary "stretch in the rubber band" going, rather than applying some tightening medicine and fiscal prudence, of which the global economy needs a dose, in order to ultimately get onto a track in pursuit of a full employment, non-inflationary growth path.

We find China's monetary tightening curiously refreshing, but China will not jeopardize more than a modest amount of its strong economic growth in the short-run, especially since China knows it must be a core engine of global growth, or else suffer deteriorating markets for its exports. One plus in the global economy is that the U.S. consumer is poised to provide more support for the economy as employment payrolls are about to start expanding. This follows a year of reducing consumer credit outstanding.

This is not to say that the U.S. expansion is without domestic risks. The two principal ones may be the residential housing sector and commercial real estate. Residential housing is still affected by high foreclosures, broadening negative equity (where the outstanding mortgage is greater than the value of the home), and impending resetting of adjustable rate mortgages. Commercial real estate is inundated by rising vacancy rates and reductions of rents, not to mention the related bank exposure to this sector.

Economic Indicators in the Week Ahead:

Tuesday, February 16 8:30a.m. February NY Fed Empire Manufacturing
The Empire Manufacturing General Business Activity Index likely advanced in February to 18.7 from 15.9 in January. Our expectation is higher than the consensus view of 17.7. February would mark the 7th straight month of expansion in manufacturing activity in the N.Y. Fed District. January's results showed gain in order backlogs, new orders, and an improving outlook six months ahead. The drop in initial jobless claims and the strength in exports suggest a higher February result in the N.Y. region.

Tuesday, February 16 1:00p.m. February NAHB Housing Market Index

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The National Association of Home Builders (NAHB)/Wells Fargo Index of builder confidence likely edged higher from 15 in January to 16 in February. The new traffic and current sales parts of the index likely rose, consistent with builder indications of reduced cancellation rates and improved order rates. Still, 16 is a woefully subdued level of builder confidence. This metric has not been above the key diffusion reading of 50 since April 2006.

Wednesday, February 17 8:30a.m. January Housing Starts & Permits

We expect January housing starts at an annual rate of 575,000 units, up 3.2% m/m. Our expectation is lower than the consensus reckoning of 580,000 starts annualized. December was suppressed by inclement weather. Prices have been pared by builder incentives, the tax credit is in place for more than just first-time home buyers, and mortgage rates are subdued per the Mortgage Bankers Association. The mortgage application index rose 21% in the last week of January. We expect gains in both the single-family and multi-family categories. Building permits, however, are likely to reflect the vulnerability of housing, with 623,000 annualized, down 4.6% from the December level of 653K, but a hair above the consensus call of 620K.

Wednesday, February 17 8:30a.m January Import Price Index

We believe import prices rose 0.6% in January, driven by a 3% hike in petroleum prices. The recent strength in the dollar has us below the consensus gain of 0.8% in import prices, which would be up over 10% y/y.

Wednesday, Feb. 17 9:15a.m. January Industrial Production & Cap.Util.

Industrial output likely rose 0.9% in January. The ISM manufacturing production reading of 66.2 and the increase of 0.6% in hours worked support this forecast. Our expectation is higher than the consensus. Industrial output would be up at least 0.7% y/y, the first y/y rise after 21 straight months of negative y/y comparisons. Capacity utilization likely advanced from 72.0 in December to 72.7 in January.

Thursday, February 18 8:30a.m. Jobless Claims, Week Ending Feb. 13

The week ending February 6th had a substantial lessening in initial claims, reaching 440,000, falling 43K from 483K due to some backlog unwinding in California. We see initial claims remaining at 440K in the week ending February 13. It is impossible to gauge the timing and the remaining backlog effect, if any, from California. The consensus sees a rise to 450K, so our number would be a positive surprise to the market consensus.

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Thursday, February 18 8:30a.m. January Producer Price Index (PPI)
The PPI likely spiked 1.1% higher, due to freezing temperatures in Florida and resultant crop damage. Also, we've seen higher prices for heating oil and gasoline in early 2010. Our expectation is higher/worse than the consensus rise of 0.8%. The January headline PPI for finished goods will likely rise to a y/y growth of 4.8%, up from 4.7% in December. Core producer prices (excluding food and energy) may have edged 0.1% higher in January, which would reduce the y/y rise in the core PPI to 0.7% from 0.9% in December.

Thursday, February 18 10:00a.m. Jan. Leading Economic Indicators
We see the Conference Board's LEI series rising 0.6% in January, the 10th straight monthly increase. Our expected increase is higher than the 0.5% consensus call. Still, the annualized advance in the LEI would slow over the past six months of data to 9.8% thru January vs. 10.8% thru December.

Thursday, February 18 10:00a.m. February Philadelphia Fed Survey
The General Business Activity Index from the Philly Fed likely slipped to 14.5 from the January reading of 15.2, as new orders eased last month, and unemployment claims have been rising in the region, hurting the employment part of the index. In contrast, the consensus sees a rise to 17.0 in February. If we're correct, the market consensus will be disappointed.

Friday, February 19 8:30a.m. January Consumer Price Index (CPI)
We believe the January headline CPI will rise 0.4%, driven by a 3.4% energy price advance. Our expectation is higher than that of the consensus gain of 0.3%. The 0.4% monthly increase would elevate the y/y increase in the CPI to 2.9%, the highest in 15 months. With late 2008/early 2009 declining oil prices, the y/y headline CPI will likely move higher in the months ahead to 3.3%. The core CPI (excluding food and energy) likely edged 0.1% higher m/m in January, and would be up 1.8% y/y.

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