February 21, 2010

A Fourth Problem

In our October 12, 2009 research piece entitled **Two Problems that Loom Large**, we addressed the serious vulnerability in **commercial real estate, as well as the anemic state of bank lending, especially to the small business community.** In our February 15, 2010 piece, **The Challenges in Europe; Tightening in China** we addressed our concern about the threat of **sovereign debt default.** Beyond the evident challenges in Europe, we referred in last week's piece to **Moody's warning to Washington of the vulnerability of a credit downgrade of U.S. government debt**, unless evidence emerges that the fiscal path is being addressed. This brings us to problem number four: the **financial condition of the state and local government sector.**

A new report from the Pew Center on the States references a $1 trillion gap between promised retirement and health care benefits vs. the current inability to fund them. To this gap must be added untold investment losses in state pension funds. The slump in state tax revenues from the weaknesses due to the Great Recession only exacerbates the problem. The difficulty also extends to the municipal sector in the aggregate.

The economy is in serios need of an enduring recovery and leadership that can change a fiscal train wreck into ongoing fiscal resolve and prudence. Bigger government is not the solution. It is, in our view, the problem. Fortunately, Ben Bernanke understands the risks the economy, global as well as domestic, faces.

The Fed's hike in the discount rate from 50 to 75 basis points should not be viewed as a tightening. It is an operational move that raises the cost to member banks of collateralized loans from the Federal Reserve. It does not change the federal funds rate, which shapes the cost of short-term credit in the economy. The funds rate remains from 0 to 25 basis points.
We continue to see the Fed not hiking the funds rate until 2011.

The economic signs of continuing recovery have been clear. The February NY Fed Empire manufacturing survey strongly outpaced consensus, though the headline level of general business conditions was not fully supported by the component detail. The Philadelphia Fed general activity index also beat consensus, had a big jump in new orders, and was in positive territory for

The Lavery Consulting Group, LLC • PO Box 734 • Spring Lake, NJ 07762-0734
Office Phone 732-974-1946; Mobile 609-731-6226 • Fax: 732-974-3140
Jack Lavery • jlavery@laveryconsultinggroup.com
Website: http://www.laveryconsultinggroup.com

the sixth straight month. Industrial production matched our above consensus projection of a 0.9% m/m January rise, and is up at an annualized rate of 8.9% in the latest six months of data.

Per the Conference Board, following its release of the January leading economic indicators index (LEI): "the cumulative change in the LEI over the past six months has been a strong 9.8% annualized." The LEI has risen for ten consecutive months, and a better precursor of strength is the improvement in the ratio of coincident to lagging indicators.

Housing starts in January ratified our above consensus expectations. Single family building permits hit their highest level since September 2008. Enhanced affordability, low mortgage rates and homebuyer tax credits continue to bode well over the next few months. Moreover, the Mortgage Bankers Association (MBA) reported a decline in the mortgage delinquency rate in the final quarter of 2009, the first such decline since the start of 2007. The drop in delinquencies portends a slowing in foreclosures. But, there is still serious concern. The delinquency rate for loans past due 90 days or more, however, reached a record high of 4.62%. Stay-tuned.

In addition to the indicators discussed above, inflation remained tame. While headline producer prices rose faster than consensus m/m in January to stand up 4.6% y/y, core producer prices are up only 1% y/y. Core consumer prices actually declined in January m/m, and are up only 1.6% y/y. The headline CPI rose less than expected. Import prices rose 1.4% in January m/m and 11.5% y/y. The driver has been a weaker dollar and a 96% y/y rise in energy prices from depressed year-earlier levels.

Economic Indicators in the Week Ahead:

Monday, February 22 8:30a.m. Chicago Fed National Activity Index

The Chicago Fed National Activity Index (CFNAI) likely improved to 0.0 from -0.61 in December. In this metric, any reading above 0.0 would indicate expansion. The December level will, we believe, be the best reading since November 2007, a month before the Great Recession began, according to the National Bureau of Economic Research (NBER), the official arbiter of turning points in the economy. It will be another few months before NBER declares some month in the summer of 2009, in our view, as the beginning of this expansion.

Tuesday, Feb. 23 9:00a.m. December Case-Shiller Home Price Index

The Case-Shiller home price index for the 20 largest metropolitan areas likely rose 0.2% m/m in December. If our view proves correct, the y/y Case-Shiller gauge would reveal **home price deflation easing** from -5.7% y/y in November to -2.8% in December. The consensus expects -3.0%. The quarterly Case-Shiller National Home Price Index (HPI) rose, in our view, 1.4% in the 4th quarter, the third straight quarter over preceding quarter increase. This would yield an HPI down 1.3% y/y. Tax credit induced activity will benefit demand. Foreclosures and mortgage delinquencies show signs of slowing. But, delinquencies 90 days or longer are at a high.

Tuesday, Feb. 23 10:00a.m. Feb. Conf. Board Consumer Confidence
The Conference Board Consumer Confidence Index slipped a bit, in our view, from 55.9 in January to 54.9, near consensus expectations of 54.8. While 54.9 is hardly a euphoric reading, consumer confidence was 25.3, a series low, in February 2009. The decline in the unemployment rate to 9.7% in January 2010 should help confidence, but the ABC News Consumer Comfort Index, the IBD/TIPP Economic Optimism series, and the preliminary Reuters/University of Michigan Index of Consumer Sentiment all suggest a modest decline in confidence in February.

Tuesday, February 23 10:00a.m. February Richmond Fed Survey
Fifth District economic conditions remain underwhelming. Still, January's manufacturing index did "improve" from –4 in December to -2. We see the Richmond Fed survey breaking into expansionary territory in February led by new orders.

Wednesday, February 24 10:00a.m. January New Home Sales
We see January new home sales rebounding 5.3% to 360,000 units annualized, after falling to 342,000 in December. The consensus has a more subdued rise to 351K. New home sales rose 4.32% in October to a 408K unit annual pace, but then new home sales plummeted in November and December, a combined 17%. We see a rebound in January, as the latest NAHB Home Buying Index and the January Conference Board "Plans to Buy a New Home" support our stronger than the consensus call.

Thursday, Feb. 25 8:30a.m. Jobless Claims, Week-Ending Feb. 20
Initial claims of 470,000 are likely, just below the prior week's 473K. Snowstorms, the fact that the week includes President's Day, and the closings of Toyota plants add seasonal or statistical noise to the data. We see the underlying level of claims as closer to 420K. We see continuing claims slowing, and those on Federal emergency extended benefits will rise.

Thursday, Feb. 25 8:30a.m. January Durable Goods Orders
We see January durable goods orders rising 2.7%, after a 1% rise in December. January was helped by motor vehicle orders. Our January

forecast is **nearly twice the 1.4% seen by the market consensus.** The strength in orders reported by Boeing the last few months suggests the transportation component will boost headline durable goods orders.

Thursday, Feb. 25 10:00a.m. 4Q:'09 FHFA House Price Index (HPI)
The Federal Housing Finance Agency (FHFA) reported that its purchase-only HPI rose 0.7% m/m in November, its largest monthly gain in four years. November 2009 also posted a y/y advance of 0.5%, the first y/y increase since September 2007, before the Great Recession began in December 2007. We believe 4Q:'09 will show roundly a 2% advance over the third quarter and a solid 0.5% m/m increase in December.

Friday, Feb. 26 8:30a.m. Real GDP 4Q:'09 (2nd Est.) & GDP Prices
4Q:'09 will likely show a 5.4% annualized advance over 3Q:'09, slower than the advance report of 5.7%. A downward revision in state and local government spending, a higher trade deficit, and a less than previously estimated gain in residential investment spending cause the downward revision in the advance in real GDP growth. This is despite a stronger contribution from the consumer, and an even slower pace of inventory liquidation. The consensus has the 4Q:'09 growth rate at 5.6%. The GDP price index likely rose 0.7% in 4Q:'09 vs. consensus of 0.6%.

Friday, Feb. 26 10:00a.m. January Existing Home Sales
We expect January existing home sales at a 5.55 million annualized pace, a gain of 1.8% from December. This is above consensus of 5.5 million units. A 1% rise in the January National Association of Realtors Pending Home Sales Index and a bounce from the expanded and extended home buyer tax credit program support our forecast.

Friday, Feb. 26 9:45a.m. Feb. Chicago Purchasing Managers Index
We see the PMI rising sharply from 61.5 in January to 64.2 in February, the **highest reading in five years.** This is **well above the consensus call of 59.0.** New orders and order backlogs in January portend very strong new orders in February around 65.0.

Friday, Feb. 26 10:00a.m. Feb. (F) Consumer Sentiment Index
We expect an upward revision to 74.5 from the preliminary February Reuters/University of Michigan Consumer Sentiment survey of 73.7. The January level was 74.4. We are higher than the consensus of 73.9.

Jack W. Lavery
CEO & Chief Economist