Lavery Consulting Group

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The Recovery Faces Deceleration

The Chicago Fed National Activity Index (CFNAI) improved in January to +0.02. December was revised from -0.61 to a less negative -0.58. Anything above 0.0 in this yardstick, comprised of 85 indicators, connotes expansion. But, far more striking, November was also revised, concurrent with the January release, both in magnitude and direction from -0.39 to +0.06. November is the 1st positive in the CFNAI since May 2007. Separately, the Richmond Fed's survey moving up to 2.0 is hardly reason to celebrate.

The Chicago Purchasing Managers Index increased to 62.6 in February from 61.5 in January. More importantly, the February reading of 62.6 was the highest reading for the Chicago PMI since April 2005. New orders have been surging for five months. But, the Chicago PMI may have given us their best readings for awhile, as the production and new orders components run into a dampening from seasonal adjustment factors.

Durable goods orders matched our expectation of rising at twice the percentage pace seen by the consensus. A nice headline, but it was driven by a 126% m/m increase in civilian aircraft orders. The reality is that non-defense capital goods shipments less aircraft declined 1.5%. Furthermore, core non-defense capital goods orders less aircraft fell 2.9%, following a 3.3% rise in December. These January measures do not bode well for 1Q:'10 capital spending.

Case-Shiller's December revelations included a 0.3% rise over November in home prices for the 20 largest metro areas. This matched November's 0.3% m/m rise. The quarterly US National Home Price Index rose 0.3% in 4Q:'09 over 3Q:'09, following a 2.2% increase in 3Q:'09. We now have the first incidence of three consecutive quarterly increases in the U.S. National Home Price Index since 2005-2006. Home price declines in the national index showed a 2.5% decline y/y in 4Q:'09, in contrast to an 8.7% y/y drop in 3Q:'09. While the y/y comparisons are still negative, the 2.5% y/y decline in 4Q was the smallest y/y drop since 1.7% in 1Q:'07. Home prices are still down more than 28% from their 1Q:'06 peak.

Residential construction is still a vulnerable sector. January new home sales fell to a record low since 1963, the period when the comparable data began being measured. January sales were off 6.1% y/y. Existing home

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sales fell 7.2% in January, but are still up 11.5%. Builder confidence rose from 15 to 17 in the latest NAHB reading, but 17 is extremely low.

The residential construction sector is fragile, commercial real estate is woeful. Last week we underscored the financial lack of health in the state and local government sector. And, the consumer sector showed a big drop in January consumer confidence, the weekly ABC News Consumer comfort Survey evidences consumer discomfort, and consumer sentiment slipped slightly from its preliminary February measure which had slipped from January. Both the assessment of current conditions, as well as expectations six months ahead, dropped. Add to these considerations the uncertainty about a pending bond sale by Greece, the depth of the "Red Sea" in Washington D.C., ongoing angst re the Middle East, the deceleration in bank lending, and concerns about the timing of Bernanke's exit strategy toward tightening. We have a "Wall of Worry" to climb.

Our conclusion is that the economy is already in a mode of slowing in its rate of expansion. No indicator tells it better than the weekly leading index coming from the renowned Economic Cycle Research Institute (ECRI). Per a Reuters release on February 26, the latest weekly reading was flat, with slowing in the rate of increase on a y/y basis. ECRI says this "bolsters expectations that economic growth will ease by mid-year." The latest Weekly Leading Index is the lowest reading since November 13, 2009. The weekly "index's annualized growth rate dropped for the 11th straight week.....to the yearly growth gauge's lowest level since August 7, 2009."

We agree slowing in the rate of economic growth is indeed underway and it will show itself in real GDP growth in 1Q:'10 slowing to less than 2% at an annual rate from the 4Q:'09 upwardly revised annualized growth rate of 5.9%. This slowing will likely assure no increase in the federal funds rate until 2011.

Economic Indicators in the Week Ahead:

Monday, March 1 8:30a.m. January PI, PCE, Core PCE Prices
In January, Personal Income (PI) is likely to show an increase of 0.4%, in line with market consensus expectations. The gain would be the 7th consecutive monthly rise in PI. The private wages and salaries component likely rose 0.3%, in keeping with the 0.3% rise in average hourly earnings in the January employment report released February 5. Government salaries likely rose sharply, due to the effect of a 2.0% annualized cost of living hike. Stronger transfer receipts also will push PI up. Personal consumption expenditures (PCE) are likely up 0.3% in January, below consensus expectations of a 0.4% rise. The cautious consumer still wants to increase

savings balances, therefore PCE likely rose less than PI. The savings rate could rise to 5%. The headline PCE deflator likely rose 0.2% in January m/m. We believe the core PCE price index was flat, like the core CPI in January. The core PCE price index will likely show a 1.4% rise y/y.

Monday, March 1 10:00a.m. January Construction Spending

Construction spending likely dropped 0.6% in January, worse than the 0.5% rate of decline expected by the consensus. On a y/y basis, construction spending would, in our view, be down 8.2%. More than normal snowfall and lackluster housing demand combine for the drop in total construction outlays. Housing starts rose in January, especially in the multi-family category. Single family starts increased a bit as well, so residential construction spending presumably rose. Nonresidential construction likely fell sharply, especially given the drop in construction employment in January. High vacancy rates and falling rents make commercial real estate an achilles heel in the economy. Public sector construction likely increased in January.

Monday, March 1 10:00a.m. February ISM Manufacturing

The Institute for Supply Management (ISM) manufacturing index likely slipped to 57.0 in January from 58.4 in December. January would be the 7th straight month with a reading above 50.0 (expansionary). At this writing, the consensus is 57.8. The orders and production components each likely remained above 63.5.

Wednesday, March 3 8:15a.m. ADP February Employment

ADP private sector payrolls likely fell 25,000 in February, after having dropped 22K and 61K in January and December. The consensus expectation is a decline of 10K in February. Weather and declining construction sector employment drove the February drop.

Wednesday, March 3 10:00a.m. Feb. ISM Non-Manufacturing

The non-manufacturing ISM index likely fell to 50.0 in February, below the consensus of 51.0 and the January actual of 50.5. While the Richmond Fed survey improved in February, its service sector component dropped. Unemployment claims remain stubbornly high, suggesting a negative employment component to this ISM index.

Thursday, March 4 8:30a.m. Jobless Claims, Week-Ending 2/27

Weather and backlogs in California have moved initial claims higher to 496K last week. We anticipate 472K will be reported this Thursday, bringing the four-week moving average from 474K to 470,500.

The combination of state continuing claims and recipients of federal extended benefits will continue to move higher, as the incidence of long-term unemployment remains exceptionally pronounced.

Thursday, March 4 8:30a.m. 4Q:'09 Nonfarm Productivity & ULC

Nonfarm productivity growth has been extraordinary, rising at a 7.2% annual pace in 3Q:'09 q/q, and the first estimate for 4Q:'09 was 6.2% annualized over 3Q:'09. We anticipate an upward revision of 4Q:'09 productivity to 6.5% vs. the consensus call holding at 6.2%. Our higher than consensus estimate is due to an upwardly revised 7.6% growth in 4Q:'09 nonfarm business production and what we estimate to be a revision in nonfarm hours worked to 1.1%. Our productivity estimate yields a larger decline in unit labor costs (ULC) of 4.7% annualized in 4Q:'09 over 3Q:'09 vs. the initial 4.4% estimate. This bodes well for corporate profit margins.

Thursday, March 4 10:00a.m. January Factory Orders

Factory orders likely rose 2.2% in January over December, higher than the 1% gain in December m/m. Durable goods orders were reported last week as rising 3.0% in January. Non-durable goods orders likely rose 1.3% in January, driven by petroleum orders.

Friday, March 5 8:30a.m. February Employment Situation

Non-farm payroll employment likely fell 30,000 in February. The consensus sees a 40K decline in nonfarm payrolls. The range of estimates making up the consensus is huge, going from a decline of 150K to a rise of 153K. The hiring of 50,000 federal census workers is a plus, but state and local government employment fell, we estimate, by a like amount. The rise in jobless claims and weakness in construction employment suggest the unemployment rate rose from 9.7% in January to 9.8% in February.

Friday, March 5 3:00p.m. January Consumer Credit Outstanding (CCO)

CCO likely dropped another $6.0 billion in January, the 11th consecutive monthly decline. It would mark the longest sustained drop since the series began in 1943. The consumer remains very cautious, given the employment environment. The desire to cut revolving credit (credit cards) and non-revolving credit (such as auto credit, education loans, etc.) is clear, as the consumer continues to deleverage. The consensus sees a $3.8 billion decline in CCO. Consumer credit demand continues to decline, while credit supply from the banks has become tighter. CCO does not include mortgage debt or anything tied to housing, e.g. home equity loans.

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