Lavery Consulting Group

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The Return of Market Angst

In its post-meeting statement of March 16, the Federal Open Market Committee (FOMC) opted to maintain the "extended period" term with respect to the fed funds target range of 0%-.25%. There were, however, some changes elsewhere in the statement, which reflect the Fed getting more constructive on the tone of the economy. The labor market is described as "stabilizing". This is a shift from prior phraseology characterizing the labor market as showing "deterioration." Housing starts are called 'flat", rather than "contracting." It is notable that business investment spending on software and equipment now says "has risen significantly," rather than "appears to be picking up."

The FOMC has also indicated that it is committed to ending its special lending facilities for the mortgage market. The FOMC underscored the beginnings of its winding down of its asset purchase programs at the end of March. Given Chairman Bernanke's lingering worries about deflationary risks in the global landscape, however, the FOMC statement said: "The Committee will continue to monitor the economic outlook and financial developments and will employ its policy tools as necessary to promote economic recovery and price stability."

The growing angst at financial institutions relates to a probable proposal, which we feel is "in the works" from the Financial Accounting Standards Board, FASB. This proposal will say that banks should "mark to market" such financial assets as loans. Banks currently keep loans valued at their original cost and build reserves as they feel needed to deal with potential losses. While this proposal, if forthcoming, would impact bank balance sheets and income statements, potentially materially altering how financial institutions are valued. It would hit smaller banks more markedly, because a larger % of their assets are loans. Chairman Barney Frank of the House Financial Services Committee is, in our view, a big supporter of such an FASB proposal.

Market angst was evident on Friday March 19 about the vulnerability of Greece to debt default. Greek Prime Minister George Papandreou has complained of a "lack of support" for Greece. Papandreou has hinted he wants to approach the International Monetary Fund. The Greek Prime

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Minister is afraid high borrowing costs will limit the impact of already articulated budget steps Greece is taking.

The reality is that Greece has market access. It has sold $17.9 billion of bonds so far this year. Greece is paying just over 6% on its bond issues in 2010, but its borrowing costs have fallen, in that its 10 year bonds are now yielding only 2.8 percentage points above German debt. In January the peak spread reached 4 percentage points over German debt. Friday's angst about Greece, however, widened spreads a bit. Market concerns on Friday included fears about the dimensions of the global expansion.

In the U.S. the reality is that February retail sales performed very well, despite winter storms. February industrial production did not decline despite weather. The NY Fed Empire survey illustrated the strong prospects for the March ISM, released on April 1. Falling initial jobless claims portend upside growth in non-farm employment in March, reported on April 2. Consumer prices were flat in February, and producer prices declined more than expected, given weaker gasoline prices, and evident slack in both the business sector and the labor markets.
The risks in the U.S. economy are commercial construction, and the state and local government sector.

Economic Indicators in the Week Ahead:

Monday, March 22 8:30a.m. February CFNAI
The Chicago Fed National Activity Index is likely to slip from January's positive 0.2 reading to 0.0, or a slight negative in February. The employment component was likely a drag, but will improve markedly in the months ahead. Not enough pundits forecast the CFNAI, so there is no consensus reading.
Tuesday, March 23 10:00a.m. February Existing Home Sales
Existing home sales are likely to burst ahead in the March and April data with the extended and expanded version of the homebuyer tax credit scheduled to expire on April 30. But, the February data on existing home sales is likely to still be underwhelming, dead even with the 5.0 million annualized pace of January. This is very close to the consensus reading, and would be weaker than the 5.05 million units annualized pace of January, and well below the 5.44million annualized pace of existing home sales in December. Pending home sales is the best leading indicator of existing home sales in the following month. Pending home sales faltered 7.6% in January, after rising 0.8% in December. Existing home sales will still get a benefit from distressed home sales at reduced prices and greater affordability.

Tuesday, March 23 10:00a.m. January FHFA House Price Index
The Federal Housing Finance Agency reported on February 25 that its December purchase-only house price index (HPI) declined 1.6% m/m. This followed increases in October and November, but the November gain of 0.7% was revised lower to 0.4%, concurrent with the December release. The HPI moved back to negative territory in December, off 1.5% y/y. November's small y/y increase of 0.1% was the first y/y rise since September 2007. We expect a 0.4% gain in January, due to demand induced by attractive home valuations. If our January m/m expectation of a 0.4% gain is realized, the January HPI would be down 1.3% y/y.

Tuesday, March 23 10:00a.m. March Richmond Fed Survey
The Richmond Fed's manufacturing index had a positive reading of 2 in February, following negative results of -4 in December and -2 in January. The new orders index jumped to +9 in February from +1 in January. The employment component had a negative reading for 4 straight months through February. The average workweek firmed from -6 in January to +4 in February. This suggests the employment numbers could be positive in March, raising the overall result to +4.

Wednesday, March 24 8:30a.m. February Durable Goods Orders
We project February durable goods orders rose 1.6%, following the 2.6% increase in January. This would be the third consecutive monthly increase. If we're correct in our February call, durable goods orders in February would be up 10.6% y/y vs. an advance of just under 10% y/y in January. At this writing, the market consensus expects only a 0.7% rise in durable goods orders, less than half the pace we anticipate. The February advance we see would be heavily driven by aircraft orders. If Boeing's orders hit in February, and they should, they could be a multiple of 3 or 4 times the January levels, depending how Boeing reports the numbers. We think durable goods orders excluding transportation will be up a more subdued 0.6% vs. the consensus view of a 0.4% gain. Core nondefense capital goods orders, excluding aircraft, are a good indicator of business cap-ex outlays. We need to focus on this gauge in the months ahead.

Wednesday, March 24 10:00a.m. February New Home Sales
February new home sales likely rose 3.2% to 319,000 annualized. This increase would only partially retrace the pronounced January decline of 11.2%, from the December level of 348K to January's 309K reading. New home sales are likely to remain subdued, given tight credit standards, higher foreclosures, and an increased incidence of distressed homes hitting the market. The prices of many existing home are becoming very attractive, causing tough competition for new construction. Although the

availability of new homes shows contained inventories at recent selling rates, the number of months from the finishing of construction to eventual closing is still historically high. There are a plethora of restraints on builder confidence, as evidenced in the woeful level of the NAHB Housing Market Index. The market consensus at this writing envisions a February pace of 315,000 new home sales annualized.

Thursday, March 25 8:30a.m. Jobless Claims, week-ending 3/21/10

It is our expectation that initial unemployment claims receded further in the week ending March 21 to 445,000, down from 457,000K the prior week. The consensus at this writing has initial claims receding only slightly to 455K. Hitting our expectation for initial claims would serve to lower the four-week moving average to 458,750 from 471K last week. The trend in initial claims is lower, suggesting payroll employment gains will be evident in the April 2nd release of the March employment figures. It should be noted that the U.S. Department of Labor, with this weekly report, will be releasing revised data on initial and continuing claims for the period dating back to 2005. New seasonal adjustment factors will likely serve to reduce the levels of claims in the last couple of months.

Friday, March 26 8:30a.m. 4Q:'09 (Final) Real GDP

The Bureau of Economic Analysis (BEA) estimated 4Q:'09 real GDP to have grown 5.7% at an annualized rate in the "advance" reading released on January 29, 2010. This was revised upward to 5.9% in the "preliminary" estimate from BEA on February 26. We expect the final estimate, to be reported on March 26, will be revised downward to a 5.6% annualized rate of growth in 4Q:'09, below consensus expectations. We believe commercial construction (non-residential investment) as well as residential investment will be revised downward vs. the February 26 estimate. In addition, we feel the downward revision will be driven by a faster pace of inventory liquidation than BEA had estimated previously. An upward revision to a less negative net export position is not, in our estimation, going to offset the negative changes to 4Q:'09.

Friday, March 26 10:00a.m. March (F) Consumer Sentiment Index

We see the Final March Reuters/University of Michigan Index of Consumer Sentiment reaching 73.2, up from the preliminary March level of 72.5. Prior to Friday, March 19, U.S. equity prices had increased sharply since the outset of March. Furthermore, the last three weeks of initial jobless claims have declined. In addition, the ABC News Consumer Comfort Index improved significantly in the week ending March 14 to -43, its strongest reading since January.

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