Lavery Consulting Group

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Climbing the Wall of Worry

The DJIA reached 11,000 on Friday, before closing at 10,997.35. It has often been said that a bull market climbs a wall of worry. There are, indeed, a plethora of things about which to worry. Fitch Ratings reduced the rating on Greek debt two notches, from BBB+ to BBB-, the lowest investment grade category. Greece's deficit in 2009 was nearly 13% of GDP. Fitch's action came as soaring yields on Greek debt underscore the country's inability to finance its debt burden without aid from the European Union (EU) and the International Monetary Fund. After the downgrade, Fitch Ratings said the outlook for Greek debt remains negative. Policymakers are, however, finalizing the terms of financial aid for Greece. Euro-Zone finance ministers agreed earlier today that, if Greece were to get a bailout, it could get as much as 30 billion Euros in loans this year at a 5% interest rate.

In previous research, we've articulated the vulnerability of commercial real estate to further decline. Some relative stability is, however, evolving. Net rents (the face rent minus landlord concessions) in the office sector fell 0.8% in 1Q:'10, and are down 7.4% y/y, per Reis, Inc., a New York research firm. Through 1Q:'10, the metro market, per Reis, with the largest 12 month drop in net effective office rents was New York, down 16.3% y/y. In terms of vacancy rates, the office vacancy rate nationwide increased 0.2 percentage points in 1Q:'10 to reach 17.2%.

Another hard-hit sector is apartments. Apartment rents in 1Q:'10 increased, per Reis data, following five straight quarterly declines. New York saw a 0.9% rise in rents in the first quarter. Nationwide, net effective apartment rents (including such concessions as one month of free rent) rose 0.3% in 1Q:'10, following a decline of 0.7% in 4Q:'09. The apartment vacancy rate remained flat at 8.0% in 1Q:'10, representing the possible peak. The 8% level is the highest % vacancy rate in the history of Reis, Inc. data, which go back to 1980.

The state and local government sector is in a serious fiscal crunch. Services must be cut, an employment decline has begun, and wage rates and other benefits will doubtlessly be addressed. State and federal pension plans are also materially underfunded. Major municipal or state financings could be difficult. **The biggest threat to the U.S. economy, however, is the mountainous debt the Treasury must try to finance. The Social Security surplus is a thing of the past. It, therefore, can no longer be used to make the federal budget**

deficit appear less than otherwise would be the case. Federal debt isn't just a long term problem.

Yields on 10-year Treasury notes have increased from 3.25% in late November to 3.9% now. The federal debt problem is amplified by our dependence on non-U.S. sources to finance the Red Sea, the sea of red ink in Washington, D.C. Non-U.S. investors may feel that at today's nominal interest rates, they already have more dollar-denominated debt than they want, especially adjusted for currency risk. We'll get the requisite foreign capital inflows that we need to finance the deficit, but how much higher will interest rates need to be to attract that demand for dollar-denominated debt? Higher interest rates will jeopardize the economic recovery.

Also, the President's trade policy looks increasingly protectionist. Doubling exports in five years plays well politically. Trade wars with Brazil and NAFTA partner Mexico, however, are potentially devastating, as reciprocal responses are forthcoming. Students of history aptly recall that the disastrous Smoot-Hawley Protective Tariff Act was the inane kind of fiscal policy that only served to exacerbate a downturn that became the Great Depression.

Bull runs, however, don't normally end when labor markets are only starting to improve, as evidenced by the March payroll employment data. The non-manufacturing ISM survey beat expectations, improving to 55.4 in March, with solid subcomponent detail and a general business activity index which reached 60.0. Pending home sales rose 8.2% m/m in February. While consumer credit outstanding contracted, the deleveraging that the household sector is achieving is ultimately a plus. Very upbeat was the Business Roundtable's 1Q:'10 CEO Economic Outlook, which increased significantly to 88.9, its strongest showing since 2Q:'06, from 71.5 in 4Q:'09.

Economic Indicators in the Week Ahead:

Tuesday, April 13 8:30a.m. February Trade Balance
We expect the trade deficit widened to $40 billion in February from $37.3 billion in January. The consensus sees a $39 billion trade deficit in February. We believe exports rose at least 2% in February, bouncing back from a 0.3% January decline. Strong emerging markets demand likely drove the exports revival. Prior to the slight slippage in January, exports had risen for eight straight months. Imports fell 1.7% in January, driven by recall distortions at Toyota, and weaker than expected petroleum imports, in part the result of a decline in petroleum volumes. Higher petroleum prices likely boosted total U.S. imports 3% in February, contributing to the wider trade deficit.

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Tuesday, April 13 8:30a.m. March Import Price Index

Following a drop of 0.3% in February, the U.S. import price index likely rose 1.4% in March, driven by what we estimate as a 6.4% increase in petroleum prices. Our expectation is well above the consensus call of a 0.9% rise in the import price index. If our forecast monthly rise in import prices is correct, the import price index rose to a y/y gain of 12.2%, the highest in 18 months, up from a y/y advance of 11.2% in February. Non-petroleum import prices likely rose 0.2% in March, the eighth straight monthly increase. It made the y/y increase 3.2% in March, its highest y/y advance in 17 months.

Wednesday, April 14 8:30a.m. March Consumer Price Index (CPI)

In March, we expect the headline CPI rose 0.1%, and the core (ex food and energy) CPI likely rose 0.1% as well, both in line with the consensus. Apparel, airfares, and medical prices likely rose faster than the indices. The March gains would follow a flat headline CPI and a 0.1% increase in the core in February. Our forecasts translate into a headline CPI up 2.45% y/y, and the core up 1.2%.

Wednesday, April 14 8:30a.m. March Retail Sales

We see March retail sales up 1.2%, following a 0.3% advance in February. The March gain was boosted by motor vehicle sales increasing to an 11.8 million annualized pace, vs. 10.4 million in February. Retail sales, ex autos, likely rose 0.6%. March same store retail comparisons were strong m/m and y/y, helped by an early Easter. The consensus sees a 1.1% gain in retail sales in March, and 0.5% ex autos.

Wednesday, April 14 10:00a.m. February Business Inventories

Following a 0.6% addition to wholesale inventories, and a 0.5% rise in factory inventories, we peg retail inventories as up 0.3%, generating a 0.5% rise in overall business inventories vs. a consensus 0.3% gain. The business inventory to sales ratio likely stayed at 1.27 in February. The switch to inventory building is induced by strong shipments and orders.

Thursday, April 15 8:30a.m. Jobless Claims, wk. ending April 10

We expect initial jobless claims to drop to 430,000 in the week ending April 10, vs. a jump to 460K the prior week. The 460K was a result of seasonal adjustment distortions with Good Friday and the end of the quarter.

Thursday, April 15 8:30a.m. April NY Fed Empire Mfg. Index

We expect the Empire manufacturing General Business Activity Index increased to a six month high of 28.5 in April, up from 22.9 in February. New orders, order backlogs and expectations all rose in March.

Thursday, April 15 9:15a.m. March Industrial Production & C.U.

We believe industrial production (IP) increased 0.7% in March, up from a gain of 0.1% in February, and above the consensus view of a 0.6 % advance in March IP. A weather–related rebound and increases in Toyota production drove the

March advance. Capacity utilization (CU) likely rose from 72.7% in February to 73.2% in March.

Thursday, April 15 10:00a.m. April Philadelphia Fed Survey

The Philadelphia Fed's general business activity index likely rose to 21.0 in April, up slightly from 18.9 in March. Much of the subcomponent detail in March and a tough seasonal factor in April lead us to the muted gain we anticipate. The consensus is at 20.0 for April.

Thursday, April 15 1:00p.m. April NAHB Housing Market Index

We expect the National Association of Home Builders (NAHB) Housing Market Index (HMI) to edge higher to 16 from 15 in March, but still below the February level of 17. It must be stressed that even an uptick to 16 leaves the HMI, a proxy for builder confidence, at an extremely low level. Better weather will help the uptick happen, but foreclosures and distressed properties will restrain pricing, and mortgage rates have risen to an eight month high of 5.21%, per the weekly survey of conforming mortgages released April 8th by Freddie Mac.

Friday, April 16 8:30a.m. March Housing Starts & Bldg. Permits

March housing starts are likely to increase 5.0% to 604,000 units annualized from the weather restrained February level of 575K. Our forecast would put housing starts up 15.9% y/y, and we expect building permits, the leading indicator of new home construction, to increase 2.1% m/m to 625K units annualized from the February level of 612K. At 625K, building permits would be 12,000K below their average level of the last three months. Tight credit promises to restrain multi-family starts. With existing and new home sales weak in recent months, and with unsold new home inventories rising in terms of the months supply at depressed selling rates, housing prospects remain constrained. While our forecast is below the consensus of 610,000 starts annualized, we are in line with market expectations on permits.

Friday, April 16 10:00a.m. April (P) Consumer Sentiment Index

We anticipate the preliminary April reading of the Reuters/University of Michigan Index of Consumer Sentiment rose to 76.0 from the March reading of 73.6. Not only is our April forecast above the consensus call of 73.0, at this writing, it is above the upper end of the consensus range of 71.0 to 75.0. The latest ABC News Consumer comfort measure improved in the week ending April 4th to -43. The daily Rasmussen Consumer Index has also moved higher. The DJIA crossed 11,000 on April 9, before closing at 10,997.35. Initial jobless claims have been trending lower, despite the Good Friday and seasonal adjustment related aberrational rise in the week ending April 3rd. **If our expectation for the preliminary April consumer sentiment reading proves accurate at 76.0, it would be a major upside surprise to current market expectations.**

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CEO & Chief Economist

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