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ECONOMIC TALKING POINTS

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Consumers are Back! But are the Banks?

Several economic reports were released today so let's weave through them and see if there's a common theme that emerges.

Retail Sales

Clearly no recovery is possible without the active participation of consumers and today's retail sales report shows they are up to the task. Last month, sales rose at a much faster clip than even the pros had forecast. Retail spending jumped 1.3% in November to $352 billion, the most Americans have spent in one month in more than a year---and those impressive numbers followed a robust 1.1% increase in October.

Even if you take out purchases of motor vehicles, retail sales still surged by 1.2%, to $292 billion, the highest level since October 2008. All that pent-up demand by households is finally being unleashed with sales picking up across nearly all retail groups, including electronics and appliances (up 2.8%), building and gardening material (up 1.5%), food and beverages (up 1%), sporting goods (up 0.3%), department store sales (up 0.7%), and restaurants and bars (up 0.5%).

Another factor supporting spending is that gasoline prices have been stable lately. Although it moved up 6% last month, consumer outlays for gasoline over last three months is actually 12.6% less than during the equivalent period in 2008.

University of Michigan Consumer Sentiment

These numbers are indicative of households who ---while uneasy about the weak job market ---are sufficiently confident that economic conditions will improve next year. How confident? The University of Michigan just released its mid-December survey on the mood of consumers and it showed the sentiment index soared to 73.4 this month from 67.4 in November. The pick up in confidence surprised forecasters, once again, who foresaw a minor gain.

Several factors support the latest spike in confidence: The November employment report stunned everyone with its much smaller loss in payroll jobs. Americans have also seen the value of their stocks and real restate investments begin to recover the last six months. In addition, layoffs are tapering off and personal income has been rising. One of the surest signs that households are growing more comfortable with the economic outlook is the decline in the savings rate in recent months, sliding from a peak of 6.4% in May to 4.4% in October.

Import inflation

Americans have also benefited from the fact that inflation remains well behaved. While the dollar (DXY spot) has fallen 8.5% over the year, import inflation, excluding fuel costs, actually slipped 1% the last 12 months. Import prices did jump 1.7% during November but virtually all of it was the result of higher oil prices. The cost of fuel imports rose 7.3% last month. Take out fuel and import inflation inched up 0.4%, about same pace we've seen the last four months.

How is it that import inflation (ex-fuel) can remain so low when the dollar is so weak? Simple, foreign producers believe that maintaining market share in the US is more important than an attempt to protect profit margins solely because of shifts in currency values. The US economy is still very fragile and any attempt to raise prices at this time could result in loss of market share. As any business leader will tell you, once you lose market share, it is both costly and time consuming to gain it back. The result: To prevent a loss in market share, foreign producers are willing to receive less in local currencies for products sold in the US.

Business inventories

We also got encouraging news on the business front. After watching inventories shrink for the last 13 months, companies have earnestly begun to refill stockroom shelves. Business inventories increased by 0.3% in October, which turned out to be yet another

surprise to forecasters who were predicting a decline. The upturn in inventory investment is particularly noteworthy because it is typically financed by borrowing. Given the scarcity of credit available to small and midsize firms, the latest decision to purchase more inventories reflects a conviction that this recovery is real and that consumers are willing to spend again.

Consensus Forecasters Miss the Mark

We want to highlight one final theme that runs through all these reports. In every instance the economic numbers turned out to be far better than consensus forecast. (You can throw the November employment report into that mix as well.) When these forecasters are consistently off the mark, it's a clear signal that something major is being missed in their understanding of the economy. At the very least, it is becoming increasingly clear that many are grossly underestimating the strength of the recovery.

In practical terms, it means that market interest rates have probably seen their lows. Our view is that yields on 10-year Treasury notes are about to begin their march toward 4%. For equity investors, the pick up in economic activity will further propel stock prices.

Some may wonder how it is the economy can exhibit such strength in the absence of a fully functioning banking system? The question is actually premature. Both households and businesses have stored up cash reserves during the recession and they are now gradually tapping those funds. The real issue is what happens next year. The current recovery will certainly lose momentum in 2010 unless the banking sector resumes lending. Without adequate credit, economic growth will be stunted. So, yes, today's news underscored the economy's willingness to bounce back. The fundamental question now is how far behind the economic curve lie the financial institutions?

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