THE ECONOMIC OUTLOOK GROUP

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ECONOMIC TALKING POINTS

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Forget the Headline On Durable Goods. It's Core Capital Goods Spending that Takes Center Stage

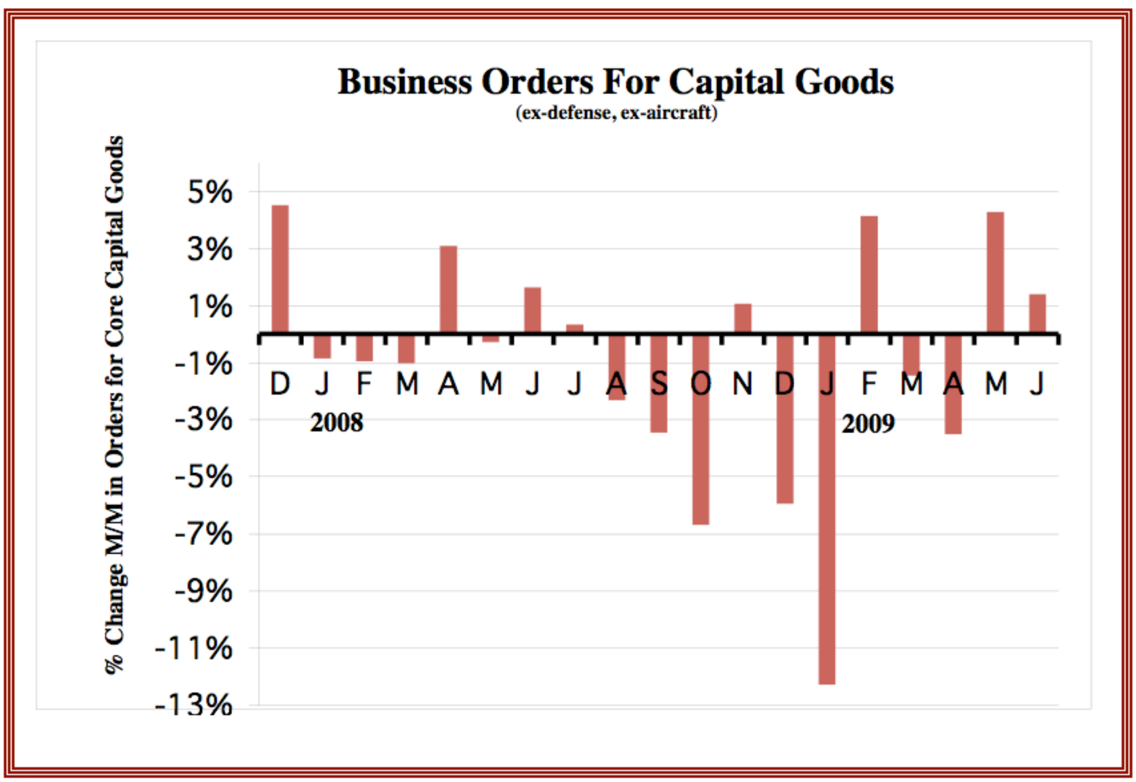
All too often we get an economic report where the real clues on the health of the economy gets overshadowed by a misleading headline number. Take the newest June durable goods orders for example. It comes as little surprise that orders overall declined last month. Bookings for autos fell in June for the second month in a row, reflecting the many troubles in this industry. Nothing really shocking here. Then there was the plunge in demand for commercial aircraft, which is such a volatile category that no reliable conclusion can or should be drawn from just this series. (Case in point: It fell 38.5% in June after soaring 60.4% in May.) Those two categories were largely responsible for total orders falling 2.5% last month, the steepest fall since the January.

But does this represent a setback for the economy? Is talk of recovery thus premature? Absolutely not on both counts.

The turnaround in the US economy is not dependant on orders for commercial aircraft, which has been hurt by the global recession. Nor should we rely on the auto industry to lead the economy out of recession. A far more telling measure at this stage of the business cycle is to look at plans for capital spending outside of commercial aircraft and defense. This sector, often referred to as non-defense capital goods orders excluding aircraft, typically leads future business spending and it has actually done better than expected. Orders for core capital goods rose 1.4% in June (…market expectations were for a rise of barely 0.2%...), and that followed a 4.3% jump in May. The last time we saw two consecutive months of increases in such orders for business capital goods was a year ago.

What could explain this solid performance? For one, we believe U.S. wholesalers and retailers have so run down their working inventory, they needed to place fresh orders to replenish their stockrooms. After all, you can't make money selling something you don't have. So these bookings becomes particularly important once businesses sense the recession is winding down. Another factor behind the pick up in business capital goods orders comes from rising demand from abroad. Germany is shaking off its worst recession in half a century. Manufacturing orders in Europe's largest economy rose for a third month in May, and industrial production surged by the most in almost 16 years. German business confidence is also on the rebound, climbing in July for the fourth month in a row. In France, consumer spending in June surged by the most in five months. China's economy, the world's third largest, grew at a huge 14.9% annual rate in the second quarter from the first three months of the year. Economies overseas are slowly coming back to life. The pickup in foreign activity has increased demand for U.S. capital goods, allowing total exports to climb by 1.6% in May, the most since July 2008.

The point here is to remain focused on the data points that provide the best insights on the state of the U.S. economy. We believe the jump in core capital goods orders will lead to higher U.S. production within the next three months, and that often results in more hiring. So while many commentators will dwell on the disappointing headline number for bookings on durable goods, it's the core capital goods orders that suggest this recovery remains on track



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