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ECONOMIC TALKING POINTS

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Mounting Evidence The Economy is Switching Gears

Finally….finally we're beginning to see some corroboration among the economic indicators that this recession is losing steam. The specific numbers we look at are not necessarily the headline figures but several of the subset components that typically lead the business cycle. Some of these measures are overlooked by analysts or intentionally dismissed, both of which are mistakes. If one tracks these components closely and impartially, a credible case can be made that this downturn appears on track to bottom out the next few months and that we should see a resumption of positive GDP growth by the end of this year.

We actually detected signs of an improvement in economic conditions at the start of the year but wanted more data points before building our case. The indicators out so far this week have strengthened our belief that the economy is nearing a turning point.

Here's why we're taking this position.

• When the NY Empire State Index came out this week, all the headlines focused on how the overall business measure plunged to record low of minus 38.2 this month.
By record, we mean at least since the NY Fed began to publish this series, which was launched in 2001. Not so long ago. Thus the first thing we have to acknowledge is that

there isn't a track record on how well this series correlates with a complete business cycle. Second, the Empire index is supposed to gauge manufacturing activity in New York and, frankly, NY does not come to mind as being one of the nation's premier manufacturing centers. Indeed, large-scale manufacturing in New York has been shrinking since the end of World War II. So let's try to put this headline number in reasonable context and temper our conclusions on what it says about the national economy.

What we seek out in the Empire index is the change in sentiment among the executives in manufacturing. Conditions may be bad right now, but do these business leaders see a new set of dynamics emerging that suggest their businesses will pick up later this year? The answer appears to be yes. When asked about business conditions in the next six months, this measure bounced up sharply, from a negative 6.6 a month ago to a positive 3.1, the first time it returned to a positive number in three months.

Drill down further and you see survey participants were much more optimistic about new orders increasing later this year, with this index shooting up to a positive 4.41 this month from a negative 4.31 in February. The same trend was observed regarding expectations to hire more manufacturing employees and projections of longer working hours. All rebounded in March.

So while there was much ink spent on out how grim the current conditions are in NY manufacturing, we were encouraged by the growing optimism manufacturers felt about the near future. They evidently have seen enough to stop the downward slide in expectations that has been in progress since last September.

- Also out yesterday was the sentiment survey by the National Association of Home Builders. Again, the numbers may not show builders in an ebullient mood, but most of the components have managed to bounce off their recent lows. The overall housing market index held at 9 for the second month, after touching an all time low of 8 in January. (True, this does not make for a confetti and Champaign moment.) The home buying traffic index also inched up to 9, above its low of 7 in November and December. The point here is not to make some argument that we are about to see a v-shaped rebound in the housing sector. It's to suggest that a bottom is starting to take shape and that we should see more signs confirming this transition.

- Today we received another good piece of real estate news with the release of February's housing starts. In a report that surprised just about everyone, new construction of homes increased by 22% last month, to a 583,000 unit annual pace. It's the first increase in seven months, and the single biggest monthly jump since 1990. To be fair, much of the increase was due to an 80% increase in apartment dwellings. But we also saw a pick up in the construction of single-family homes, which rose 1.1% in February, the first pick up in nine months.

Equally impressive was the rebound in permits, a sign of future construction activity. Permits to construct single-family homes jumped by 11%, the first increase since last April. Permits for all types of housing was up 3%.

One of the stats not in this report, but one we pointed to in the past because of its significance, is the total inventory of unsold homes. Too often, analysts point to the inventory/sales ratio of unsold homes to show how poor the market is. But this specific data point doesn't say anything about the future. Far more telling is the fact that the supply of unsold new and existing homes has been shrinking. The inventory of new homes completed and ready for sale has dropped to 167,000 (in January), the lowest since September 2006, a time when the residential real estate market was white hot. In other words, the decline in new construction over the past two years combined with the pace of home buying – as sluggish as it was --- still sopped up lots of excess inventories in new homes. We see a similar pattern with existing homes sales. Even with the addition of foreclosed properties, the supply of existing homes on the market dropped to 3.6 million in January, the lowest in 2 years! All these measures tell us the hemorrhaging is over for residential real estate, and that a bottom is forming for this industry.

• Another positive sign came from producer prices. Both the headline and core (ex. food and energy) wholesale inflation numbers rose, 0.1% and 0.2%, respectively. It's the second monthly increase for total PPI and the third consecutive rise for core. The risk of a deflationary spiral, which is characteristic of an economy sinking deeper in recession, has thus diminished.

One of the price measures in this report that is most sensitive to a turn in the business cycle is the change in prices for crude goods minus food and energy. Essentially, we are talking about the price of raw material entering the market for the first time. Once a recession ends, demand for commodities such as wheat, timber, cattle and iron ore pick up and that begins to lift prices at the earliest stage of production. That's precisely what we are starting to see with this leading indicator. Price of crude goods (excluding food and energy) rose 1.5% last month, following a 0.1% pick up in January. These are the first increases we have seen in five months.

Bottom line: At this stage of the cycle, we have to keep a close eye on those indicators that are hypersensitive to an economy switching gears. Remember, well before an economy shifts from recession to recovery, the slide has to slow and a leveling out begins. We believe that process is underway and expect to see additional economic indicators confirm this trend in coming months.

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