THE ECONOMIC OUTLOOK GROUP

475 WALL STREET
PRINCETON, NEW JERSEY 08540 TEL: 609 - 529 - 1300
WWW.ECONOMICOUTLOOKGROUP.COM

ECONOMIC TALKING POINTS

Bernard Baumohl
Chief Global Economist

November 16, 2009

The Recovery Gathers More Steam

Those green chutes spotted earlier in the year are now showing signs of flowering. Just look at the economic reports released today: October's the retail sales, business inventories, and the New York Empire Manufacturing index --- all portray an economy that is far from sluggish. Moreover, with each successive month we get more data that supports the view that this recovery is not only real, but also durable. At the very least, the latest set of economic numbers support our long held view this holiday shopping season will turn out to be better than expected.

You will recall that last month the National Retail Federation, a large trade association representing retailers, concluded that holiday sales in 2009 would be ***worse*** than the year before. We said right then and there the NRF was way too pessimistic and that retailers will likely end up collecting more revenues the final two months of the year, not less. Today's release buttresses our position. Retail sales jumped a hefty 1.4% last month, led by a surprisingly strong 7.4% increase in sales of motor vehicles and parts. No one expected to see such high demand for autos in October so soon after the "cash for clunkers" program expired in August. There was much talk the Fed program would only end up accelerating sales from the future and that demand would plummet once the program ended.

But that scenario has not yet materialized for several reasons. Let's list a few. (1) Every year we typically see 2 million to 2.5 million new drivers enter the market looking for cars or trucks. On top of that, some 12 million to 13 million sales occur annually just to replace older vehicles. So we're talking about a potential yearly market of 14 million to 16 million auto sales. Remember, that's *potential*. Obviously consumers were in no mood to make such expensive purchases during the long 2008 – 2009 recession. People were nervous about job security and income, and simply shut down spending the last two years. Now some of that pent up demand for new autos is being unleashed.

(2) A second reason why sales have picked up are the unprecedented incentives coming out of Detroit. GM, for instance, raised eyebrows with its 60-day, no risk, no hassle car return policy.

(3) Finally, there is a growing perception that US autos are being built better, with some models matching the top line Japanese and German cars.

By the way, don't think the improvement in retail sales last month was solely the result of improved car sales. Retail sales ex-autos rose another 0.2% in October, following a 0.4% increase in September. In fact, non-auto sales have now risen for the third straight month, climbing to $288.5 billion in October, the most in nearly a year!

This leads us to another point that bears repeating. We often hear how consumer spending will remain depressed because the unemployment rate is high and still climbing. It is certainly true that joblessness is painfully high. However, when we assess the outlook for consumer spending, our focus is ***not*** on the spending behavior of the unemployed. We know they will continue to retrench. If we're to see a pick up in household spending it must come from the 90% of those in the labor force who held on to jobs throughout the recession, but were overly cautious about on spending ----until now. As ***their*** confidence grows the recovery is real and that layoffs shall continue to diminish, there will be far less resistance to shopping.

We have also shown in our past research that in the first year of a recovery, we typically see BOTH real consumer spending and the unemployment rate climb simultaneously. The former occurs once households believe economic conditions are improving, and the latter can be attributed to the methodology of counting who is unemployed. "Discouraged" Americans, those who have stopped looking for work, are not counted among the official unemployed. But once they resume searching for work, they re-enter the ranks of the unemployed and that causes the jobless rate to kick up.

With the economy gathering more steam, consumers who have jobs feel more comfortable spending again. Indeed, we saw sales jump at clothing shops, department stores and with vendors on the Internet. In one of the most promising signs, Americans have shown a willingness to even go out and dine again. Spending at restaurants soared to $38.4 billion in October, the second highest in history!!

With both American and foreign consumers thus ramping up expenditures, it should come as no surprise that inventory levels at US businesses continue to shrink. The value of goods in US stock room shelves and on back lots dropped another 0.4% in September, to $1.3 trillion, the lowest in nearly four years. Now that economic activity has turned up, companies are rushing to rebuild inventories and this will translate into increased production and new hiring in the months to come, events that can fuel more economic growth in 2010.

We saw signs of that this morning with the release of the New York Federal Reserve Empire State Manufacturing survey. Factory activity in New York rose in November, the fourth straight monthly increase. Though this month's index, at 23.5, was below that of October's, keep in mind last month's index at 34.6 was the highest in five years. Any reading above zero indicates manufacturing activity is increasing.

Bottom line:

With each month that goes by, the economy shows more signs of resilience. Attribute this nice rebound in activity to the global recovery (which has lifted foreign demand for US products), the falling dollar, a more emboldened American consumer and to companies filling their stockrooms.

So what's next? The key to maintaining the economy's forward momentum next year will be the availability of credit. Whether banks will step up to the plate and lend in 2010 will determine whether the economy's current vigor can be sustained.