THE ECONOMIC OUTLOOK GROUP

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ECONOMIC TALKING POINTS

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A Good Start For The 4th Quarter

With that hefty 3.5% GDP growth in the 3rd quarter behind us, all eyes now turn to the current quarter. Was the economic rebound this summer just a fluke, pumped up by the "cash for clunkers" deal, now expired, or will the economy continue to demonstrate firm growth in the final months of the year and into next year? Today's reports lent support to the view that this recovery is actually gathering momentum, with the primary sources of strength coming from manufacturing and housing.

ISM – Manufacturing

The October ISM survey on the manufacturing activity was in several respects a stunner. The overall Purchasing Managers Index shot up to 55.7, its third increase in a row and accelerating. The PMI index is now at its highest since April 2006, a period long before the onset of the latest recession. New orders also came in at a respectable 58.5, though it slipped a little form 60.8 the previous month. Production, however, surged to 63.3, its fifth month of expansion and the most since 2004!

But get this! The most impressive part of the report is that manufacturers are now back in a hiring mood. Yes, rub those eyes. The employment index finally crossed the 50 threshold and jumped to 53.1, its highest since 2006. Eight manufacturing industries have said they were adding workers: (1) Petroleum & Coal Products; (2) Apparel, Leather & Allied Products; (3) Electrical Equipment, Appliances & Components; (4) Computer & Electronic Products; (5) Transportation Equipment; (6) Food, Beverage & Tobacco Products; (7) Machinery; and (8) Fabricated Metal Products.

Three broad factors are behind the improvement in manufacturing. First, US retailers, wholesalers and factories have seen their inventories shrink to a level inconsistent with a recovering economy. As demand for goods picks up, companies are going to have to refill their stockrooms to make the sale. You can't produce revenues if your stockrooms and backlots are empty or contain goods no one wants. Second, foreign economies (Brazil, China, Germany, France, South Korea) are on the rebound as well and they are now importing more from US producers. Finally, the $787 billion Obama stimulus has also helped lift manufacturing output as the demand for construction equipment and other capital goods increased.

Pending Home Sales

In addition to the upbeat ISM report, we got good news on the housing front. The National Association of Realtors said pending home sales shot up another 6.1% in September, after a rising 6.4% in August. We've now seen eight straight months of increases in the number of contracts signed to buy a home. The August and September surge came as prospective home buyers finished their negotiations and haggling and went to contract so they could close before the end of November and take advantage of the tax credit.

What happens after the tax credit expires? Some believe sales will cool in the months ahead. We believe the pace will slow a bit, but just temporarily. Congress is preparing a bill that will not only extend the tax credit but expand it so it includes existing homeowners for the first time. In the works is a plan that will continue the $8,000 tax credit for first time home buyers through April 2010, and also include existing home owners, though their credit would max out at $6.500. But there will be some limitation imposed on those with high incomes and on houses priced above $800,000. Nevertheless, our assessment is that once the bill becomes law, we could see a new round of homebuying in the first half of 2010.

The only risk at this point would be if mortgage rates creep above 6.5%, compared to current 5% or so for a conventional 30-year mortgage. Incidentally, that risk should not be casually dismissed. As the US economy picks up steam, private credit demand could clash with the massive borrowing needs of the government and that will push interest rates higher. The key players here are not just private and public borrowers, but also foreigners who may choose to take their excess savings and invest outside the US for higher returns. In other words, the much-needed pool of foreign capital flowing into the US could start to dry up as international investors seek out non-dollar markets and other countries for higher returns. Once the competition for limited savings heats up in the U.S., 10-year Treasury yields will move significantly higher in 2010 and that could derail the recovery. This is not an immediate threat, of course, but it will be part of the economic narrative early next year.

Bottom line: The U.S. economy does not appear to have lost any of its summer momentum. Manufacturing activity continues to accelerate this quarter and factories even found it necessary to hire more workers last month. When was the last time you heard that? In addition, homebuying activity has picked up (thanks to the government) and there is legislation in the works to further bolster the residential real estate market. So this quarter got off to a fairly good start. This week we expect to see more positive news coming out of the ISM Services Report, the Employment Cost Index (no sign of wage inflation) and fewer job losses in the Employment release on Friday.