

THE ECONOMIC OUTLOOK GROUP



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ECONOMIC TALKING POINTS

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September Begins With Promising Economic Reports

We end the summer on a solid economic note. Today's releases on pending home sales, manufacturing ISM, and even construction spending reinforce the view that this recovery is beginning to gather some steam. Ironically, stock market investors continues to be distracted by the prospect of new losses in the banking sector – and by the fact that September has historically not been a kind month for equities. Stock prices have been sliding for the past three sessions. Our take is that so long as housing improves, it will help defuse some of the problems on bank balance sheets. And for those who are squeamish about taking risks in September, we say focus on the fundamentals because they are improving each day.

Pending Home Sales

Pending home sales (PHS), which tracks purchase contracts signed, rose in July for a 6th straight month. The National Association of Realtors (NAR), the group that puts out this series, noted it was the first time in its history that PHS increased by so many consecutive months. The index itself jumped to 97.6, the highest in more than two years. July's pending home sales index was 3.2% above June's, and 12% higher than the year ago level. All of the increase in contracts signed took place in the West and South, two areas hit hardest by the real estate recession. PHS sales fell slightly in the Northeast and

Midwest during the month. However, all regions saw a higher level of contract signing in July compared with the pace 12 months earlier.

Aside from its obvious role as a leading indicator of existing homes sales, the PHS index is now edging closer to the important 100 milestone. At 100, the PHS index represents the same level of contracts signed as in 2001. As it turned out, that year was the first of four consecutive record-breaking sales of pre-owned homes. As a result, we expect overall sales and prices to move higher the rest of the year and through 2010.

Why are we seeing so many contracts signed in recent months? Certainly, sharply lower home prices and cheaper mortgages have played a role. But the latest rush to buy has been fueled by the one-time \$8,000 tax credit, which is to expire at the end of November under current law. The NAR has estimated that 1.8 million to 2 million first time homebuyers will take advantage of the tax credit this year, of which 350,000 occurred solely because of this tax credit. So give the government some credit here for coming up with a program that has helped revive an industry that heretofore showed little sign of life.

Will Congress choose to end the tax credit once it expires, or extend it further? Our expectation is that Washington will move to continue the program another 6 to 9 months. Many prospective homebuyers, however, are not taking chances. They've chosen to play it safe and grab the credit now. But they have to move quickly. The \$8,000 tax credit is available ONLY if the deal "closes" by the end of November. In other words, even if the contract was signed prior to November 30th, you're not eligible for the tax credit unless the transaction fully closes by that date---- with the only caveat being if Congress intervenes to extend the date. We expect the government will do just that and that's why we're so bullish about the economic outlook and, specifically, on home building stocks.

Construction Spending

The headlines may splash news of an overall decline in construction expenditures. But look beneath the topline numbers and you'll see good news where it counts at this stage of the business cycle: the residential front. Private construction spending for homes jumped 2.3% in July to a \$245.6 billion annual rate, the highest level since April. Public spending on residential homes rose 3.6% to an \$8.6 billion rate--- which is a RECORD! Where we see consistent weakness in the report is in commercial construction. Construction of office buildings, hotels, shopping malls are in free fall. But that's not a surprise. Non-residential construction is a lagging indicator, typically trailing homebuilding by 12 months. That's why the focus ought to be on both private and public spending residential building right now, which together make up 27% of all construction outlays. Once residential construction reaches a critical mass, commercial building will, with a lag, turn up as well.

ISM – manufacturing

August's ISM manufacturing numbers are among the most bullish signs yet that this recovery is real and likely to be sustainable. The jump in industrial production for July (the first since last October) and now the August hike in the ISM manuf. index to 52.9 (the highest level since June 2007) tell us that factories are revving up their production to offset the sharp decline in inventories among wholesalers and retailers. Indeed, all the key ISM components are telling the same story. The overall PMI measure at 52.9 exceeded all expectations. The production component shot up to 61.9, the strongest showing in nearly four years! Not only is this the third straight month that saw production increase, the pace has started to accelerate!! And, it looks like manufacturing activity will continue to be strong in the coming months because factories are seeing new orders coming in at an even faster rate!! The New Orders index surged to 64.9, the most seen since December 2004. Even the employment index has managed to turn up, from 45.6 to 46.4 last m month. OK, that's not much of a gain, but when you take into consideration the increase in US productivity lately, any slowdown in job losses at factories suggests the labor markets may be starting to stabilize.

One other point needs to consider here. It is not just demand from US companies that has driven up new orders, US manufacturers are seeing a pick up in sales internationally. The ISM export index shot up to a 12-month high of 55.5 in August --- from 50.5 the month before.

Bottom line:

Both the ISM and pending homes are valuable leading economic indicators and they portray an economy that has shaken off the last vestiges of recession. With that positive backdrop, the big question now is how long will it take for the job market to do the same? Our answer: Perhaps sooner than you think. The chances have improved that we will see joblessness finally top out by March 2010, if not before.