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## ECONOMIC TALKING POINTS


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### Lots of Positive Economic News Lately. So Do We Still Need QE 2?

There is now a preponderance of evidence showing economic growth is re-accelerating in the U.S. Since summer, we have been tracking several key forward-looking indicators and have detected more and more signs that economic conditions are in fact improving faster than most forecasters have argued.

(See previous ***Economic Talking Points*** reports: "*It's Time for the Economic Bears To Exit Stage Left*" – September 1, "*The Pause Is Over As the Economy Gradually Picks Up Momentum*" – September 3.)

The better than expected October jobs release and the upward revisions on employment in previous months are just the latest signs showing business activity is shifting into higher gear. Indeed, we are revising up our forecast for fourth quarter GDP to 3.2%, from 2.9%. We are also in the process of reassessing to what extent the economy, jobs, consumer and business spending will turn out better in 2011 than we initially thought.

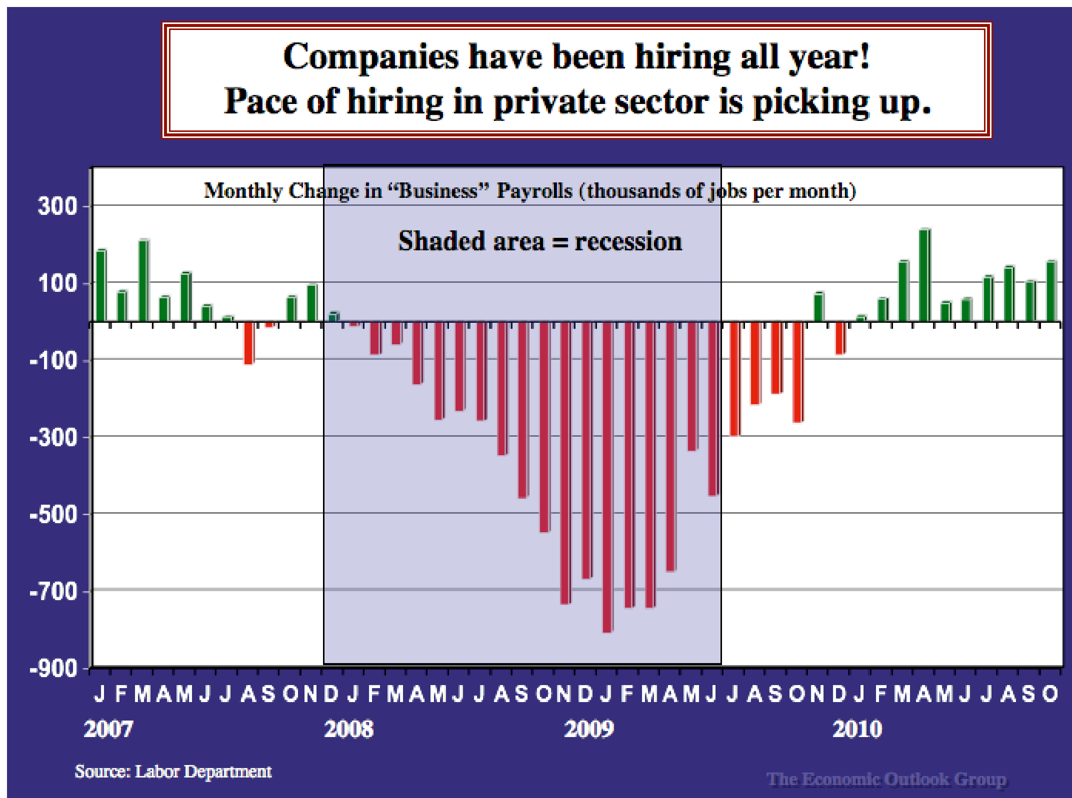
One worrisome issue, however, does loom larger now. Given the latest set of upbeat economic news, is another round of quantitative easing by the Federal Reserve even necessary? We don't think so and hope the Fed will reconsider firing a $600 billion bolt of liquidity into the economy between now and June. Doing so could imperil the Fed's credibility as an inflation fighter. Indeed, one of the biggest threats to the economy next year may be a sharp reversal in bond prices. A precipitous fall would quickly kick yields higher and pose new risks for the recovery. More on this point later.

**Employment**

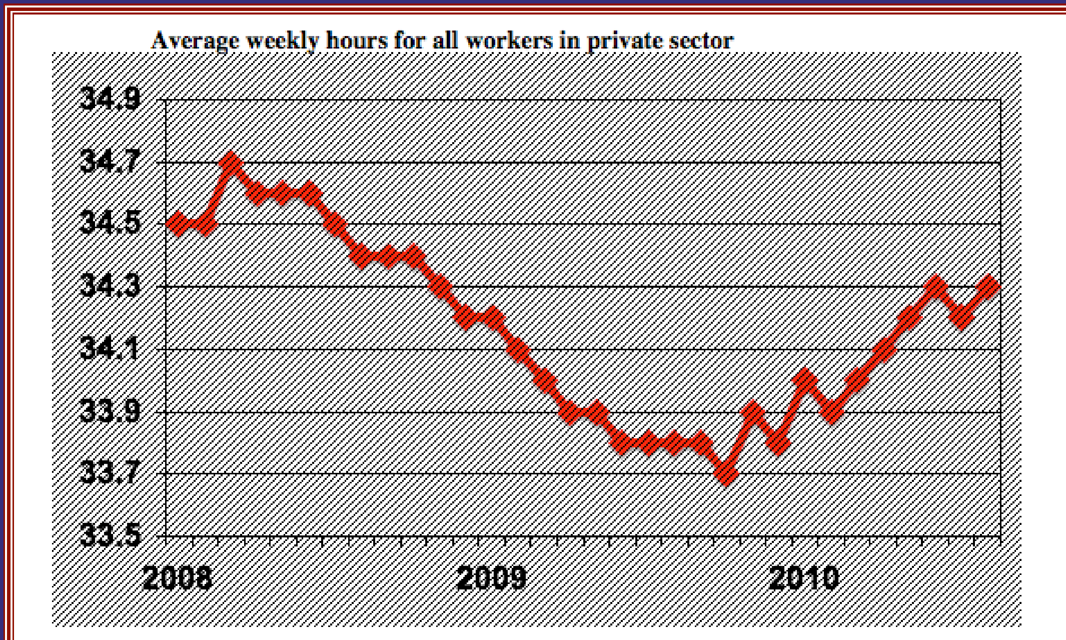
As for the latest jobs report, there is little ambiguity in the story it tells. Labor market conditions are clearly getting better, though still not fast enough to bring down the stubbornly high unemployment rate.

Total payrolls jumped by 151,000 in October, the first positive number for this category since May. It would have been higher were it not for the 8,000 layoffs that occurred at the federal and local government levels. (There were no net new layoffs at the state level, according the to BLS.)

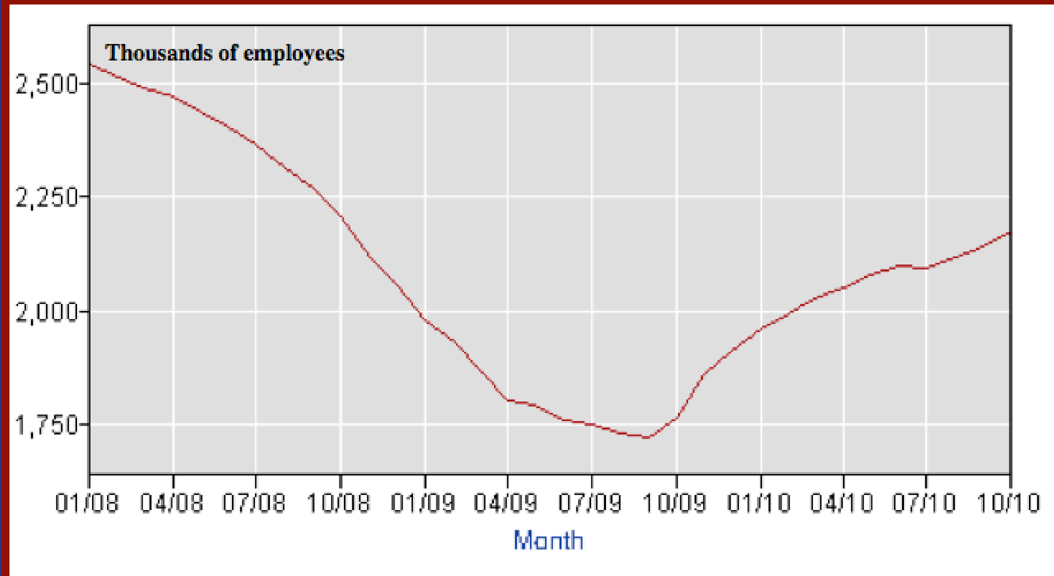
The far more important point is what happened with private payrolls. Are companies sufficiently confident about the recovery's strength that they have ramped up hiring? The answer is yes. And not just during October! The BLS has significantly revised up the growth in private payrolls for August and September as well. October private payrolls rose by 159,000, the biggest since April, and second largest jump since March 2007. The BLS also scratched August's preliminary rise in private payrolls, which was 93,000 and corrected it to 143,000; September's original 64,000 increase was also changed to show a pick up of 107,000. On average, the monthly pace of job growth in the last three months is nearly double that of the previous three months (136,000 vs. 76,000).



Among the leading indicators in this report are average weekly hours worked and overtime. Are employers asking workers to stay on the job longer? That appears to be the case as well. Workers spent an average of 34.3 hours on the job during the weeks of October, more than in September. The last time Americans put in longer hours was two years ago. Average overtime hours remained at 3.0 hours in October, the high so far this year.




Another useful leading indicator is temporary employment. A persistent rise in temporary workers does lead to more permanent hiring. Last month temporary employment jumped by 34,900, the largest increase since February. In addition, both August and September's numbers on temp. workers were revised higher.




**More signs of improvement on the job front:**

• The number of Americans in the non-farm sector who were forced to accept part time work because of the lack in suitable full time employment dropped to 9.05 million (vs. 9.33 million in September. Indeed, last month's figure even slipped below the year ago level of 9.16 million.

• Another encouraging indicator is the slowdown in recent layoffs. The number of Americans who have lost jobs within a period defined as "less than five weeks" dropped to 2.66 million, the lowest since last March. It stands significantly below the year ago level of 3.13 million.

This improvement does seem to contradict the weekly claims for new unemployment benefits, which remains stubbornly above 400,000. But here we get into the anarchy of statistics. The weekly series on new claims for jobless benefits are based only on those who expect to receive unemployment benefits. This is a narrower group within the newly unemployed population. The decline in layoffs from today's household survey makes no distinction whether they are eligible to receive unemployment or not. In other words, the figures in the October jobs report looks at a larger population of unemployed than does the weekly release on applications.

• Another positive, if slight, turn for the better is that for the first time since June the broader underemployment rate fell to 17% from 17.1% in September.

This, too, may seem a bit bizarre since the number of Americans who lave left the labor force increased by 462,000. One may wonder why such a large increase wasn't reflected in the rate of underemployment?

Well, it actually was. The composition of the underemployment series (U-6) includes discouraged workers AND those Americans who are unhappily stuck with part time jobs. The decline in the latter more than offset the increase in the former --- and this lowered the underemployment rate by a tenth.

• One less followed, but very useful forward-looking indicator on business activity is employment in the trucking industry. As the economy gets busier, so do highway shipments of goods to retailers, wholesalers, manufacturers and to ports. Such transports make up the heart of the supply chain business of the economy. So we look to see if trucking companies are getting busy enough to hire more drivers. That, too, has been the case. Employment in trucking has been rising for four consecutive months and now stands at 1.243 million, the highest of the year.

**Other releases out this week have surprised forecasters.**

The October employment report is just the most recent in a string of indicators this week that took analysts by surprise.

• The ISM manufacturing index for October outperformed most forecasts. New order, which portend future increases in production, rose to the highest in five months. Service sector activity, which makes up nearly 90% of the economy, also blew past consensus expectations. The ISM's new orders index for services expanded last month at a faster rate than September's.

• Construction spending unexpectedly rose in September, largely because of increases in residential building and structures.

• Consumer spending jumped in September. When the government released the personal income and spending report, we saw that real (inflation-adjusted) expenditures has been climbing for five straight months, with the largest jump coming from expensive durable goods.

• That was in September. Apparently, households were happily spending in October too. Retailers reported yesterday that same store sales for October came in above Wall Street forecasts. Macy's, Saks, Costco Target and others said sales outperformed expectations.

• October auto sales were strong, with purchases of cars and light trucks exceeding the 12 million-unit annual pace, the best performance in two years. (Sales did briefly spike above that in August in 2009 but this was fueled by the Cash for Clunkers program, so we're not counting that.)

**What will the Fed now do?**

As we said earlier, all this economic activity raises an important question. If the economy is in fact gathering more steam, should the Federal Reserve continue to pump another $600 billion into economy? After all, the recession has ended, the problems in the financial sector are largely past us, and now the recovery is picking up more speed.

Frankly, we believe QE2 is a mistake. If it is implemented at a time when the economy is coming back to life, it could pose a more serious problem for the Fed later next year as the spotlight shifts from deflation to inflation. Our concern is that the instant inflation expectations become unanchored, bond vigilantes will pounce on the bond market and push market rates much higher.

Will the Fed proceed with QE2 even in the face of a stronger recovery?

We expect they will --- at least in the beginning as it purchases $75 billion worth of new government securities a month. What Fed Chairman Bernanke and most others on the FOMC appear most focused on is the large output gap in the economy. There is still too much slack in the industrial and labor sectors. After all, the Fed's two principal mandates are two maximize employment and to keep inflation steady (with core at around 2%). They have now failed in both, which is why we expect the Fed will go ahead with the next tranche of QE.

**The Fed's strategy here is multifold.**

**(1)** By purchasing more Treasury securities, they hope to pound longer term rates so low it will encourage more investments into the equity market. Rising stock prices and falling yields on fixed incomes, of course, also lowers the cost of capital. This will create new incentives for firms to raise funds and, hopefully, channel it into more business capital spending and hiring.

**(2)** Higher stock prices also increases household wealth, assuming no further catastrophic fall in home prices. If households feel wealthier, they are inclined to spend more and that boosts overall demand in the economy.

**(3)** Lower yields on fixed incomes will hold mortgage rates at historically low levels. The backdrop of record low borrowing costs, excellent home prices for buyers, and better labor market conditions should set the stage for a stronger housing market once the real estate season returns in late winter and early spring.

**(4)** The last part of the Fed's strategy, however, is the most controversial. All the additional liquidity being injected into the economy should keep dollar's value low enough to boost exports, and thus GDP. Moreover, a cheap dollar could lure in foreign direct investments and increase tourism to the US.

The fundamental problem with this last strategy is that it could seriously backfire on the Fed. The central bank can influence the direction of interest rates, but it has little

control over the movement of the dollar. That is the domain of the world's foreign exchange market, where some $4 trillion worth of dollars are traded every day.

Here's what foreign investors fear most. With conservative Republicans and Tea Party members having captured the House of Representatives, the chance of another spending program coming out of the White House has dropped to nil. That means the U.S. economy's fortune now rests entirely on the shoulders of the Federal Reserve. Since the Fed seems intent on pursuing a "full steam ahead on monetary easing and damn the dollar" policy, the danger is the greenback could conceivably fall off a cliff next year. That could trigger a sell-off in bonds, cause a leap in longer term market rates and instantly threaten the recovery. In other words, the implementation of QE2 (...and possibly QE3, and QE4) could end up with the Fed staring at another recession late next year or in 2012. It would be the ultimate liquidity trap.

**What should we watch now that the economy is showing fresh signs of resilience?**

First, the Fed will have to be mindful of the economy's growing strength when it deliberates on how much additional liquidity needs to be injected into the banking system from this point on. Since we're forecasting stronger economic activity and faster job growth in 2011, our sense (or hope) is the Fed will NOT execute the full $600 billion stimulus program.

Second, watch the bond market. The threat of deflation has now greatly diminished. Fixed income investors may soon become increasingly uneasy holding a dominant position in bonds. Throwing massive amounts of money into an economy that has come to life can quickly stoke inflation fears and rally the bond vigilantes. If investors sense for a moment that the Fed is having difficulty managing inflation expectations, it could be enough to initiate a massive exodus out of bonds as every one heads for the exit, and that would dramatically kick rates higher.

Thus for us, the big story in 2011 and early 2012 will be the tug of war that could erupt between the Fed and the bond vigilantes. The winner of this contest will be determined by two factors: How comfortable will foreign investors feel holding dollar-denominated securities in the next two years? And second, will the Fed be successful in sopping up the excess liquidity fast enough to prevent an outbreak of inflation fears.

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