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ECONOMIC TALKING POINTS

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Economic Bears, Time To Exit Stage Left

We certainly faced a barrage of dismal economic reports this summer and they left many business leaders and investors bewildered about where the economy was headed. What's so interesting is that the recovery began with lots of momentum late last year, before hitting some speed bumps this spring. The speed bumps weren't all that serious in my opinion but they were enough to instill lots of fresh doubts about the durability of the US recovery. You remember what they were: the eruption of the sovereign debt crisis in Europe, concerns that China was about to experience a real estate crash that would sharply slow its economy, the inability of the US housing sector to spring back to life, and the waning impact of Obama's $814 billion stimulus program on the economy. All these events gave the economic bears extra credibility as they warned of doom and gloom for the US economy. The pessimists had the stage for the last six months. Will they continue to hold the spotlight the next six months? No.

It's September now and the economic recovery is about to begin its next act. We have just seen a fresh batch of data points from around the world and they suggest the U.S. and international economy are in no real danger of slipping into a double dip recession --- or doomed to suffer slow-motion growth for the next decade or so.

Let's begin with the ISM release on August manufacturing. While a consensus of forecasters called for another slowdown in manufacturing activity last month, the fact is factories have actually become busier. Defying many experts, the Purchasing Managers

Index increased in August to 56.3, from 55.5 in July. Of the 18 industries surveyed, 11 reported more growth and that helped drive factory activity to its highest level since May.

We did see some slippage in new orders, however, as that gauge ticked down to 53.1 from 53.5. Still, the volume of new orders continues to rise (if a bit slower) and that should lead to more production in the months ahead. In fact, August's ISM production index shot up another 2.9 points to 59.9. Typically, when this measure rises above 51, it signals another increase in the Federal Reserve's series on industrial production. So, in terms of factory output, we are starting to regain momentum.

Most interesting is the jump in the ISM employment measure because it so clearly contradicts the trend in jobs reported by ADP. The ISM survey showed employment in manufacturing surged 1.8 points in August, to 60.4, the highest since December 1983!!! Yet, according to ADP, employment in manufacturing fell by 6,000 the same period. These are sharply conflicting outcomes for the same month and someone has got to be way off. After all, the ISM registered factory employment near 30-yr high last month, while ADP computed jobs in that sector to the lowest since April. (Friday's jobs report will certainly bring one of these two organizations major bragging rights.)

And for those economic bears who warn we are on the precipice of a deflationary spiral, better look again. The ISM price index jumped 4 points to 61.5 last month, with 12 of the 18 industries reported paying higher prices. This is the kind of news that should not only put the deflation crowd on the defensive, it serves as a warning to bond holders that perhaps the time to reduce their exposure to fixed incomes has arrived.

But let's not stop with ISM. One of the most consistently underplayed reports out today is the weekly count on mortgage loan applications. We look at it closely to monitor how aggressively households are repairing their balance sheets. What we see is very encouraging. With mortgage rates on conventional loans down to 4.43%, the lowest since the Mortgage Bankers Association first began recording them in May 1990, Americans are rushing to refinance in ever-greater numbers. The MBA's refinance index jumped to its highest level since May 2009.

Refinancing improves household cash flow, and when you combined that with how Americans have replenished their savings and pared their outstanding debt, it should set the stage for more vigorous spending by consumers in the final quarter of this year. The improvement in household finances, we believe, has also contributed to the recent lift in consumer spirits. Both the University of Michigan's consumer sentiment survey and the Conference Board's consumer confidence series agree that Americans are more upbeat. Yesterday, the Conference Board said its index of consumer confidence rose to 53.5 in August from 51.0 in July. A few days earlier, the University of Michigan final index of consumer sentiment rose to 68.9 last month, from 67.8.

We also got some reasonably good news on the international front. The bears --- yes, they've been busy lately---have been warning all summer that China's economy may experience a hard landing as the government reigns in real estate activity and slashes credit to other industries, such as those that are energy inefficient. Needless to say, a serious drop in activity in the world's fastest growing economy can have global repercussions.

But if there is one thing we've learned the last two decades, it is that Chinese policymakers have been successful at keeping their economy out of any serious trouble. They have adroitly steered the country away from several earlier global economic storms, including the Asian financial crisis, the Russian debt default in the late 1990s, the collapse of the dot.com bubble in the US, and have even suffered minimal damage from the 2008 – 2009 global recession.

Now those skills have come into play again. We got fresh evidence overnight that Chinese officials continue to be successful at engineering a soft landing. China's purchasing manager's index showed manufacturing activity grew at a faster pace in August, rising to 51.7 from 51.2. Our forecast calls for the world's second largest economy to grow by 9.7% this year and then ease back to a still respectable 8.6% in 2011.

It is true that India's economy is downshifting as the government tries to cool inflation. But, here gain, the slowdown is minor and poses no risk to their expansion. The Reserve Bank of India has been very deliberate in raising interest rates to stabilize prices. As a result, manufacturing activity has eased back a bit, with their purchasing manager's index slipping marginally, to 57.2 in August from 57.6 the prior month. Again, we see no danger of a sharp drop in growth. India's economy will expand close to 9% this year, followed by 8% next year.

Viewed together, we believe the global economic recovery is still very much on track. Our expectation is for the US economy to pick up more speed in the final three months of the year and continue through 2011 as both consumer and business spending comes back to life. Frankly, the time has come to start elbowing the pessimists off the stage.

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