

THE ECONOMIC OUTLOOK GROUP



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ECONOMIC TALKING POINTS

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The Pause Is Over. The Economy is “Gradually” Picking Up Momentum

For months, we’ve been getting dire warnings from a noisy group of forecasters proclaiming that a double dip recession is near. They have been so successful pontificating the coming demise of the recovery that investors rushed out of equities and into safer fixed income securities. In the meantime, business leaders turned cautious and fearful consumers became parsimonious.

That is about to change.

The latest employment report for August along with key revisions for earlier months give us more clarity on the current health of the economy and where it is likely to head. Given the jobs report, as well as other recent upbeat economic releases, we can say with greater confidence that a relapse into recession now looks far more remote. In fact, evidence is mounting that the economy is gearing up for a stronger fourth quarter (with the holiday shopping season looking brighter) and a better 2011 than most current forecasts.

To begin with, companies added 67,000 more workers than they dismissed last month, continuing a trend of rising employment that began at the start of the year. In addition, after receiving more complete information, the Labor Department revised upwards the hiring figures for the two previous months as well, with private payrolls increasing by 61,000 in June (vs. the original 31,000) and 107,000 in July (vs. 71,000).

Of course, even these numbers reflect a subpar recovery. After all, the unemployment rate did creep up to 0.1 percentage points to 9.6%, as the labor force outgrew the rise in employment. Part of this is because federal and state governments were forced to lay off 121,000 workers. Nevertheless, when you dig deeper into the report, you find numerous forward-looking statistics that suggest labor market conditions in the private sector are improving. Let's point some of them out.

- There was a rebound in the size of the temporary work, a measure that is highly sensitive to turning points in the economy. It increased by 16,800 in August after falling by 900, the month before.
- Workers also put in more hours on the job to meet rising domestic and foreign demand. Average weekly hours worked in manufacturing rose to 40.2 hours (vs. 40.1 in July); Overtime in manufacturing increased to 3.0 hours (from 2.9 the previous month); Total average weekly hours worked in the private sector was unchanged from July, at 34.2. But even this is encouraging when you consider the last two months of private sector hours combined were the most we have seen in more than a year!
- More hours worked brings greater income to households. Average hourly earnings jumped 0.3% last month, the most since January. But here's the real surprise: average weekly pay in the private sector, after adjusting for inflation, jumped 1.7% in August from a year ago, the biggest annual leap so far this year. Remember, an increase in real pay is one of the strongest predictors of consumer spending.
- Another positive trend is the decline in time spent out of work. The average duration people were jobless fell to 33.6 weeks in August, the second drop in a row. It peaked at 35.2 weeks in June. The median number of weeks unemployed has fallen to 19.9 weeks. That, too, has been slipping for two months after topping out at 25.2 in June.
- One other noteworthy indicator in the jobs report is that companies have scaled back firings in the last month. (This raises serious doubts about the value of the stats on weekly claims for jobless benefits.) The number of Americans out of work five weeks or less last month fell by 79,000. Also heartening is the fact those out of work 27 weeks or longer dropped by 323,000. In fact, the number of Americans who have been jobless more than half a year has fallen to 6.25 million, the lowest level since February.

August's fairly good employment numbers is consistent with a group of other recent positive reports.

(1) For example, consumer confidence has improved last month according to both the Conference Board and the University of Michigan. (2) Households have been successful at repairing their balance sheets, improving cash flow so much that delinquencies have been declining, according to the Federal Reserve. (3) Personal spending in July jumped by the most since last March. (4) The National Association of Realtors reported that pending home sales rebounded better than expected in July. (5) Industrial production this summer has also been stronger than forecasters projected, with every production sector (consumer and business goods) showing greater output. (6) Activity in manufacturing and services continued to expand in August, according to the ISM. True, the ISM services index out today slipped from 54.3 to 51.5 last month. Some of the components

were disappointing and even dropped below the 50 threshold line that designate expansion. However, services have always been a poor leading indicator when it comes to detecting an inflection point in the economy. The manufacturing sector is a much more reliable forecasting tool in that regard and it has bounced back last month. We expect to see all of the ISM service components resume their upward movement again in the fourth quarter. (7) Last, but certainly not least, the global economic recovery remains intact. Europe's largest economy, Germany, grew in the second quarter at a pace close to that of China and India! And the latter two emerging countries have so far demonstrated they can cool inflation and contain real estate prices without endangering their expansions. Forecasts for growth in the European Union will likely be revised higher now that its sovereign debt crisis has been defused.

Since last spring there has been a lack of conviction on the direction of the US economy. For months, business leaders, consumers, and investors were caught up in a tug of war between two competing views: One side warned of a profoundly weaker economy looming, if not recession. The other argued that the spring and summer weakness was little more than a temporary pause, and that a more palpable recovery will emerge later this year and next. Our clients know we have never been in the double-dip camp. Based on the data points we track, our confidence has increased that this recovery is real, sustainable, and in the process of picking up steam. The implications for portfolio management are huge, with asset allocation shifts out of fixed incomes and into equities. Moreover, companies will likely accelerate capital spending, not just to replace aging and obsolete equipment, but also to add to capacity. As the recovery firms up, so will employment trends. To increase the incentive for banks to lend to the private sector, we expect the Federal Reserve will shortly announce a decline, if not elimination, of the interest paid on excess reserves banks hold with the Fed. After all, why reward banks for keeping their cash idle when so many small and midsized businesses are starved of credit. That rate paid to lenders on such reserves is currently 0.25% and that may drop to 0.10%, or, we hope, to zero.