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ECONOMIC TALKING POINTS

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"The Future Isn't What It Used To Be"

The turmoil in North Africa, Persian Gulf and in Japan is starting to reshape the US recovery. Current economic reports show inflation accelerating, consumer confidence plunging, industrial output slipping, homebuilders disappearing, and fuel costs still climbing (both WTI and Brent are over \$100 a bbl. this morning). Expect to see even more evidence in coming months that the economy's pulse is weakening.

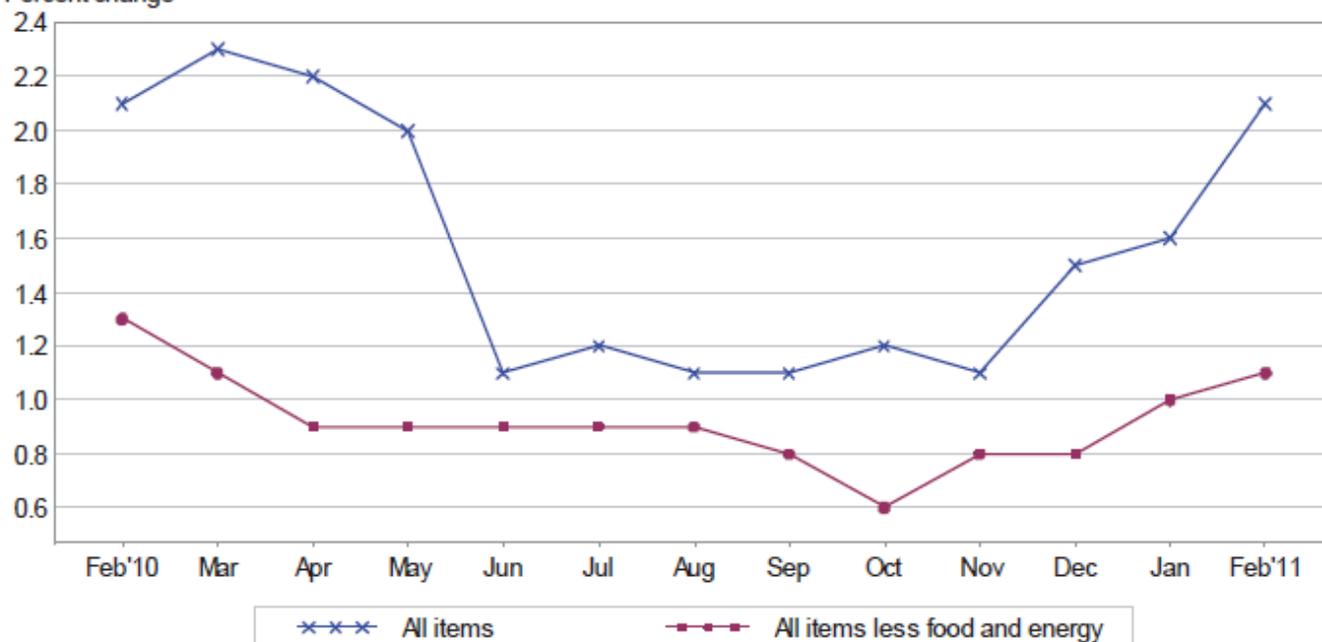
What a remarkable change in just two months! After entering the year with strong momentum and optimism, the world economy has been buffeted by an onslaught of external shocks that threaten to materially slow economic growth.

CPI

Let's begin with the inflation data out this week. If consistency is what you seek, you've got it. Virtually every measure of price behavior shows inflation pressures building. The government reported this morning that headline consumer price inflation climbed 0.5% in February, following a 0.4% increase in January. Both represent the fastest monthly pace in more than two years. Over the past 12 months, the CPI rose 2.1%, the biggest bounce since last April. Take out food and energy, core retail inflation rose 0.2% in both February and January, a pace we haven't seen in nearly two years. Core prices over the past year was up 1.1%, the most since last April.

Since bottoming out last summer, consumer prices have turned higher. That is a trend we have seen with producer prices and the import price index. (One of the Fed's primary goals is to ratchet up annual inflation to between 1.6% to 2%. Well, guess what? Import price inflation has now jumped to 6.9%, --- the most in 8 months, and core PPI reached 1.8%, the highest since August 2009! And Core CPI is on the move too and will likely reach the Fed's target range before the summer.)

Chart 2. 12-month percent change in CPI for All Urban Consumers (CPI-U), not seasonally adjusted, Feb. 2010 - Feb. 2011
Percent change



Industrial Production

U.S. industrial production surprised the market this morning when it fell 0.1% in February, after three straight months of gains. Much of the decline can be attributed to a 4.5% fall in the output of utilities. But even manufacturing activity has been decelerating the past two months, largely because of cutbacks in consumer goods production.

Scaling back on consumer goods is a category we will watch particularly closely in coming months. For instance, are retailers and wholesalers increasingly worried that higher fuel costs will force consumers to scale back spending and leave stockrooms filled with unwanted inventories? If so, new orders to factories for consumer goods will wind down. We think that scenario is becoming more probable.

Consumer confidence

Are consumers about to retrench? We have to wait for March data on retail sales and personal spending, but one thing we can say is that confidence has already collapsed. The consumer sentiment index plummeted mid-March to the lowest level in five months. In fact, the nine-point drop from 77.5 to 68.2 was the largest monthly decline in more than two years, according to the University of Michigan! One of the best predictive indicators of household spending in that series is how Americans view the 6-month outlook for the economy, and that measure just imploded. It fell 13 points, the biggest monthly drop since 2005!

Declines in confidence of such magnitudes cannot be dismissed as some statistical aberration. They tell us that Americans are increasingly worried these external shocks may slow economic growth, squeeze household finances, and perhaps even undermine future job security.

Homebuilding

If that wasn't bleak enough, check out the near total shutdown in homebuilding. It is important to recall that builders typically resume construction this time of the year, since this is when the home buying season commences. Instead, housing starts plunged 22.5% in February, the steepest decline in 27 years!! Also disconcerting was the outlook for new construction. Builders in February filed the fewest permits ever recorded for future construction, just 517,000 at an annual rate.

Yet the Fed says the economy is looking stronger?

It is, therefore, quite frustrating to see the Federal Reserve end its latest FOMC meeting with a statement that says the "economic recovery is on a firmer footing," and that "household spending and business investment...continue to expand." With respect to the behavior of prices, the Fed noted "longer-term inflation expectations have remained stable, and measures of underlying inflation have been subdued."

These observations make perfect sense if one looks at the rear view mirror. The problem is that given the massive non-economic shocks assaulting the US and international economy, there is little confidence from these words that the Fed is staying *ahead* of the business curve. It appears to us the Fed relies way too much on rigid mathematical models to assess the health and direction of the economy. **Our concern is that these models have little value at a time**

when the macroeconomy is being battered by waves of major “non-economic” shocks. Remember, the assumption underlying such models is that past patterns are likely to be repeated in the future.

But what we are witnessing this time are multiple shocks, each of which is a marked departure from anything experienced in the past. This is precisely when models break down. You cannot compose an equation that incorporates shocks of such magnitude. There is an old saying: Mathematics has given economics rigor –but alas also mortis!

The unique set of dynamics now playing out in Africa, the Middle East and Japan requires that we rely less on economic models at this time and more on an intuitive and agile analysis of what is likely to come around the corner in terms of growth and inflation.

Let me throw out a few examples. By mid-year, the Federal Reserve will conclude its second round of quantitative easing, which means that under the current plan the Fed will no longer be a major buyer of net new Treasury securities. This could place upward pressure on longer term interest rates.

What is of greater worry, however, is if Japan also chooses to scale back purchases of US Treasuries --- or even acts to sell some of those assets to finance the cost of rebuilding. Japan has long been a major global creditor. It is the world’s second largest foreign holder of US treasuries, owning \$886 billion. Should two major buyers cut back on their purchases of US debt at a time when this country has to finance a record \$1.6 trillion budget deficit, the competition for global savings could lift yields on Treasury notes and bonds to levels that can damage the U.S. recovery, and especially housing.

Another development that may fester for months if not years is the turmoil in Libya and in the Persian Gulf. Even if Gaddafi manages to regain his position, the country may still descend into civil war. After a brief taste of freedom, rebels will likely choose to continue their fight in the form of a gorilla war. Our expectation is that the country will remain unruly until Gaddafi is gone.

The uprising and violence in Bahrain has also earned the spotlight because the real story here is the emerging political and military battle between Saudi Arabia and Iran. This is a confrontation that has been brewing for years. Iran seeks to expand its influence across the Middle East. Indeed, Iran’s clerical leaders have called Bahrain the 14th Province of their country. It is thus little wonder that Saudi Arabia and other members of the Gulf Cooperation Council chose to send in troops into Bahrain to quash the Shiite rebellion.

That military move has upset Iran. In a comment of monumental hypocrisy, Iran’s Ahmadinejad denounced the use of troops in Bahrain, saying: “The people’s demands for change must be respected. How is it possible to stop waves of humanity with military force?”

Imagine the self-control he had to summon to utter such a specious sentiment.

The key point here is that the military steps taken in Bahrain really represents the next stage of a hotter clash between the two largest oil producers in the region, Saudi Arabia and Iran. This will keep crude prices elevated well into the future.

Bottom line:

Yogi Bera's quote that "the future isn't what it used to be" seems appropriate these days. Investors in the financial markets are understandably spooked by all these events. Every piece of news coming out of Japan regarding its nuclear crisis is received with apprehension. The fighting in Bahrain could escalate into a direct confrontation between Saudi Arabia and Iran, an extremely unnerving prospect. Libya, another oil exporter, could devolve into anarchy. These are all momentous events and it is impossible to discern how it will all be resolved at this time. Given how jittery global financial markets are, investors would be wise to cut back on risks. This is not a good time to make a major commitment with investment capital.

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