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ECONOMIC TALKING POINTS

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Nerves Force Consumers and Businesses To Turn More Cautious

The battle of nerves continues. American consumers and business leaders have clearly been spooked by the rebellions in the Middle East, the enormous destruction in Japan, and the sustained leap in energy prices.

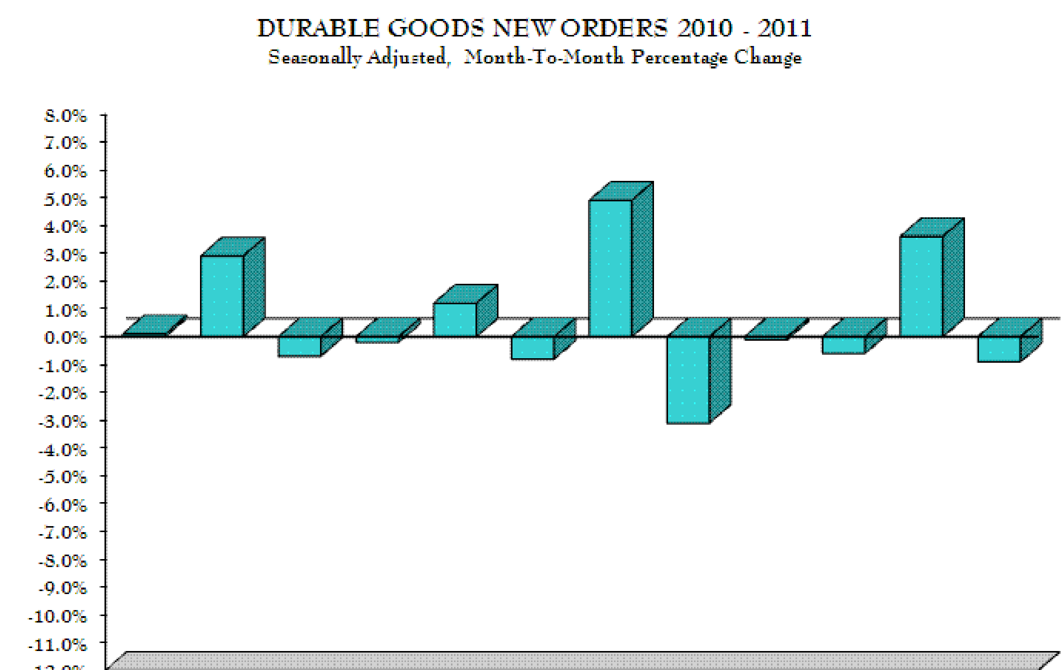
We won't stop there. Adding to these jitters is the likelihood the second and third largest economies in the world (China and Japan) are slowing, and that monetary policy is also being tightened across the universe of emerging countries, with the European Central Bank hinting it will do the same next month.

The cumulative effect of all these headwinds raises the question of whether the U.S. recovery itself is starting to wobble? We're not talking about a relapse into recession this year or next. The probability of an actual downturn is quite remote, less than 20%. The looming question is how much US economic growth will decelerate as result of these headwinds --- and how will that affect sales, jobs and incomes?

At the very least, evidence is building that companies and households are turning more cautious about spending.

Dismal surprise for durable goods

For instance, up until this morning, there was widespread expectation that business orders for durable goods would jump by more than 1% in February. Forget that! Instead, the government reported companies CUT orders by 0.9%. If you take out the more volatile transportation component (which includes civilian aircraft orders --- which was actually up 26.7%!!), bookings still dropped by 0.6%. One major reason for that decline was that core business capital spending, which reflects confidence companies have about future demand, dropped 1.3% last month, after plunging 6% in January. A decline in orders of such magnitudes means that factories will have less to produce in the months ahead and that can cool hiring and slow household income growth.



	Mar-10	Apr-10	May-10	Jun-10	Jul-10	Aug-10	Sep-10	Oct-10	Nov-10	Dec-10	Jan-11	Feb-11
% Change	0.1%	2.9%	-0.7%	-0.2%	1.2%	-0.8%	4.9%	-3.1%	-0.1%	-0.6%	3.6%	-0.9%

Source: Commerce Department

It is true that manufacturing accounts for just 12% of the economy, but it is a much more sensitive sector than services when it comes to reacting to changes in the business cycle. Remember, it was manufacturing that led the US out of recession in 2009 so any persistent weakness here is a worrisome sign ---- especially given the newly passed tax incentives Congress granted firms this year to write off 100% of their capital spending. Evidently worries about the unrest encircling Saudi Arabia, the cold war brewing between the Saudi Kingdom and Iran, the ongoing civil war in Libya, and how they all promise to keep oil and gasoline prices elevated have trumped the inducement to invest from these temporary tax incentives.

Consumer moods sinking

Consumers also appear to be in retrenchment mode. Fuel and food prices have been surging, yet Americans have no leverage to demand more pay in this soft job market to help offset the higher lost of living. That leaves less available for discretionary spending. In fact, real income growth (earnings adjusted for inflation) has been either zero or falling the last four months.

This erosion in purchasing power has very clearly frustrated consumers. Several recent measures of consumer confidence show optimism over the economy and personal finances are rapidly falling. Today's release of the weekly Consumer Comfort Index put out by Bloomberg, plummeted to the lowest level since last August. It fell to a minus 48.9 in the week ending Mach 20th. That's the third straight weekly drop for the index.

The University of Michigan also detected rising anxiety among households. Their Consumer Sentiment Index out mid-March showed confidence suddenly dropped to its lowest in five months. (We say suddenly because that measure hit a three-year high in February! We'll get a final reading for March on Friday.)

This erosion in confidence has not gone unnoticed among retailers and real estate agents. Earlier this week, the International Council of Shopping Centers reported same store retail sales dropped 0.1% in the week ending March 19th. On top of that, new home sales collapsed last month, dropping to a 250,000 annual rate, the lowest since such records began in 1963, and that followed a near 10% drop in existing home sales the same month.

Headwinds getting stronger

The drag on economic growth is building and becoming more formidable. Here is a list of forces straining the recovery.

- Energy prices to remain high (especially now that Japan will increase purchases of oil).

- A tightening of monetary policy virtually everywhere in the world except the U.S.
- American households see their finances getting squeezed and their real estate assets still declining in value.
- Higher commodity costs are hurting profit margins at US companies.
- State and local municipalities are laying off workers and cutting outlays.
- Congress will enact further spending cuts this year.
- QE 2 is coming to an end in June and the Federal Reserve has little public or internal support to launch QE 3.
- Europe's sovereign debt crisis is heating up again as speculation mounts that a massive bailout is inevitable for Portugal.
- Chinese policymakers continue to tap the economic brakes to quiet inflation and cool-off their real estate market.
- The risk grows that protests in the Persian Gulf will escalate into a full-blown multi-country violent clash between Sunni and Shiite Muslims.

Given the all this drag on the economy, we have lowered our forecast for US GDP growth in 2011 from 3.5% at the start of the year to 2.8% --- and even that may be too optimistic. We'll have to await more comprehensive data for March and April before we review our macro forecasts.

We suspect the data in coming months will show businesses have chosen to put off major capital spending projects and scale back hiring in the face of so much uncertainty about future sales and earnings.

Clearly, the head of steam the economy displayed when it entered 2011 appears to be dissipating. As gloomy as this sounds, we still expect to some of that earlier momentum to return in the second half of the year and in 2012 as geopolitical tensions ease in the Middle East and once Japan begins its reconstruction program.