

THE ECONOMIC OUTLOOK GROUP



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ECONOMIC TALKING POINTS

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November 17, 2011

Signs Emerge Of A Stronger Economy. But Can It Really last?

Quick note of caution. We have certainly seen an unambiguous string of upbeat news on the US economy lately and that is certainly comforting. A few forecasters have even begun to express a more optimistic outlook for the rest of this year and 2012. This turn in sentiment is understandable given the latest data points.

- Claims for jobless benefits fell to 388,000 in the latest week, a seven-month low, and the fourth decline in five weeks. The stats are finally moving in the right direction and that is encouraging. Even the total number of people receiving benefits plummeted to its lowest level in more than three years. Good news.
- Industrial output also rebounded nicely in October and capacity utilization jumped to 77.8, its highest level since July 2008. Impressive.
- Retail sales rose a decent 0.5% last month, its fifth consecutive increase.
- The Institute for Supply Management numbers showed output still expanding for both services and manufacturing. Encouraging.
- Exports are at a record high levels. Good for US jobs and economic growth.

- Homebuilders admitted they were the most optimistic about the housing market since May of 2010. That was underscored by today's release on housing starts. While it slipped by 0.3% in October, builders broke ground on more homes than experts initially predicted. And building permits, a sign of future construction activity, jumped nearly 11%, to its highest level since March 2010.

Look, when you get such an assortment of positive economic indicators, it's hard to dismiss them. The US economy is no longer showing the inertia it displayed throughout much of 2011.

BUT.....

At the same time, we have to admit there is a sense of dejavu about this final quarter.

A year ago, the economy was also on the mend with consumers significantly ramping up spending. Forecasters even rushed to revise up their GDP growth numbers for 2011. Indeed, the US economy entered 2011 with considerable momentum.

However, you will recall that this momentum quickly faded after the eruption of several major shocks last February and March. Geopolitical instability across North Africa and the Middle East kicked oil and gas prices higher. Japan's devastating earthquake disrupted the global supply chain network and slowed production. These events brought the US recovery to a screeching halt. GDP growth in the first half came to an imperceptible 0.8%, only 1/3rd of the consensus forecast given just a few months earlier.

A DOSE OF REALITY

Back to the present. While the latest string of indicators paint a rosier picture of the economy, we have to be mindful of how fragile this recovery still is, AND the numerous "high probability" geopolitical risks it now faces. Among the most serious threats are these:

- (1) Yields on European sovereign debt are on the rise again---not just on those issued by the troubled southern countries, but also of France, the Netherlands, Austria, and even Germany. It all reflects a vote of no confidence among investors. They just do not see European leaders moving any closer to a credible, comprehensive and well-funded program to resolve the debt crisis.

Indeed, conditions appear to be getting worse. France and Germany are butting

heads over the role of the ECB (France wants to give it a greater flexibility in buying sovereign debt, Germany fiercely opposes this) and whether the EFSF should seek a banking license, which would allow the facility to borrow from the European Central Bank (France is in favor of it; Germany's adamantly rejects this). This dispute has now *the* central and fateful battleground in the European sovereign debt crisis.

France is fearful of losing its AAA rating and furious with Germany's hard stance. Germany's greatest nightmare is that France's proposals would ultimately unleash higher inflation in the Eurozone and cause a collapse in the euro.

The lack of assurance that Europe is able to avert a sovereign debt default and contagion greatly increases the risk of a full blown financial meltdown. It's hard to imagine this crisis continuing into its third year. Something has to break. For now, the crisis threatens to push major European banks into insolvency and ultimately trigger credit default swaps. In the meantime, the rating agencies will launch another review of the creditworthiness of US financial institutions after studying their exposure to European governments, investors and corporations.

(2) Here's another concern. With Europe in recession, the US economy still wobbly, and emerging country growth slowing, how is it that oil prices are holding at around \$100 a bbl.? At these levels, it should be a matter of weeks, if not days, before gasoline prices edge higher and cut into consumer spending.

Why is oil priced so high? Well, the latest weekly inventory data from both the Energy Department and the American Petroleum Institute showed oil stocks falling. Moreover, investors have bid up the price of oil in response to better than expected economic news in the US. Finally, we believe there is now a \$10 to \$20 dollar premium permanently imbedded in the price of crude as tensions build over Iran's nuclear military program.

(3) Failure of the super-committee in Washington to agree on reducing the public debt by \$1.2 trillion will also have consequences. The political paralysis will prompt the rating agencies to further downgrade US credit. Nor is the economy likely to make much progress if the uncertainty over government spending and taxes continues through the November elections.

(4) Worries over the collapse in Europe and instability in the Middle East could make the dollar so attractive as a safe currency, its appreciation will hurt American competitiveness and undermine exports, a sector that has helped keep the US out of recession this year.

(5) We also have to wonder how China will react to the Obama Administration's plan to beef up America's naval presence in the Western Pacific. Will China

passively accept this build-up, or counter it in a manner that will further strain US – Chinese political and economic relations?

Bottom line:

The point of this exercise is to put the latest batch of positive economic news in perspective. Most of these numbers reflect business conditions in the past. The economic storm in Europe, however, is getting more intense and there is no chance the US will be able to escape damage.

This looming threat, plus stubbornly high oil prices, a crippled Congress, and rising tensions over Iran call for a sober assessment of the very real dangers the US economy and the financial markets still faces. The mere fact the economy has done better lately is no reason, we believe, for investors to lean further out on the risk spectrum. The comfort level just isn't there yet.

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