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ECONOMIC TALKING POINTS

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The Economic Numbers Suggest This Recovery May Soon Be History

After barely showing signs of life the first half of the year, the US economy has now reached a critical turning point. The headwinds against growth are incessant. Something will soon have to give. Domestic demand is very feeble. Europe is crippled by the specter of a blow-up in sovereign debt defaults. Emerging economies are slowing in response to tighter monetary policies. And then there is Washington, which apparently believes being dysfunctional is a virtue. It all has the feel of an economic recovery that is coming apart before our eyes.

Today, we got a fresh batch of dismal economic measures and they hint that consumers and business leaders are ready to throw in the towel. Americans are beleaguered, perhaps sufficiently enough to hunker down the rest of the year, perhaps longer. We believe there is now an even chance the recovery will prematurely end by mid-2012, if not earlier.

The Federal Reserve has done all it responsibly could, though it will never admit to this in public. Short term rates have been virtually zero for

years and longer term Treasury yields are at their lowest in six decades. We have had one stimulus program after another, and while they probably saved the US from sinking into a 1930s-like Depression, the fact still remains that America's economic heartbeat is now barely audible. There is no other way to interpret the data out this week

INITIAL CLAIMS

First time claims for unemployment insurance shot up by 11,000, to 428,000 in the week ending September 10th, the most since June. What's so disheartening is the number should have fallen during the week that included the Labor Day holiday. The latest rise in applications adds more weight to the broad argument that this country faces a serious structural problem when it comes to job creation. Employers see little justification to ramp up hiring given the weak economic outlook, rising health care costs, the pressure to fund pensions, and the cost of complying with burdensome regulations. We have spoken to dozens of business leaders in recent weeks and most have admitted they are focusing on investing in capital rather than labor. Their goal is to improve internal productivity to the point where any future increase in demand can be met by their existing workforce. What this means is that the hurdle to hire more workers is getting higher and higher. Makes you wonder whether we are gradually moving to a "labor-less society."

NY EMPIRE STATE INDEX

The drumbeat of depressing news continued with the release of the Empire State Manufacturing index put out by New York Fed. Manufacturing activity declined for the fourth consecutive month, with the index now dropping to minus 8.8 in September, from minus 7.72 the previous month. If you dig deeper into the report the news gets grimmer. New orders, which influences future output, accelerated its dropped (minus 8.00 from minus 7.82). The most telling statistic may be the sharp plunge in inventories, which tumbled to a minus 11.96, from minus 7.61. Apparently, manufacturers are so worried about the lack of demand they have stopped adding to inventories.

PHILADELPHIA FEDERAL RESERVE SURVEY

The Philadelphia Federal Reserve's Manufacturing Survey for September also came in worse than expected. The first sentence of that

report succinctly summarizes conditions: “Regional manufacturing activity is continuing to contract.” Private forecasters had expected the Philly Fed’s Business Outlook Survey index to climb to minus 16, from minus 30.7 in August (which was the worst since 2009). Though it did improve to -17.5 in September, the chance of it returning to a positive number anytime soon is slim. One key question the Fed survey asked companies in this survey was whether they expect to increase production in the coming fourth quarter. More than 48% said they were planning to “slow output” and nearly 11% were holding at current levels. This sets the stage for what we expect will be some disappointing national ISM manufacturing numbers the next few months.

INDUSTRIAL PRODUCTION

Less current is the Federal Reserve’s report on industrial output, which inched up 0.2% in August, after a 0.9% rise in July. Overseas demand plus orders from US firms to purchase additional equipment and machinery has buoyed industrial output. But with emerging country growth slowing and US manufacturers and retailers cutting back on inventory orders, we expect factory output will weaken markedly this fall. Output of consumer goods and business equipment has already begun to decelerate in August from July’s pace. For example, the production of basic material needed for consumer parts fell by 0.3% in August, after growing 1.2% in July and 2.7% in June. Output of machinery has declined the last two months. These can serve as leading indicators of future industrial production.

CONSUMER COMFORT

The overall gloom has certainly affected consumer psychology. Consumer confidence is also holding close to the lowest level of the year. The Bloomberg Consumer Comfort Index came in at minus 49.3 in the week ending September 11th, a sliver above the year’s bottom of minus 49.4 reached last May. According to the Bloomberg report, “nine out of 10 Americans polled had a negative view on the economy.” The ominous implication is that if household spending turns down, it is point, game, and match for this recovery.

EARLIER THIS WEEK…

All these economic reports comes on top other bad news we had earlier this week when August retail sales showed no growth at all and July’s was revised down to show a smaller improvement. The Small-Business Optimism Index survey, which polls the mood of small and mid-

size firms, fell 1.8 points to 88.1 in August, the sixth straight monthly decline. Also worrisome is that these firms trimmed jobs in August for the third month in a row.

Troubling, too, was the overall Business Inventories data out this week. Inventories levels have been slipping relative to sales, which indicates that companies are sufficiently worried about the economic outlook they are taking no chances getting stuck with stockrooms and back lots filled with goods. Remember, inventories are typically purchased on credit. If you can't sell those goods, it can seriously squeeze future cash flow, earnings, and lead to more layoffs.

THE FED IS EFFECTIVELY DONE WITH THE CPI MOVING HIGHER

The main factor that will determine where the US economy is headed from this point on is whether the White House and Congress will show resolve and work together to revive growth. As we said earlier, the Fed has done all it could. Rates across the maturity spectrum are at historically low levels. It's hard to see how Operation Twist, even if it does succeed in lowering yields another 10 to 20 basis points, will fundamentally change anything. Nor do I expect the Fed to launch QE3 now that stagflation has reappeared. This morning we got word consumer price inflation is climbing at 3.8% pace, the highest annual rate in nearly three years. More interesting is that core CPI has now climbed to a yearly rate of 2.0%, the fastest since 2008. Core inflation has now reached the upper limits of the Fed's preferred target so it is hard to see how the Fed can begin another wave of quantitative easing without damaging its credibility as a central bank dedicated to maintaining price stability.

Face it. The Fed has essentially run out of bullets. The burden now rests with the White House and Congress and whether they will work together in the interest of the country. That means Washington has to realize we do not have an immediate fiscal crisis. The emergency the country now faces is a lack of aggregate demand, which means that sharply cutting government spending at this moment is precisely the wrong action to take. All that does is further tighten the chokehold around an economy that is already asphyxiating for lack of oxygen.

One recent move is particularly baffling because it illustrates how sublimely shortsighted key members of Congress can be. They all agree the economy is ailing and something needs to be done to restore it back

to health. So what have some chosen to do? Incredibly, one bill currently before Congress eviscerates funding to the Census Bureau so much it impairs the agency's ability to compute how the economy is performing! The House has proposed slashing the government's main data collection division by 25%, or $295 million, in 2012.

We understand the pressures on Congress to shrink the deficit, but this is tantamount to curing a patient who has fever by getting rid of the thermometer. If this folly becomes law, it would hamper the Census Bureau's ability to calculate GDP, employment, housing, manufacturing and many other vital measures. It does not take the mind of a rocket scientist to realize that having good economic intelligence is absolutely essential for business leaders and policymakers to make the right decisions. Faulty or poor data on the economy will not accelerate growth; indeed, it may backfire and lead to flawed policies. With the economy now close to stall- speed, let's hope wisdom prevails in the nation's capital.

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