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ECONOMIC TALKING POINTS

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Housing and Consumers Will Offset The Sequester. But Beware of Gas Prices and Geopolitics.

Keep your eye on the economic fundamentals. That is the one theme we return to again and again. Unfortunately, impressions on the business outlook are too often based on just a cursory look at the statistical headlines of economic indicators. But that practice is risky, lacks context, and can easily mislead.

Similarly, non-stop talk about the sequester has obscured the fact that economic fundamentals in the U.S. are the best they have been in more than half a decade. In fact we believe growth in demand from the private sector -- not the effects of the upcoming sequester --- will be the key determinant of economic activity in 2013.

Let's start with the first point raised on the tendency to pay excessive attention to top line numbers from economic reports.

Home builder confidence

When the National Association of Home Builders issued their monthly release on builder confidence earlier this week, it showed the Housing Market Index (HMI) dropped a point to 46 in February. The decline immediately set off a cascade of stories that residential real estate construction may be "in trouble" and in danger of "stagnating." That was followed the next day with the government's release on housing starts for

January, which plummeted 8.5% in the month. It triggered more stories suggesting the housing recovery has begun to stall.

But a closer look at both these reports, along with today's existing home sales data, tell a more nuanced story, one that should quash alarms that housing has lost its momentum.

For example, yes, it is true HMI did slip in February. But let's put this in perspective. It has been climbing steadily since last April, during which the confidence measure nearly doubled from 24 to 47 by January, before it slipped a notch to 46 this month. Even the Home Builders trade group characterized February's drib as "virtually unchanged" from the previous month.

A better leading indicator in that same report is how builders expect construction activity of single-family homes to be six months form now. Here the index firmed to 50 in February, versus 49 the previous month and 34 a year ago. The six-month expectations barometer has a better track record as a predictive tool in the HMI report.

The government's latest release on housing starts for presented in a similar story. The headline announced an 8.5% drop in total starts for January. But again, the more relevant figure is ***not*** total starts but activity in the single-family home market, which accounts for more than 70% of all residential construction. The category on multi-unit dwellings (5 or more units) makes up a far smaller proportion of starts and can be highly volatile because they involve larger structures (each apartment in a building is counted as a unit) and construction here is more influenced by the mood of real estate investors, access to construction capital, and changes in the tax code.

What pulled down January's overall housing starts was, in fact, a 26% plunge in these large multi-unit dwellings. Single-family home starts actually rose in January to a 613 million-unit rate, the fastest pace since the summer of 2008!

Equally important is the number of permits filed with municipalities for future single-family homes. Builders typically break ground one to three months after such filings. So what happened? Permits submitted last month jumped by 1.9%, to a 584 million-unit rate, the most since June 2008. How's that for builder confidence?

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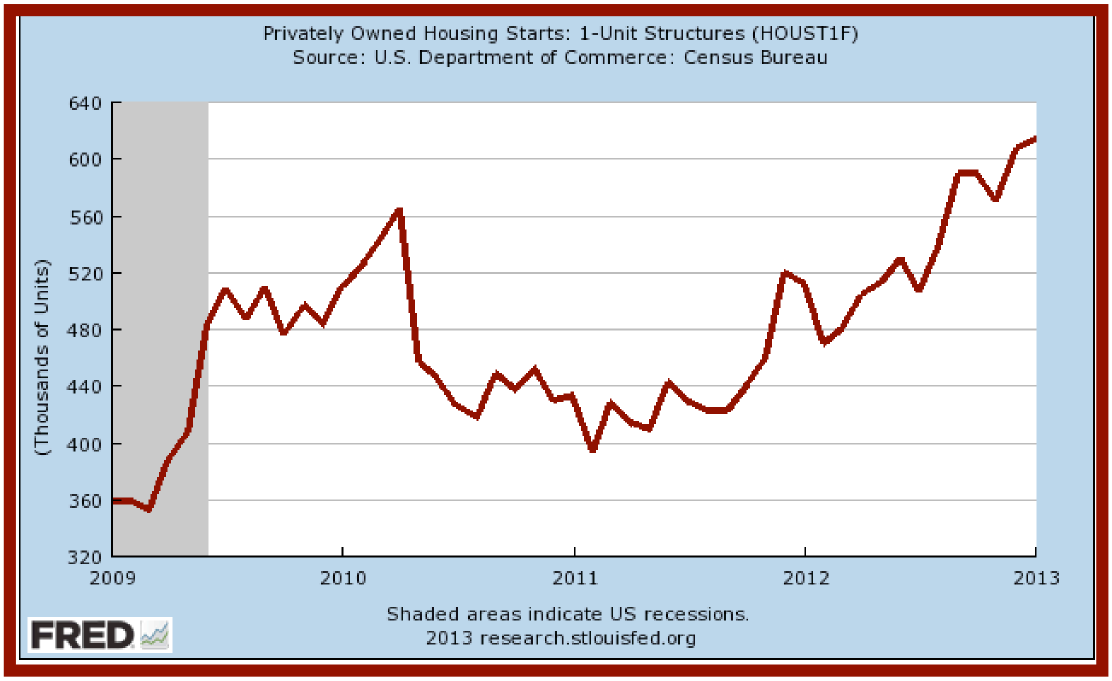

Ultimately, it is homebuyer demand that drives new construction and we got some better newsw on that front too today. Existing home sales increased January to a 4.92 million rate in January, the second highest pace since November 2009. Sales rose in every region except in the West where inventory is in critical short supply. Nationally, inventory levels have dropped to a 13-year low last month.

What all these data points tell us is that the housing recovery is still very much intact and will be an important contributor to GDP growth this year.

Let's assess the risks stemming from the sequestration cuts.

The debate over sequestration has become something of a distraction unfortunately. But we can't evade the obvious question: Will the automatic cuts endanger the economic recovery? We'll answer this by breaking that query up in to three parts: (1) Will Washington really allow the sequester cuts to take place? (2) If they are implemented, how long will they last? (3) What impact will the cuts ultimately have on the economy?

Will Washington really allow the sequester cuts to take place?

The odds are better than 80% at this point the mandated cuts in spending as outlined in the Budget Control Act of 2011 will take place next month. Forget the fact that sequestration is actually reviled by both Democrats and Republicans. The problem is they are engaged in political trench warfare at this point with no talks underway to prevent the sequester. Democrats shout “no!” to Republican calls for significant up front cuts in federal spending, especially on entitlements, while Republicans scream “hell, no!” to Democratic demands for more tax revenues.

House Republicans are certain to play hardball this time, if only to regain some negotiating credibility.

Regain credibility, you ask? Remember, they caved during the New Year holiday and grudgingly agreed to increase tax rates for those with incomes above $250,000. Republicans also backed away from commencing the sequester cuts at the start of the year and re-scheduled it for March 1st. In addition, instead of carrying out the threat to use the debt ceiling crisis to force the White House to come up with significant reductions in federal spending, the GOP blinked again and punted that whole issue to mid-May.

With sequestration, however, the Republican leaders appear ready to dig in their heels.

How long might the sequester last?

If the spending cuts were to continue the balance of the year, it would result in a reduction of $85 billion in spending authority, distributed equally between defense and non-defense sectors. We believe a year long sequester is highly unlikely. The more probable outcome is one where the cuts are in place for a few weeks, before an accord of some sort is reached on spending cuts and tax revenues sometime in late March or early April.

What impact will it ultimately have on the economy?

A three to four week duration of sequester cuts will have ***no measurable*** impact on GDP growth. On the other hand, should the sequester remain in place for the entire year, it would slow growth by half a point (0.5%), with GDP advancing by 2.7%, instead of our 3.2% projection for 2013.

Some may characterize even our 2.7% GDP growth with full sequester cuts as overly optimistic too, so an explanation is in order here.

We believe there is growing public fatigue over the sequester. While Americans continue to expresses frustration with the lack of progress on controlling the government’s finances, they are also looking past Washington's histrionics and concentrating more on the growth in real demand for US goods and services. For just about every important metric on the private economy has been moving in the right direction.

• Household finances are in much better shape and the job market has improved. As a result, consumer spending has picked up. We explained in our previous report ("Don't Write Off the Consumer') why the payroll tax hike would have only a minimal effect on personal expenditures. The International Council of Shopping Centers announced that its Retail Chain Store Sales Index rose 2.7% in the week ending February 16th from the previous week. Redbook, which conducts its own surveys also saw retail sales climb in the first two weeks of February. For the week ending last Saturday, Redbook noted sales were up 3.1% compared with the same week a year ago. This morning Bloomberg put out its Consumer Comfort index and it climbed for the 3rd consecutive time, despite the rise in both payroll taxes and gasoline prices! Indeed, the rise in confidence so far this month completely erased January's slide.

• Corporate earnings also remain solid, with profit margins and cash reserves at record levels. About 71% of the 413 companies in the S&P 500 that issued quarterly results so far have beat profit forecasts. This has helped set the stage for more hiring a well as larger orders for capital goods and commodities.

• US banks have the healthiest balance sheets in decades. They hold more and better quality capital and continue to see delinquencies on consumer and business loans fall. Lending officers have consequently ramped up lending. The Federal Reserve recorded that bank lending to businesses rose at double-digit annual rates in both December and January. Even residential mortgages by commercial banks jumped at a 10.7% rate last month.

• The housing and auto sectors, two vital contributors to economic growth, turned the corner last year and continue to recover.

• Stronger economic activity overseas has also helped boost US exports, another positive for GDP growth.

• Last, but certainly not least, is the Federal Reserve's commitment to keep the cost of credit historically low.

The US economy is thus poised to show stronger than expected growth in 2013, whether or not the sequester takes effect. Buttressing this outlook was another increase in the Index of Leading economic Indicators, which rose 0.2% last month, following a 0.5% gain in December.

There are some caveats to this positive outlook.

A sustained jump gasoline prices will at some point harm the economy. The average retail price of gasoline reached $3.75 this week, the highest nominal price ever for this time of year. The reason? It's a perfect storm that saw a lot more refineries than usual go offline, effectively curbing gasoline supplies. You also have investors and speculators pouring money into oil futures as evidence mounts the global economy is on the mend, which should boost future demand for fuel. We view gas at $5 a gallon as the tipping point that will do more serious damage the economy.

A second cause for concern is the state of geopolitical conflict. There are three incidents that pose the highest probability of erupting and carry the greatest potential to harm the world economy: A military confrontation with Iran, a shooting war between Japan and China over disputed islands, and a North Korean attack on the South. Each can cause oil and gasoline prices to spike to levels that can cripple economies.

Barring such gasoline and foreign shocks, the US economy could grow this year at its fastest pace since 2006 --- even if the sequester is implemented.

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