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ECONOMIC TALKING POINTS

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Making Sense of a Mixed Bag of Economic Reports

Lots of mixed reports out today and they can lead to some head scratching regarding the economic outlook. Is there anything we can we glean from this gallimaufry of data? Yes, quite a lot actually.

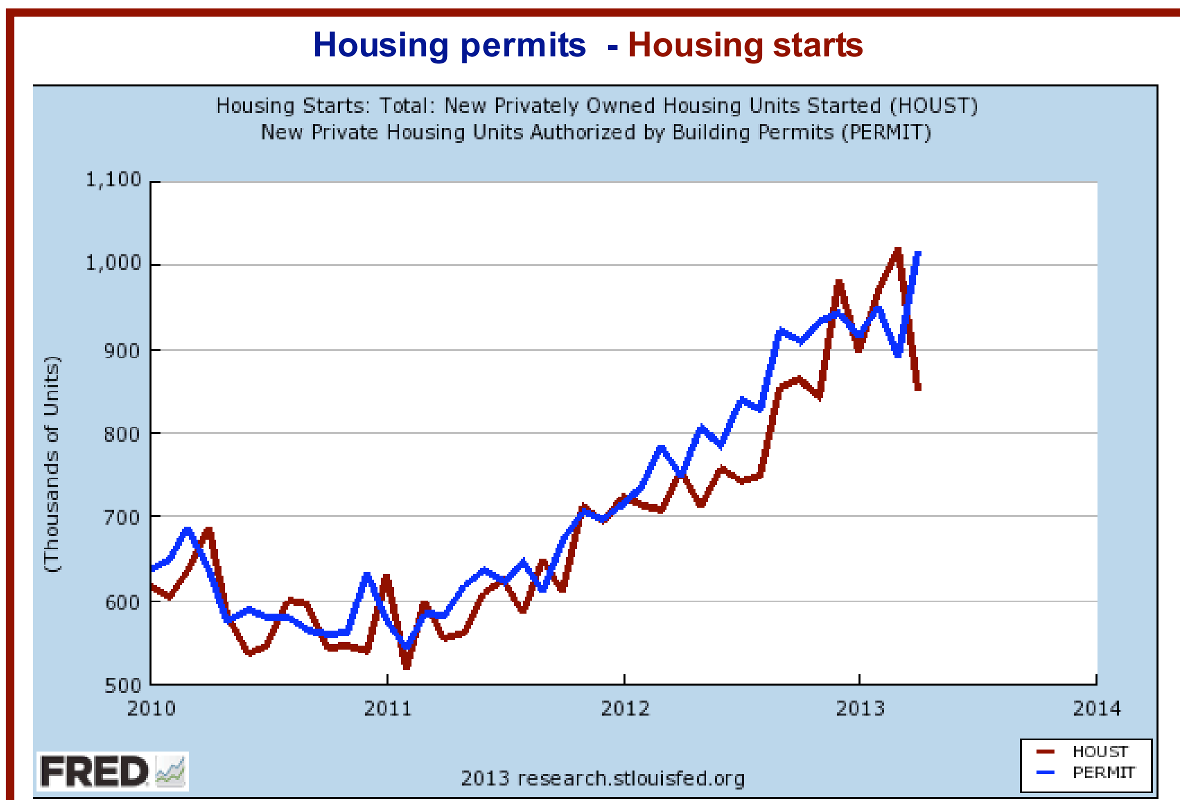
Housing Starts & Permits

Let's begin with April's drop in housing starts, which took many by surprise. It fell a steep 16.5% last month and brought new construction down to an 853,000 annual rate, the lowest since last November. However, before concerns are raised that the housing market is stumbling, take note of the fact that permits filed that month jumped an impressive 14.3%, to 1.02 million rate, the most in nearly five years!

If builders are registering plans to significantly ramp up home construction, shouldn't that be viewed as a bullish sign? Which of the two housing indicators ----starts or permits ---better represents what is really happening on in this sector?

In this instance we are giving more weight to permits for several reasons. First, the demand for new homes continues to get stronger. Just

yesterday, the National Association of Home Builders (NAHB) released their Housing Market Index for May and showed that those on the very front lines had the most positive outlook about the next six months than anytime since February 2007!! Driving this optimism in large part has been the increase homebuyer traffic (i.e., demand) into builder showrooms. Moreover, that same report by the NAHB noted a growing number of new home seekers have expressed some urgency to buy as the inventory of such houses shrinks. The total stock of new homes available for sale is 153,000, which at the current sales pace can be bought up in just 4.4 months. That ratio between demand and supply is the tightest in nearly a decade. Indeed, demand is so strong that homebuyers are even rushing to place deposits on builder lots. The most recent monthly figure (March) on new homes sold “but not yet started” climbed to 13,000, the largest in five years.



Well, you may ask if demand is so strong, why then did we get such a soft number on new starts for April? No surprise here either. Talk to just about any builder and they will tell you how exasperated they are of the impediments to new construction. Among the most common complaints: (1) Lots are becoming increasingly scarce. (2) Producers of building material, who suffered greatly during the last housing collapse, are still reluctant to accelerate output. That has led to shortages of critical building supplies. (3) However, the most common gripe heard from home builders is the shortage of skilled workers in construction. The devastating housing

recession and weak recovery drove many of them to leave real estate construction and migrate over to the booming and more lucrative oil and gas industry (thanks in large part to the boom in hydraulic fracturing and horizontal drilling in North America). Making matters even worse, especially in the southwest, is the passage of tougher immigration laws by states that have effectively frightened away undocumented but skilled construction workers.

So it is important to make a distinction between "housing starts" and the "demand for new homes." The former reflects an industry that momentarily faces physical constraints to new construction. In contrast, the latter shows that new home buyers are growing in numbers. The imbalance between the two, where demand is greater than supply, shows up in new home price stats. The median price of new homes in the first quarter of 2013 was $246,433, the highest since 2007. For the reasons cited above, we are thus less concerned about April's soft housing starts, and prefer to look to permits as a better metric of future industry activity.

Claims for Unemployment insurance

Also out this morning was the weekly report on initial applications for unemployment insurance, and it spiked to 360,000 the week ending May 11th. This jump of 32,000 from the previous week did startle many and raised fresh doubts about labor market conditions. But it should go without saying that asset allocation decisions ought never to be based on this volatile weekly series. A better gauge is the more stable four-week average, which did tick up, but it still remains at a low 339,250 (compared to 338,000 a week earlier). The overall trend, however, has been clearly downward from its year ago four-week level of 372,750.

Is the small rise still worrisome? Hardly. Let's take a broader look at labor demand by focusing on the sector that typically hires the most workers, small businesses. Earlier this week, the National Federation of Independent Business (NFIB) put out its Small Business Economic Trends for April. The number of small firms who said they were ready to increase hiring in that report rose to the highest level since last summer. And the NFIB's series on actual job openings so far this year were coming in at the most since 2007.

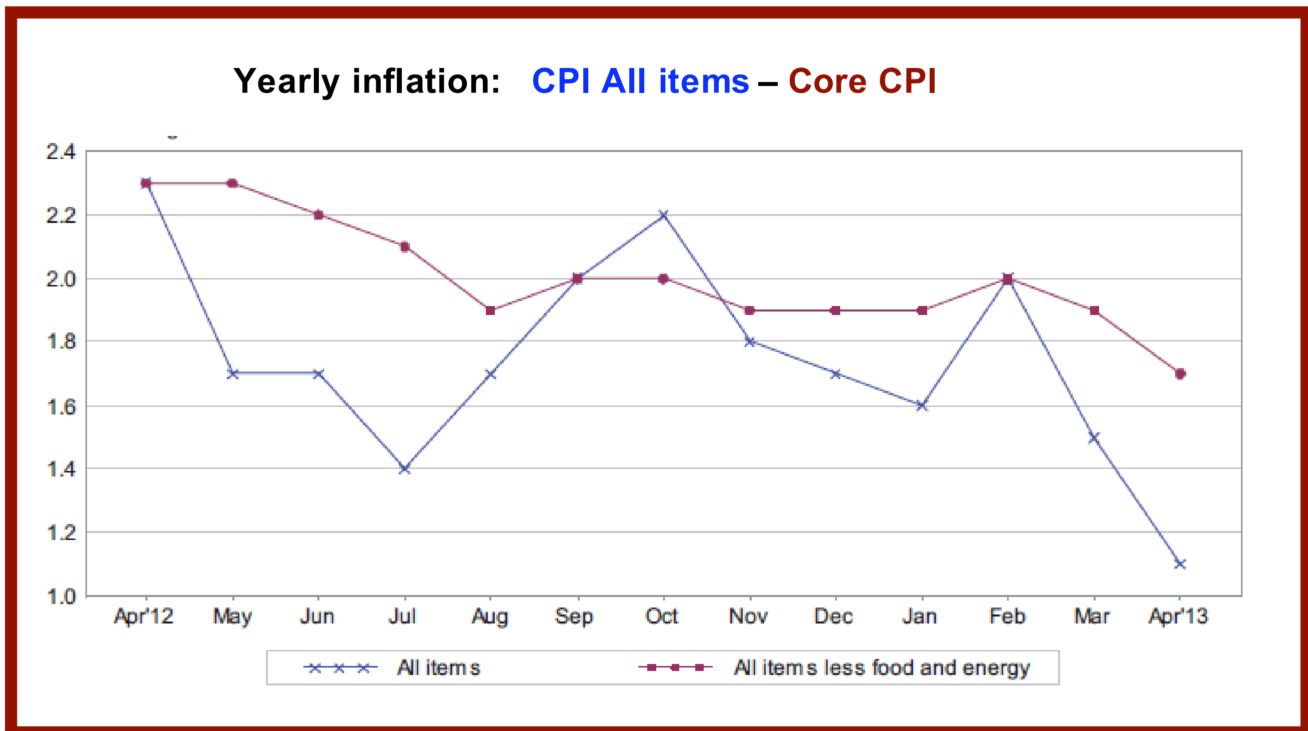
So while the latest pick up in claims for jobless benefits diverged from recent trends, we remind you that the weekly series is volatile and often subject to significant revisions.

Consumer Prices & Real Earnings

A more relevant indicator out today was April's drop in consumer prices. Simply put, inflation is not an issue. Both headline and core CPI have been sliding in each of the last two months. Over the year, CPI has fallen to 1.1%, which petty much brings it into line with the Fed's preferred measure on the cost of living, the PCE price index. April's core CPI year over year declined to 1.7%, the lowest since June 2011. Virtually all the slippage can be attributed to the sharp fall in energy prices, a trend that is likely to continue as both oil inventories and production are at multi-decade highs.

With consumer prices on the downswing, there are two important developments to consider.

First, the Federal Reserve continues to miss achieving goals on both its primary mandates. The Fed prefers to see inflation closer to 2% and unemployment approach 6.5%. The fact they have fallen short on both targets means we are unlikely to see any significant change in QE this year. Purchases of Treasury and mortgage backed securities will continue through 2013, though the actual volume may vary slightly from the previous $85 billion monthly pace. Remember, with the federal deficit coming down more than expected this year (the CBO has just slashed the 2013 red ink by $200 billion), the government will need to borrow less than first thought. Thus, the Federal Reserve can afford to scale back purchases and still achieve its goal of keeping interest rates across the maturity spectrum historically low.



The second important point to make is how the decline in inflation is lifting consumer purchasing power. Along with the release on inflation, the government also published the latest figures on monthly “real earnings” and, as expected, it has been climbing. Though the increase in nominal average hourly and weekly pay has been modest, the cost of living has risen even less. That combination has improved real income growth---and that usually augurs well consumer spending in the months ahead.

Regional Fed Bank Reports

Finally, there were two other economic reports released and both were genuinely disappointing. Both the Philadelphia Federal Reserve’s Index of Business Conditions and the New York Fed’s Empire State Index turned negative, suggesting that manufacturing is in a slump. Both coincided with the decline in April’s industrial production. All three outcomes are disconcerting and require close more monitoring in the coming weeks. Our expectation is that as the international economy picks up steam in the second half of the year, led by Asia, Latin America, Africa and even parts of Europe (Germany and the UK), it will reignite factory activity in the US.

Bottom line:

The mix of data recently may have clouded the picture on economic conditions. But the fundamentals continue to remain strong in terms of household finances and spending, corporate profits, housing, exports, bank lending, and both CEO and consumer confidence. We are still holding to our forecast of better than 3% GDP growth this year.

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