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ECONOMIC TALKING POINTS

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With winter winding down, job creation is gearing up again. But will Russia and China wreck it all?

After a plethora of ugly economic reports, mostly due to the harsh winter season, we are now finally beginning to see the US economy make its way back to kind of growth we saw in the back half of last year.

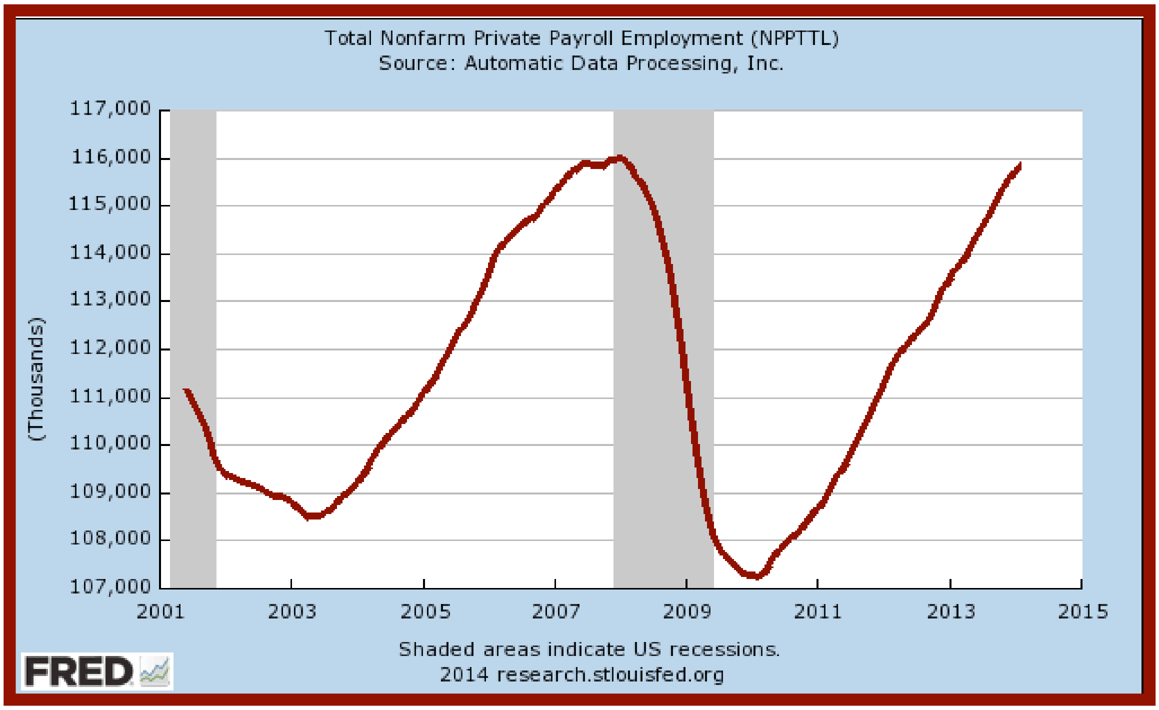
The repeat snowstorms and frigid temperatures have clearly impaired retail sales, manufacturing output, new factory orders, home sales and employment. But we always viewed this as a temporary detour. No economist, no CEO, and no meteorologist had anticipated such a severe winter --- and the economy suffered for that. But February's employment report shows the depressive effects of this severe winter is starting to wind down.

Total payrolls last month bounced back up to 175,000, after a winter-slammed rise of just 84,000 in December and 129,000 in January.

A similar, but more meaningful trend could be seen in the private sector where net new hiring accelerated to 162,000 in February, from 145,000 and

86,000 the two previous months. Why is this more meaningful? Private sector employment has now recovered more than 98% of the 8.8 million jobs lost during the recession! (Table 1) By March or April private payrolls should exceed the previous record of 115.98 million set in February 2008.

Table 1.



We did see the unemployment rate move back up a tenth, from 6.6% to 6.7%, but that should not be viewed with fresh alarm. Now that long-term unemployment benefits have expired for 2 million people, many have chosen to renew their efforts to find work last month. As a result, the number of unemployed who actively sought a job surged by 223,000 in February, the biggest single month increase since December 2012.

Indeed, as the economy continues to bounce back this spring, we could see the unemployment rate edge up another one or two tenths, but for benign reasons. When a rise in the headline unemployment rate (U-3) is ***accompanied*** by a decline in the broader U-6 metric (unemployment that includes discouraged and underemployed workers), it suggests the labor market is at long last in the process of normalizing. Simply put, part timers and discouraged workers are transitioning back to the active labor force.

So while the main unemployment rate rose to 6.7%, the broader jobless rate plummeted to 12.6% in February, the lowest we have seen since November 2008. (Table 2)

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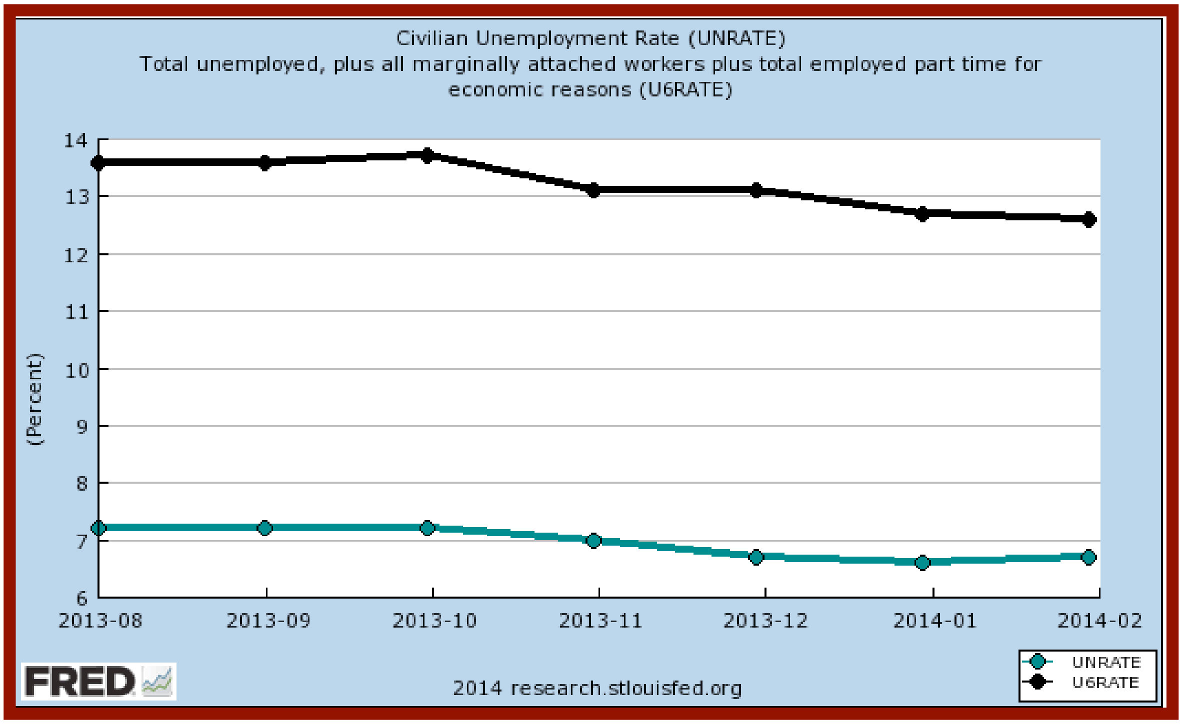

The February jobs report contained additional data that we believe highlight the economy's underlying energy. Among the reliable job categories that either lead or moves in tandem with the business cycle are employment in temporary services (up 24,400 last month to a record 2.80 million total), construction (an increase of 15,000 to 5.94 million, the most employed since June 2009), leisure & hospitality (rose by 25,000 to a record 14.48 million), trucking (which remarkably showed no layoffs during the storm-wracked month held at 1.39 million, best since June 2008), and child day care services (up 300, to 851,700, the most employed since August 2012).

The point to underscore is that the winter did cause serious dislocations in the economy. That drag on growth, however, shall soon be history. Those who argue the economy's sudden softness has little to do with weather and more the result deteriorating fundamentals have it wrong.

All you need to do is look at the state of household finances, corporate earnings, profit margins, the stock market, real estate values, bank profitability, exports, and yes, even private employment trends and one sees an economy that is poised to break out of its lethargic pace of 1% to 2% growth. We now expect to see consumption and capital spending increase this spring and that should support faster hiring and higher wages.
Our main theme here is that consumers spending and business hiring plans have not been cancelled this winter, but merely postponed

While GDP growth has been revised downward to 2.1% (from 2.8%) in the first quarter, we do see a bigger bounce back in the second with a 4.2% jump. For the year as a whole, real US GDP is projected to expand 3.2%, compared with 1.9% in 2013, with unemployment sliding to 6.2% by end of 2014.

OK, so what can go wrong?

There are two caveats to our forecasts. Both relate to threats that originate outside the US, but which ultimately could infect us here as well as the rest of the world economy.

Russia

The first alarm is the growing geopolitical crisis in the Ukraine. Our assessment is that Russia's seizure of Crimea is a done deal! Like it or not, Crimea has now been devoured by Russia. Vladimir Putin sees his place in history as the Russian leader who finally put a stop to the creeping Westernization of Central and Eastern Europe. The line in the sand he drew was Ukraine, more specifically Crimea, though it may not end there.

Putin watched how, since the unification of Germany in 1990, the NATO military umbrella has been extended to cover one former Soviet satellite nation after another, a process that brought the Atlantic military alliance right up to Russia's border. The overthrow of Ukraine's pro-Russian, but corrupt, president, Victor Yanukovych, was the trip wire that brought Putin in.

We believe Russia will pay heavily for its aggressive action. In one major respect, it is already a failed super power. Their economy grew a meager 1.3% in 2013, while inflation stubbornly accelerated. Despite the (arguable) glitz of the Sochi Olympics, Russia has utterly failed to modernize its economy despite being endowed with a wealth of energy and natural resources. Oil and natural gas still account for more than half of its exports. Even that may soon be in jeopardy as the technology used for hydraulic fracturing and horizontal drilling spreads around the world. The subsequent increase global oil and gas supplies will almost certainly reduce future demand for Russian energy.

In addition, Russia has serious demographic challenges. Its working population is aging fast, and the number of ethnic Russians in the country is shrinking while that of ethnic Muslims is growing. Indeed, the grab for Crimea may have as much to do with boosting the national population of ethnic Russians as it is to preserve its massive naval base in Sevastopol. (Remember, Russia has other key naval bases in the Black Sea that are already on its own soil, such as Novorossiysk and Tuapse.)

Among the questions we now have to ask are these:

1. How much more will tensions escalate if Crimea falls into Russian hands? Is a new round of cold war brinksmanship about to begin?
2. Can the US and EU ramp up enough painful economic sanctions to pressure Putin to pull back from Crimea and end this venture? (We doubt it.)
3. Is it possible western Ukraine launches a shooting war against Russia as a way to drag the US and Europe directly into the conflict? And won't that serve as a pretext for Putin to rush in and grab all of Ukraine?
4. Will this incursion by Russia reach a point where it will interfere with the global capital flows and economic growth?
5. Will Putin's action embolden China to make a military grab for resource rich seabeds and islands in the East China Sea and South China Sea?
6. Will Iran view US foreign policy as so feckless as to scrap current nuclear diplomatic talks and proceed more forcefully to build its own nuclear weapon?

Until these questions are answered, there is a risk that household and corporate spending may soon be in suspended animation. One conclusion that can be made is that Putin's actions have set back US – Russian relations at least by a decade.

China

The other major cloud hanging over the world economy is China's growing credit risk.

While its leaders project economic growth this year to be about 7.5%, that forecast sounds way too optimistic to us. China's economy is not on solid ground at the moment. The country's gargantuan state and corporate debt is at risk of blowing up into financial systemic crisis.

The prime strategy of its policymakers is to allow market reforms teach borrowers and lenders the lessons of moral hazard. Such lessons are important, of course, but with the risk of default so high among corporate and state borrowers, is this the right time to do so?

We just saw the first onshore default of a corporate bond. Shanghai Chaori Solar Energy Science & Technology failed to pay investors what they were due this week. The government has shown no sign of stepping in to bail out investors, and that greatly increases the default risk for many more firms overburdened with debt in China's $1.5 trillion corporate debt market.

Should such defaults spread and destabilize financial markets, the fallout could quickly turn global. Remember the old saying: "Liquidity is a coward, it disappears the moment there's trouble." Much remains to be seen how China will proceed. Will the government allow for selective defaults, where it intervenes in some cases and not in others? Will investors demand a much higher risk premium on future loans? What impact could all this have on growth in China? If GDP growth slips below 7%, won't that lead to higher unemployment and social unrest? Can we even trust the debt numbers coming out China?

Bottom line:

We are more confident the US economic stall of the last two months was almost entirely due to the effects of a harsh winter, and thus temporary. With the winter season coming to an end, we look for the economy to display more of the energy shown during the final six month of 2013.

If there is a substantial risk to that scenario, it would likely not originate from within the US. The two biggest threats to our upbeat forecasts are a significant escalation in tensions between the US and Russia over the Ukraine, one that saps the confidence of corporate leaders and investors around the world. The second worry is that the reckless expansion of credit in China this past decade could now come crashing down in an avalanche of corporate and state defaults, and possibly set the stage for another global financial crisis.

The next several weeks could determine whether events in Russia and China have reach a point where an entirely new assessment will be needed of US and international economic conditions in 2014.

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