



Beware the Upbeat Economic News

By Rick Newman | Fri, Nov 18, 2011

Everybody's eager for some good news on the economy, and lately we've been getting some.

After a summer swoon that included an epic display of ineptitude in Washington, the first-ever downgrade of the U.S. credit rating, a stock-market plunge and a sharp decline in consumer confidence, the numbers have been looking rosier lately. Consumer spending is up, suggesting that ordinary folks aren't as glum as they say they are in confidence surveys. Jobless numbers have been gradually improving. There are signs of optimism in the beleaguered housing industry. And the index of leading indicators, which hints at the future direction of the economy, recently recorded a sharp increase.

Forecasters who were worried about a double-dip recession just a couple of months ago now see a more robust U.S. economy. Since September, for instance, forecasting firm Macroeconomic Advisers has upgraded its forecast for GDP growth in the second half of 2011 from less than 2 percent to 2.7 percent. That's a meaningful bump that could mean more jobs and a brighter outlook, if it happens.

But we're also in more volatile, less predictable times than economists are used to, and many of the hopeful signs we've seen lately could be head fakes. It's worth recalling that there was a faux recovery in 2010, with real GDP growth hitting nearly 4 percent during the first two quarters and coming in at a respectable 3 percent for the year. But that comeback faded, with GDP growth falling to less than 1 percent during the first half of 2011--"stall speed," as economists say. That dip was partly due to Middle East unrest, rising oil prices and the Japanese tsunami, but it also reflected deep underlying problems like falling incomes and a huge overhang of private and

public debt.

Those problems still exist, and by some measures they're getting worse, not better. The European sovereign-debt crisis appear to be approaching a boiling point, for instance, and political paralysis in Washington suggests there will be little or no additional help for the economy in 2012. So the latest upticks might be mere outliers in a scattershot recovery. Here's a breakdown of several recent trends, with reasons why the upward blips may be misleading:

A boost in consumer spending. Retail sales have risen for five consecutive months, and the latest numbers on consumer spending show a surprisingly large 3.7 percent increase from levels of a year ago. The National Retail Federation predicts that holiday spending will rise by 2.8 percent this year, which would be a win for retailers considering that unemployment is still sky-high and the odds of another recession are about 40 percent. Consumer spending remains the biggest driver of economic growth, so sustained spending gains would be good news for the broader economy, and help bring back jobs.

Why it may not last: While spending is up, real incomes, after inflation, have barely been rising. To finance higher spending levels, consumers have been saving less and borrowing more. The savings rate, which rose above 6 percent during the recession, is now just 3.6 percent. And after shedding debt for two-and-a-half years, consumers now seem headed back toward old patterns of borrowing to finance everyday purchases. If the economy were booming, recent spending gains might last. But that seems unlikely, since hiring is weak, home values remain severely depressed, and temporary tax breaks Washington can no longer afford are due to expire.

"We worry about the first months of 2012, when the bills finally come due," **Bernard Baumohl of the Economic Outlook Group** recently warned clients. "The current pace of consumer spending is unsustainable once we get past 2011."

Signs of a housing pickup. A key index of home-builder sentiment showed a surprising jump recently. Housing starts have been higher than expected, and building permits have jumped as well. Those developments suggest that construction could pick up soon and the housing market might finally turn a corner.

Why it may not last: The housing bust has been underway since 2006, and it has to end eventually. But there have been several false dawns in this gloomy drama, and a true recovery may still not take root for a year or longer. One factor delaying a recovery has been the investigation into

foreclosure practices in many states, which for the most part has merely postponed a big, second wave of foreclosures.

Merrill Lynch, for instance, predicts that another 8 million homes will be liquidated by 2015, on top of 6 million that have been liquidated since 2007. The foreclosure peak, in that scenario, wouldn't come until 2013. And the huge volume of distress sales would push prices down by another 8 percent, with the bottom coming in 12 to 18 months. Other housing forecasts are more optimistic, but almost all predictions of a housing recovery until now have been premature. Even with mortgage rates at record lows, scarce jobs, stagnant incomes and tough lending standards seem likely to keep home sales depressed.

Job gains. Fewer people have been applying for jobless benefits over the last several weeks, with one measure crossing a threshold that suggests the unemployment rate--which has been stuck near 9 percent all year--may finally start to fall. The total number of people on the unemployment rolls is at the lowest level in three years. And overall, the economy has been adding more than 100,000 jobs per month, which is weak but consistently positive growth.

Why it may not last: The biggest threat to jobs is probably the mushrooming debt problem in Europe and the deadlock over taxes and spending in Washington. A recession seems likely in Europe no matter what, and if that mushrooms into a full-blown financial crisis it could easily trigger a U.S. recession as well. Many employers, aware of the gravity of Europe's problems, are unlikely to hire until they feel the worst is past. In Washington, backsliding on efforts to reduce America's debt could lead to another credit-rating downgrade and a domino effect that hits state and municipal bonds, as well as the financial sector. These are major risks that could quickly escalate beyond political leaders' ability to control them.

Falling gas prices. Drivers have gotten a break since the spring, with gas prices falling from nearly \$4 per gallon in May to about \$3.45 now. That decline saves consumers about \$35 billion over the course of a year, freeing money to spend on other things. The end of the Libyan civil war is bringing more oil back to the market, reducing the risk of a supply crunch. And gas prices typically fall during the winter, since people drive less.

Why it may not last: When fears of a global recession rise, oil prices usually fall since consumers and businesses cut back on energy use during a downturn. That happened in late summer and early fall, when oil prices followed stock prices down, hitting a low for the year of about \$75 per barrel in early October.

But since then, oil prices have spiked to nearly \$100 per barrel. A bit of that rise reflects a recent pipeline deal, which probably won't trickle through to gas prices. But oil prices still seem higher than a weak global economy would ordinarily justify. Part of it could be speculators gambling that policymakers in Europe and the United States will solve chronic debt problems, boosting the economy. And **Baumohl** estimates that recent tensions over the nuclear program in Iran--a major oil producer--have added \$10 to \$20 to oil prices, since a military strike to disable that program would send prices skyrocketing. That may not come to pass. But optimism, these days, is a risky gambit