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Paul Edelstein, Ph.D.
Vice President and Sr. Economist

Boston
+1 617 994 0524
pedelstein@decisioneconomicsinc.com

A Bleak End to a Bleak Month

MARKET DATA AND THE OUTLOOK

The economy failed to add jobs in August, with the Employment Report printing zero net gains. Even adjusting for special factors such as the Verizon strike doesn't get us anywhere near to the expected +75K net jobs. The unemployment rate held steady at 9.1% while the workweek was cut to 34.2 hours from 34.3 in July. Hourly wages fell -0.1%, and took an even bigger hit in inflation-adjusted terms. Businesses, like consumers, are registering their pessimism about economic prospects, the debt-ceiling debate, and stock market sell-off by not hiring. It may not actually signal double-dip recession, but concerns that the economy is moving in this direction will grow. Consumer spending was strong in July thanks in part to a rebound in vehicles, but August could be another story given the litany of negative shocks that month. Making matters worse, housing indicators released this week showed no signs of improvement in that market. While this may not be "news" to most investors and policy makers, a weak housing market is a clear negative for the consumer and adds to the list of concerns. The one bright spot this week – if you can call it that – was that the ISM Manufacturing Index didn't sink into contraction territory like recent regional indices. So the manufacturing recovery remains in tact but vulnerable, especially to a slowdown in global export demand.

THE OUTLOOK

- **Growth**: The latest jobs report is a clear negative for the U.S. economy and highlights ongoing struggles for the consumer. Baseline growth forecasts, however, remain in tact: +1.8% for 2011 incorporating a rebound in H2, followed by more reasonable though weak growth of 2.5-3% in 2012 and 2013. But the risks have shifted even further to the downside. We are now just 55% sure of our baseline scenario, down from 60%. Double-Dip Recession odds are now 10% - up from 5%. We put 25% odds on a prolonged "Japan-like" growth recession.

- **Inflation**: Inflation is likely to peak in the near future due to a weak economy that will push down oil and commodity input prices. Core rates of inflation are likely headed below +2% in the next 3-6 months.

- **Markets and Asset Allocation**: Jobs report was a clear negative for stocks and will reinforce the current market correction. But positive stock market fundamentals – earnings and interest rates – keep us long-term bullish on this asset class. We continue to believe in the sustainability of the recovery, but look to a minefield of risks that will be with us for a long time. As such, we advocate a more defensive asset allocation – strategically overweight on stocks (but less so) and strategically underweight on bonds (but less so). Applying a downgrade PE ratio of 12X forward earnings, fair value on the S&P500 is 1,250-1,275. Interest rates will stay low for a long time, with the 10-year Treasury trading range of 1.5% - 2.75%. The backdrop remains negative for the U.S. dollar against most currencies (particularly currencies of countries with clean sovereign balance sheets), and positive for gold. A new gold target of $2,200 will take us above previous inflation-adjusted peaks.

- **Policy**: Bernanke offered no policy prescriptions at the Jackson Hole Conference. But the announcement of an extended 2-day FOMC meeting in September, leads us to believe that additional easing is coming. The latest disappointing jobs report likely wasn't bad enough for another balance-sheet expansion, but it raises the odds of QE3 within the next 3-6 months to 35% from 30%. Instead, the next step will be a baby step measure – most likely a twist in the balance sheet towards longer-dated securities.

WEEK AHEAD (August 29 – September 2)

- **ISM Non-Manufacturing Index:** Among the data items in the normally quiet post-Employment Report week is a reading on the non-manufacturing sectors of the economy. The ISM survey is expected to fall in August, but there is some disagreement on whether we'll see outright contraction. DE expects 49.8 – an essentially neutral reading. Consensus expects 51.5 – just within expansion territory. In any case, the index will likely follow other indicators and report a bumpy ride for the economy last month.
- **Trade Balance:** The July trade balance will set the stage for Q3 international trade. Expectations are for a $1.3B narrowing in the gap to -$51.8B thanks to a rebound in exports. In June, a drop in exports helped widen the gap. International trade remains a pillar of the U.S. economic recovery. But questions over the health of the Eurozone and EM economies could dent the U.S. through the trade channel.
- **Bernanke speaks and will Obama bring back the forced refi option?** Bernanke will be asked to speculate on what next steps the Fed might take, now that he has called for a special two-day meeting. Obama is speaking before Congress about the unemployment problem. What may grab investors attention is a rumor that he will revive talk about a forced refi proposal for government owned mortgages, which could save homeowners as much as $50B. This would not cost the government any money immediately and might not need Congressional approval. With the Federal cupboard bare, Congress will not be receptive to his proposals to extend expiring tax cuts to offset a major swing in fiscal drag or efforts to better match available workers to available jobs. Unfortunately, training unemployed construction workers to become highly paid software engineers is costly and time consuming and the results are not immediate.

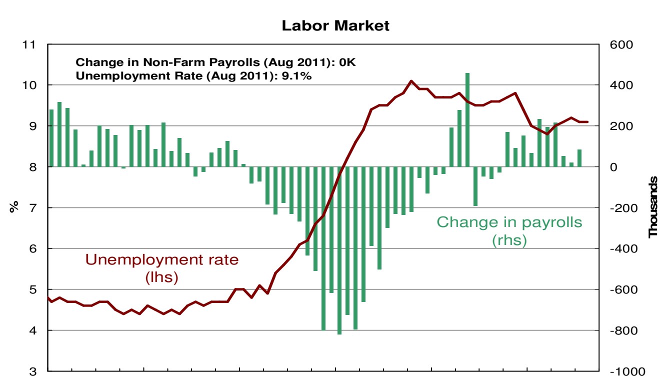
PAST WEEK'S ECONOMIC INDICATORS IN DETAIL

Employment Report

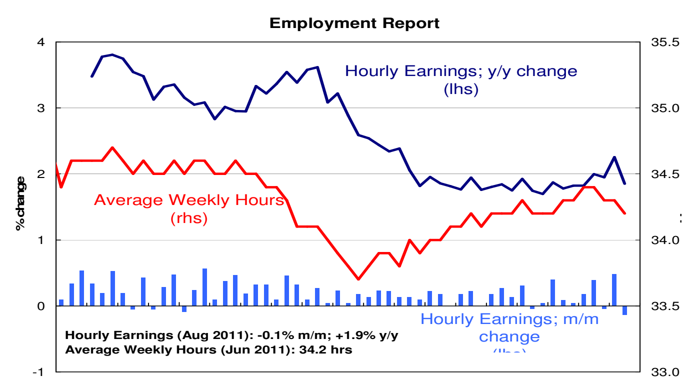
Assessment: The economy failed to add jobs in August, with the Employment Report printing zero net gains. Even adjusting for special factors such as the Verizon strike doesn't get us anywhere near to the expected +75K net jobs. The unemployment rate held steady at 9.1% while the workweek was cut to 34.2 hours from 34.3 in July. Hourly wages fell -0.1%, and took an even bigger hit in inflation-adjusted terms.

Major Points: The details of the report offered little reason to think that the headline results were actually better than they seem. The private sector added just 17K, compared to 156K in July with the Verizon strike a big factor. But even adding back these 47K would result in just 64K net private sector payroll growth. Construction (-5K), manufacturing (-3K), retail trade (-8K), and transportation (-2K) sectors all slashed payrolls while growth in the leisure and hospitality industry slowed sharply. The one bright spot, again, was education and health care (+34K). Government payrolls continued to contract (-17K) though not as sharply as in recent months thanks in part to some job creation at the state level. But the trend in government jobs is pointing downward as governments grapple with debt and deficit issues. Within the Household Survey, an employment gain of +331K was a bright spot. The labor force grew quicker than the unemployment count, but the unemployment rate failed to decline.

Bottom Line: There is no way to spin this report in a positive light. Businesses, like consumers, are registering their pessimism about economic prospects, the debt-ceiling debate, and stock market sell-off by not hiring. It may not actually signal double-dip recession, but concerns that the economy is moving in this direction will grow.



Sources: Bureau of Labor Statistics; and Decision Economics, Inc.



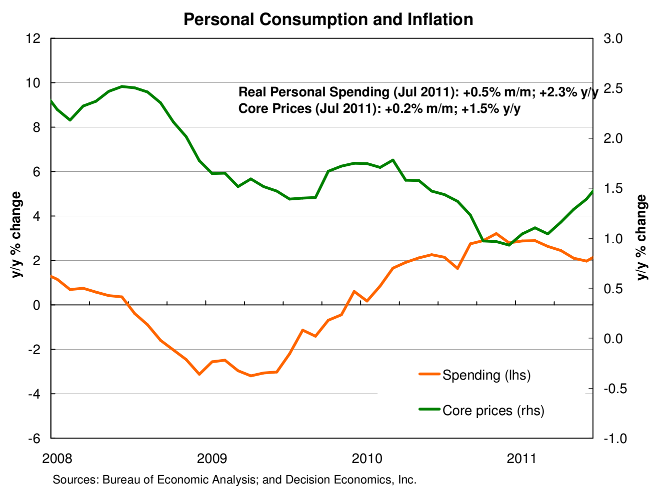
Sources: Bureau of Labor Statistics and Decision Economics, Inc.

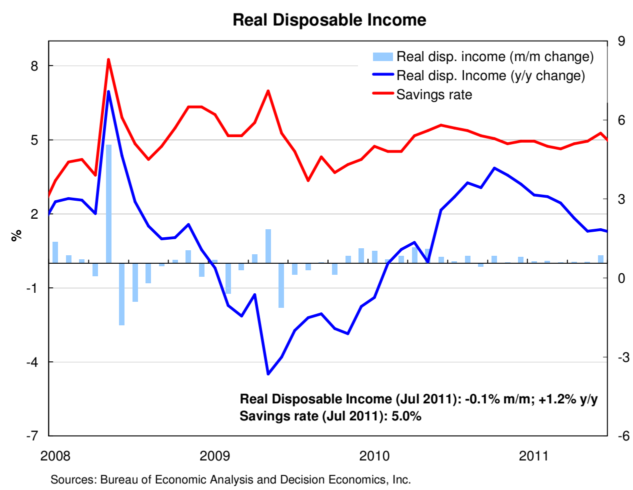
Personal Income and Consumption

Assessment: Personal incomes rose +0.3% in July as spending gained +0.8% - way more than expected. In real terms, disposable incomes were down -0.1% while spending rose +0.5%. PCE inflation was +0.4% while core inflation was +0.2%.

Major Points: There were a number of factors that lifted real consumer spending in July. Services spending grew +0.5% - the strongest pace since the start of the recovery. Motor vehicle spending (+5.3%) lifted durables spending (+2%), but even excluding vehicles, durables were up +0.7%. Nondurable goods fell -0.3% as higher gas prices lead consumers to economize (-2.2%). Excluding gasoline, spending on nondurables was flat for the month.

Bottom Line: After a weak Q2, consumer spending appears back on track thanks to a rebound in autos and services. Even with more modest gains in August & September, Q3 real consumption growth could reach +2.5% annualized, compared to +1% in Q2 and +0.4% in Q1. The implication would be that temporary factors were behind the growth slowdown in the first half of the year and that growth should rebound in the second half. The danger, however, is that disposable incomes are barely keeping up with inflation. The future path of gasoline prices will be important to watch going forward. On that note, inflation – both headline and core – are firming, but remain low by historic standards. Year-on-year core PCE inflation has risen to +1.6% compared to +1% at the beginning of the year. Annualized monthly inflation has average +2.5% over the last three months – somewhat higher than the Fed would like to see.



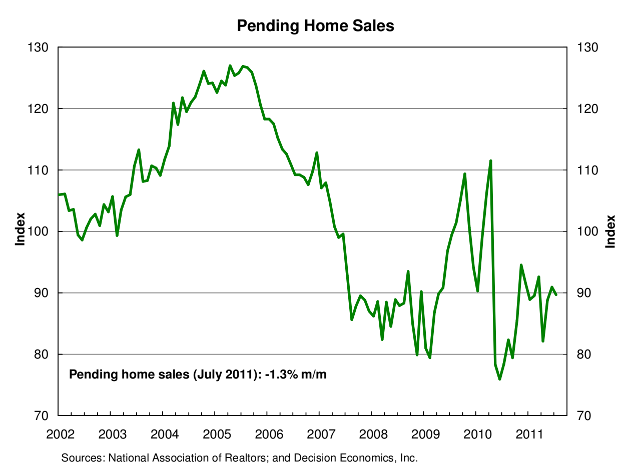


Pending Home Sales and

Assessment: Pending home sales fell -1.3% in July. The decline was bigger than expected.

Major Points: After two strong months, fewer contracts were signed in July. Consumers, anticipating a tough mortgage credit environment, could have stayed on the sidelines. Many contracts are failing to close now due to the unavailability of credit. All in all, there are really no hopes for a rebound in sales in the very near future.

Bottom Line: The housing market is not revivable at this time despite the improvement in affordability. There isn't enough demand or enough credit. There will be up months and down months, but no real upward momentum for the time being.

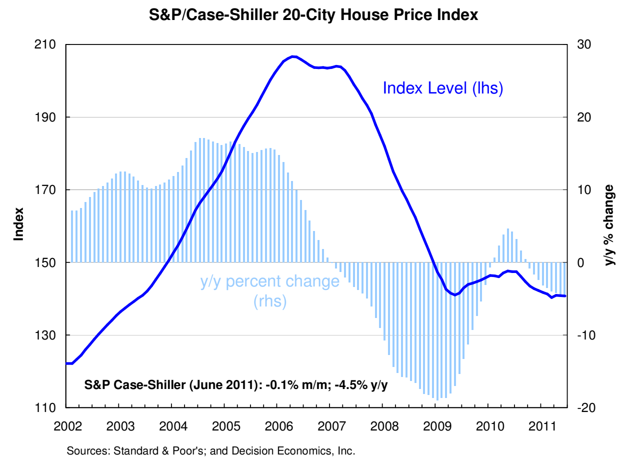


Reuters/Case-Shiller Home Price Index

Assessment: Year-on-year declines in the S&P\Case-Shiller Home Price Index narrowed to -4.5% in June from -4.6% in May.

Major Points: On a seasonally-adjusted basis, home prices fell -0.1% following -0.1% in May and +0.5% in April. Of the 20 cities in the composite index, 8 reported price gains.

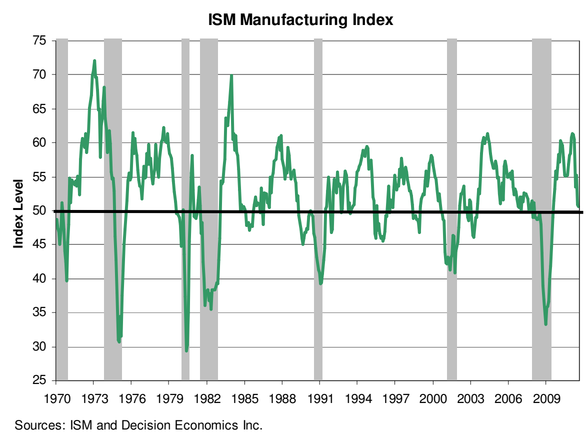
Bottom Line: It seems that the double dip in home prices that began last year is now bottoming, but there is still the potential for a false bottom. The problem remains the imbalance between supply and demand, particularly on the existing homes side of the market where foreclosures and distressed properties continue to add to a glut of inventories.



ISM Manufacturing Index

Assessment: The ISM Manufacturing Index edged down to 50.6 in August from 50.9 in July. Expectations were for a sub-50 reading indicating a contraction in the manufacturing sector.

Major Points: Production fell (48.6 vs. 52.3 in July) as orders continued to contract, but at no faster a pace than in the previous month. Employment growth weakened (51.8 vs. 53.5) but didn't turn negative. Export orders were essentially flat – removing a needed source of growth for the sector last month.



Bottom Line: The bearish spin on this report is that manufacturing – a bright spot in the tepid economic recovery – was stagnant this summer, with production ultimately falling in August. This was the lowest reading in two years. But the bullish spin may be more compelling. Clearly, the sharp contractions seen in the regional Empire State and Philadelphia Fed indices were not ratified with this national report. The slowdown signaled by ISM is certainly troubling, but actual manufacturing output has continued to grow so far – albeit at a slower and rockier pace. Perhaps most importantly, the decline in ISM does not signal recession for the U.S. economy. Readings in the 60-range for this index have never been sustainable and there are several instances over the past 20 years in which the ISM hovered around neutral during an economic expansion. As long as consumer and business spending growth is sustained domestically, assisted by export demand, the manufacturing recovery should endure.