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U.S. Markets Weekly

September 9, 2011

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What Should We Expect From Obama's Spending Plan?

MARKET DATA AND THE OUTLOOK

The two main economic indicators released during this light data week, both outperformed expectations. First, the ISM Non-Manufacturing Index registered a small increase in August, defying expectations of a small decrease. Coupled with the Manufacturing Index that managed to stay above 50 last month, the message seems to be that the economy continues to expand, but at a depleted pace compared to the beginning of the year. Second, the trade gap narrowed more than expected in July thanks to a rebound in capital goods exports and modest growth in non-oil imports. Trade has been a pillar of economic strength for the U.S. recovery, but remains subject to the risk of a global slowdown centered on the Eurozone.

More attention, however, was on fiscal policy this week. President Obama unveiled a plan to spend another $450B to help shore up the recovery. The plan included $250B in payroll and job-related tax cuts for employees and employers, most of which will start in 2012. It also included roughly $200B in new spending on infrastructure projects and extended unemployment benefits. If $250B is spent in 2012 (representing 1.6% of forecasted GDP), then assuming a typical Keynesian multiplier, growth would be boosted by 2 percentage points above baseline. This would bring DE's 2012 real GDP growth forecast to +4.5%, the kind of growth we've only dreamed of since the start of the recovery two years ago. This rate of growth would be much more conducive to job creation than what we've seen to date.

The actual impact, however, will likely be more modest. Payroll tax cut and unemployment benefit extensions are already incorporated in most forecasts for next year, so the 2 percentage point assumption would be double counting. What's more, the Republican-controlled Congress is unlikely to adopt all of the provisions so the final bill may be smaller. Any offsetting outlay cuts would reduce the beneficial impact even further. If so, the benefit may be closer to 0.75-1 percentage point, lifting growth projections to +3.5%. Another possibility is that, with household and business expectations so depressed, a new round of spending may only solidify expectations. So baseline forecasts may not increase, just our confidence in them.

Ultimately, the big question is whether this new round of stimulus will put the economy on a stronger, sustainable growth track. If our recent experience with fiscal stimulus is any guide, it will have only a modest and temporary impact. Stimulus will buy the consumer sector another year's time to heal, but it won't generate sustained growth. By injecting nearly ½ a trillion dollars into the economy, we can expect a boost to real GDP that would not have occurred otherwise. Through a series of tax cuts and public works programs, the federal government will inject money into household wallets. Some of it will be spent. Much of it, however, will be used to pay down debt. But this is a good thing as it hastens the day when consumers feel more confident about their individual balance sheet positions to begin spending again.

What this latest round of government spending won't do is serve as a perpetual source of growth for the economy. As Obama correctly pointed out, it is ultimately the private sector that creates jobs on a sustainable basis. Investors have been burned before (remember the 2010 tax cut compromise). They should not expect very large fiscal multipliers from this program, nor should they expect a surge in confidence or "animal spirits" that will lift the economy out of the doldrums. The plan also won't eliminate the risks from the Eurozone debt crisis and the potential for another credit crunch.

Nevertheless, this is the right course of action to take. The recovery is faltering and Monetary Policy options are extremely limited. Though the plan will likely add another $450B to the debt, the federal government is currently able to borrow at very lower rates. Ideally, the short-term stimulus will be coupled with medium-term fiscal consolidation to reassure markets and tax-payers that the government is serious about debt and deficits.

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 (September 12 – September 16)

- **Retail Sales:** August retail sales were offer a preview of second-month consumer spending in Q3. DE expects a healthy +0.5% gain sales (+0.4% ex-autos). Consensus, however, sees smaller gains of +0.2%. Gasoline prices likely boosted ex-auto sales a bit, but other sales categories should continue to rise modestly.

- **Inflation:** This week also brings two readings on inflation from the PPI and CPI for August. DE expects the PPI to rise +0.1% and +0.3% within the core. Consensus has the headline PPI falling -0.1%. A drop in energy prices last month is the main factor holding down the headline PPI. The CPI is expected to rise +0.3% and +0.2% within the core. A seasonal-adjustment factor is causing the behavior of energy prices to differ between the CPI and PPI. In general, these inflation numbers are expected to confirm a modest but firming outlook for inflation. These forecasts would imply that year-on-year core CPI inflation inched up to +1.9% - a historically low rate, but much stronger than the +0.6% rate seen late last year.

- **Industrial Production:** Industrial production likely pulled back -0.2% in August after a strong autos-related boost in July. Consensus sees a small increase of +0.1% - still much weaker than July. Small declines in manufacturing payroll and hours, along with an ISM reading of around 50, suggest a flat month for the manufacturing sector. Meanwhile, milder weather in August probably meant a decline in utilities output that month after the July heat-wave.

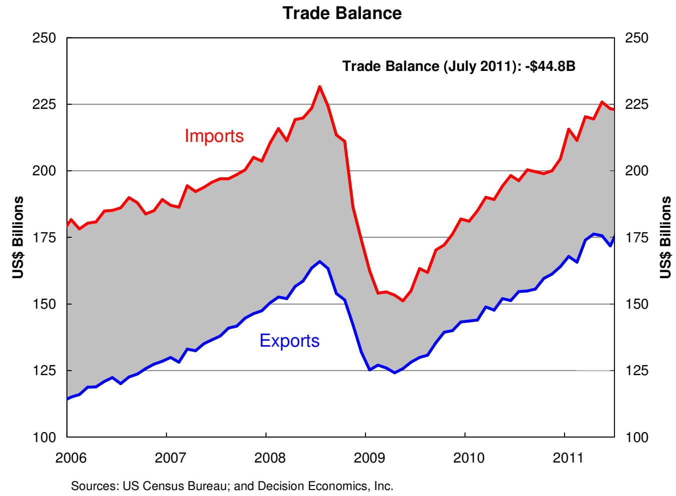
- **Regional Manufacturing Indices:** Regional manufacturing surveys will provide an early look at sector performance in September. DE expects the Empire State Survey to read -7.0 compared to -7.7 in August, and the Philadelphia Fed survey to read -29.0 compared to -30.7. Consensus sees the indices rising but remaining within contraction territory. So far, however, national surveys have failed to ratify the negatives seen at the regional level. But a slowdown has clearly been signaled.

PAST WEEK'S ECONOMIC INDICATORS IN DETAIL

Trade Balance

Assessment: The trade deficit narrowed to -$44.8B in July from -$51.6B in June. Exports rebounded +3.6% after a decline in June that lead to concerns over the health of global demand. Imports fell slightly by -0.2%.

Major Points: Oil imports fell in both real and nominal terms. Excluding oil, imports actually rose +1.3%, with gains autos (+15.0%) and apparel (+8.3%) suggesting ongoing strength in consumer spending. The export rebound following two months of contraction centered on capital goods (+5.5%), industrial supplies (+6.9%), and autos (+11.7%). Consumer goods exports, however, fell -4.2%.



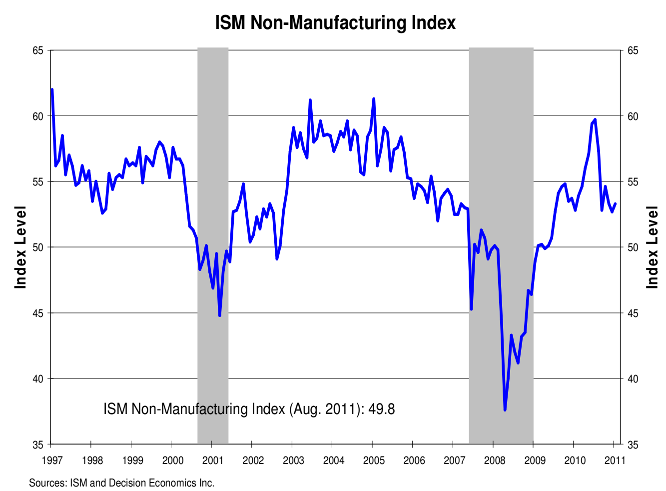
Sources: US Census Bureau; and Decision Economics, Inc.

Bottom Line: Exports have been a pillar of the U.S. economic recovery and a rebound is a welcome sign. But the possibility that Europe sinks into recession raises the risk that exports could dip again and hurt U.S manufacturing. The August and September numbers will likely tell us if the worsening situation in Europe is having an impact on trade. But for now, these better-than-expected trade numbers will likely buttress expectations of Q3 growth in the 2-2.5% range.

ISM Non-Manufacturing Index

Assessment: The ISM Non-Manufacturing Index defied expectations of a small decline and registered a small increase of +0.6 points to 53.3 in August.

Major Points: New Export Orders (+7.5 points to 56.5) was the main driver of the expansion last month, following a dip into contraction territory in July. New Orders gained about 1 point to 52.8. Employment dropped about 1 point, though stayed above the 50 mark.



Sources: ISM and Decision Economics Inc.

Bottom Line: Non-manufacturing sectors of the economy continued to expand last month. In fact, the composite Manufacturing and Non-Manufacturing Index inched up to 53.0 in August from 52.5 in July, suggesting no further deterioration in activity. But the pace of expansion has slowed considerably since the beginning of the year when the composite index stood at around 60, and activity remains vulnerable to negative shocks, which could still push it to contract.