



Quarterly Economic Report – 2nd Quarter 2010

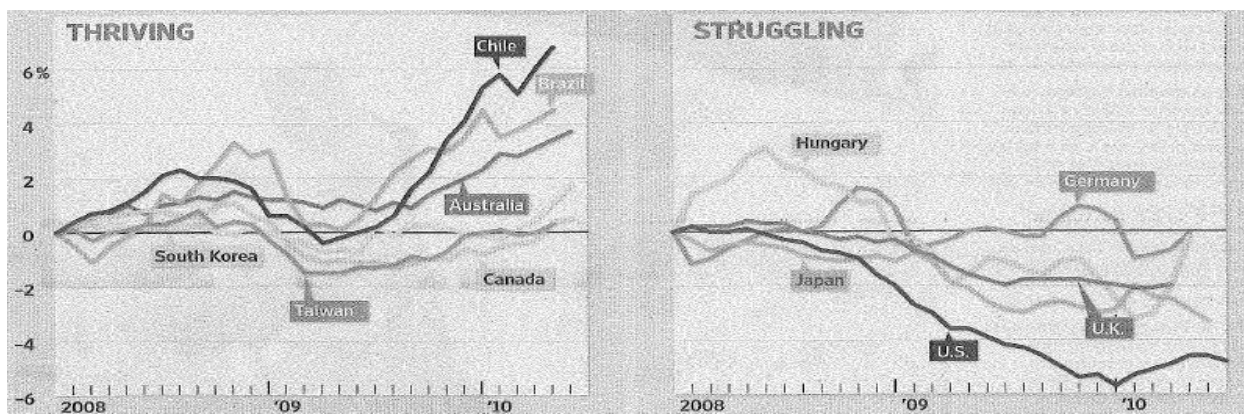
It is fundamentals and dysfunction now, not just fear.

Not just fear and uncertainty are holding the economy back now. The litany of problems seems to be growing with more negative than positive news. Since history shows that recessions associated with financial institutions are deeper and longer lasting than others, it should not be surprising that the “V” recovery has stretched into an extended “L”. The weakness in the past quarter may not be creating just a “new normal,” but a whole new economic foundation which calls for new solutions. This recessionary period has not been so different but much of the developed globe did go into the crisis with huge deficits and are left with little wiggle room to climb out of this hole. Only the private sector truly creates sustainable growth. The anemic growth in 2010 has been from (a) the private sector productivity and (b) government spending. Until the private sector kick starts the growth, the situation can not appreciably improve. Spending is not enough. Spending without building equity gains little.

After \$800 billion in stimulus, the US deficit now stands north of \$1.5 trillion and debt in the last 18 months has grown from \$5.5T to \$8.6T. The magnitude of the debt, limits our options globally, has started to affect sovereign credit as seen most dramatically in Greece and Spain. A concern over sovereign and local debt epitomized by Greek and Spain has started to restrict even state and local governments ability to borrow. State and local balance sheets are strained with combined state deficits projected to \$112 billion by June 2011. Marginal projects are cut and efficiencies sought. Forty-six states face budget deficits adding up to \$112 billion for FY 2010-2011 and that state spending represents 12% of total GDP. With falling appraisals and without access to the capital markets, government has no choice to cut budgets and jobs, adding further to the downturn and reducing GDP. Every cut at the local level cuts points off GDP.

The recent G-20 set a goal to halve debt by 2013 with “stabilization” by 2016 but that is where cross-border agreement ends. With this scenario the Fed can (and indeed perhaps must) stay accommodative with no sign of inflation recognizing that financial conditions have become even less supportive of economic growth. At some point should the situation worsen government can not bail out the private sector if it has destroyed its own credit-worthiness.

Although options were few, the \$800bb stimulus as enacted was primarily tax cuts and short term fixes and may have even extended some of the employment and housing problems. Cash for clunkers worked but merely shifted spending, not increased it. Homebuyer’s tax credits helped but only temporarily. Over the past year, GDP grew at a mere 2.7% - far from the projected 3% - relying heavily on inventory buildup and trade. Even the hard-fought victory for a more flexible Chinese yuan has a downside with a strong dollar cutting into US trade. Private business has no clear view to the monetary impact of thousands of pages of untested new programs. Banks are told to lend, but also to build balance sheets by regulators. Which one would you listen to? With private activity moving at a glacial pace, employment may stay stubbornly elusive and unfortunately the key factor now, as it has been, is Jobs.



Cumulative change in jobs around the world since the recession began in 2008. (Source WSJ.)

The chart above clearly shows the US is struggling against all major economies in building jobs. (Source WSJ) Most of the differences can be tied to infrastructure investment that put people to work. The efficacy of extensions in unemployment benefits can be argued, but results can't, and with budget cuts even the extension of those benefits, which means an additional 900,000 people, will come back on the rolls in the coming fiscal quarter. There has been much talk of a "new normal". One factor that does appear to have some credence in that formulaic title is that we may see a continuance of an 8-9% unemployment for some time as businesses re-evaluate and face new challenges.

The economy does have some power behind it. It continues to be the little engine that could but the incline is steep. Corporate profits for this quarter will be closely watched for any changes in magnitude and workers. The first quarter showed business pulling in and reserving for major unintended consequences of the health and financial regulations bills. This quarter should show a more defined direction. Only so much can be gained by productivity and without the domestic consumer (with a job), small business and large can not grow.

Housing is again at a stand-still. The median price of existing homes falling 9.4% started much of the talk of a double-dip. New home buyers plunged in May 33% after the effect of the tax credit was pulled. (Lennard Homes saw a 25% decrease in the first 30 days after the subsidy stopped). 31% of homes sold were distressed property often sold in lots. The sales rate is less than 1 per 1,000 or 1/3 the normal annual rate. One has to wonder if properties are being bought only to be flipped extending the problems. All of this suggests a continuing decline through 2010 and well into 2011 with a current two-year inventory of un-sold homes. Every government unit is feeling the result of the housing problems as appraisals drop and foreclosed properties sit empty.

Smaller purchases are also being viewed warily by this changed US consumer. Without a job, without a clear indication of health care costs and pension stability, the consumer has slowed her input appreciably. Spending, with gimmicks, used to jumpstart buying stopped when the incentives disappeared. Energy efficient appliances, homebuyer credits, auto deals, free phones were used because they offered temporary value but consumers are afraid enough now to pull back and start rebuilding their own balance sheets. In many cases, like homebuilding, the consumer can simply not buy. A no-money down 100% mortgage offered in 2006 could be had for a FICO score of 560. Now even an 80% mortgage is available to only 1/3 of the population (with scores above 700).

The financial regulations overhaul may be another stumbling block for the consumer. Although it has yet to find its final form in the Senate and conference committees it is clear that the big loser will be the consumer. This sweeping overhaul did little to touch the causes or concerns of Main Street, but it will clearly raise prices or curtail availability further for less than the highest rated consumer. The bill appears to not realize that the services, like merchant services offered by banks, cost those banks to provide them and they simply do not have to offer them. The bill has to also be partially responsible for the first of many changes in banking such as the recent announcement by Wells Fargo, to curtail certain lending services to only prime customers – resulting in a projected loss of 3,800 jobs.

With increased productivity, business has turned to the international markets to sell their products and has used the time to rebuild inventories. However, problems in the euro zone are curtailing those consumers. If the US economy soon does not rebound, inventories will become overstocks driving prices lower. This deflationary trend is one that bears watching and has to have the Federal Reserve concerned. Core inflation is trending down allowing the FOMC to keep interest rates low. If growth further stumbles, deflation (a general decline in prices) becomes a real threat. The credit markets, as reflected in the yield curve, portray a worrying trend bringing even long rates lower. This flattening often portends a deflationary situation.

There is little rousing good news to report or contemplate, but we find it difficult to see a double-dip recession taking us back to 2008-2009 recessionary lows. There is too much growth on the global markets to stop our large corporations from continuing a very slow but measured pace. As many other countries raise interest rates and get their economies started through job creation, as opposed to government spending, we should see some appreciable differences. The growth curve, however, is a steep one even for a little engine that always could before. Business needs to see some change in direction and a clearer definition of what it is facing in regulation and costs in order to be convinced to hire in appreciable numbers. That may require an election or changes from government leading into that election. Too many problems and unintended consequences of our actions have been identified. The world is moving towards lower government spending and a re-balancing of fundamentals. The US has to go there also.