

We expect restrained economic growth through 2011.

The economy continues to track an anemic recovery path from a June cyclical trough, and we continue to expect restrained growth through 2011. The vehicle sector boost to U.S. output and sales in the third quarter has dwindled in the fourth quarter, and though GDP growth is now expected to post a 3.5% fourth-quarter bounce following the downwardly-revised 2.2% third-quarter gain, nearly all of the fourth-quarter growth reflects a balancing of inventory growth with sales that leaves more limited room for a big inventory contribution going forward. We believe prospects for U.S. growth in 2010 will hinge on the willingness of business to reverse the sizable downdraft in business investment spending in the face of sluggish consumption growth.

We expect bond yields to climb in 2010 and 2011.

Downside economic risks in this cycle will switch to inflation concern by late 2010 and beyond. In our opinion, the speed of transition to an exit strategy at the Fed will dictate the path for inflation fear. We expect bond yields to climb in 2010 and 2011 with massive new supply, a diminished flight-to-quality premium, a falling dollar and an expanding global economy that should keep a bid on commodity prices. By 2011, we expect \$80-a-barrel oil and a 4.5% 10-year Treasury yield, with restrained equity market gains.

The U.S. jobs report revealed weaker than expected December payroll headline.

The U.S. jobs report revealed a weaker than expected December payroll headline that captured the negative tone to the report overall, following mostly offsetting back-revisions. Yet, weakness in the establishment data was capped by a firm workweek on the month that left a flat hours-worked figure for December, and higher than expected wage levels. The household survey was quite weak, however. We saw sizable downward revisions to the labor force and civilian employment that exacerbated the odd 2009 trend of a contracting labor force, and that included big December declines of 589k for civilian employment and 661k for the labor force overall.

Payroll declines continue.

For payrolls, the 85k December drop followed a 1k net downward bump to the prior two figures. This left a November gain of 4k, versus the prior 11k drop, and a 127k October drop that exceeded the prior 111k figure. The workweek sustained the November pop to 33.2 in December, versus the 33.0 reading in October, but 33.1 figures in the three months of Q3. The flat December hours-worked figure followed a big 0.6% November surge that mostly just reversed the 0.4% October decline and 0.1% September decrease.

U.S. Forecast Summary

Michael Englund, Ph.D.
Chief Economist
Action Economics, LLC
actioneconomics.com

KEY ECONOMIC INDICATORS	Actual →			Forecast →				Actual 2008	Forecast →		
	1Q09	2Q09	3Q09	4Q09	1Q10	2Q10	3Q10		2009	2010	2011
Gross Domestic Product	-6.4%	-0.7%	2.2%	3.5%	2.5%	2.5%	2.7%	0.4%	-2.6%	2.5%	3.1%
Change in Inventory (2000\$,bln)	-\$76.5	-\$46.3	\$21.0	\$91.9	\$66.2	\$16.6	\$19.5	-\$45.4	-\$89.3	\$161.0	\$17.9
Civilian Unemployment Rate	8.1%	9.2%	9.6%	10.1%	10.2%	10.1%	10.2%	5.8%	9.3%	10.2%	9.5%
Capacity Utilization	70.4%	68.7%	69.9%	71.2%	72.2%	73.3%	74.3%	77.6%	70.1%	73.7%	77.3%
ISM Index	35.9	42.6	51.5	55.1	55.0	55.5	55.0	45.5	46.3	55.1	55.0
ISM Non-Manufacturing Index	41.8	44.9	48.6	49.8	51.0	52.1	53.2	47.3	46.2	52.5	55.2
Retail Sales	-5.5%	-1.4%	6.4%	6.0%	4.0%	2.7%	2.1%	-0.7%	-6.1%	3.7%	3.9%
Michigan Consumer Sentiment	58.3	68.2	68.4	70.2	72.5	74.0	75.5	63.8	66.3	74.8	83.6
Total Vehicle Sales (mln units)	9.7	9.8	11.7	11.0	11.3	11.6	11.9	13.5	10.5	11.8	13.4
Housing Permits (millions)	0.531	0.529	0.573	0.573	0.602	0.640	0.685	0.895	0.551	0.664	0.870
New Home Sales (millions)	0.338	0.372	0.407	0.378	0.415	0.450	0.482	0.481	0.374	0.466	0.605
Existing Home Sales (millions)	4.583	4.757	5.290	6.343	6.360	6.317	6.300	4.893	5.243	6.324	6.470
S&P Case-Shiller C-20 (Y/Y)	-19.0%	-14.7%	-8.9%	-0.8%	7.8%	5.2%	2.8%	-15.8%	-11.2%	4.6%	0.0%
WTI Oil Price	\$42.96	\$59.54	\$68.20	\$76.58	\$78.92	\$80.10	\$80.95	\$99.57	\$61.82	\$80.23	\$83.08
CPI	-2.4%	1.3%	3.6%	3.5%	2.0%	1.4%	1.4%	3.8%	-0.3%	2.2%	1.8%
CPI (Y/Y)	0.0%	-1.2%	-1.6%	1.5%	2.6%	2.6%	2.0%	0.1%	2.8%	1.5%	2.0%
CPI Core (Y/Y)	1.8%	1.8%	1.4%	1.7%	1.7%	1.5%	1.5%	1.8%	1.8%	1.5%	1.8%
PPI	-6.2%	1.8%	4.5%	7.1%	3.8%	2.4%	2.7%	6.4%	-2.5%	3.9%	2.8%
PPI (Y/Y)	-1.9%	-4.3%	-5.4%	1.5%	4.1%	4.2%	3.8%	-0.9%	4.2%	2.4%	2.5%
Fed Funds Rate	0.16%	0.22%	0.07%	0.13%	0.13%	0.25%	0.75%	1.88%	0.17%	0.45%	2.10%
2-Year Note Yield	0.81%	1.11%	0.95%	1.00%	1.25%	1.60%	2.00%	1.94%	0.94%	1.65%	2.94%
10-Year Note Yield	2.71%	3.53%	3.31%	3.80%	3.85%	3.95%	4.10%	3.61%	3.28%	3.98%	4.45%

Source: Action Economics

Housing permits have overperformed starts over the past two months.

The 6.0% surge in housing permits to a 0.584 mln pace in November followed a smaller October drop for permits than starts, of 4.2% to a 0.551 (was 0.552) mln pace, and September pace of 0.575 mln. The better performance for permits helps to close the gap to starts, as the recovery in permits since the April bottom has generally underperformed starts until the readings over the past two months. We see the current permits trajectory as consistent with a 0.585 mln December starts forecast.

Despite consistently outpacing housing starts, permits underperformed in 2008.

More generally, permits underperformed starts in the early 1990s, but permit growth consistently outpaced starts in every year between 1992 and 2002. The faster growth for permits left the level of permits above starts, on net, in each year since 1999. The gap reached a maximum of 108k units in 2004, before the pattern started to reverse with a gap of 87k in 2005, 32k in 2006 and 49k in 2007. The gap was completely unwound in 2008, as starts came in 23k above permits during the year.

November retail sales gains were stronger than expected.

The U.S. retail sales report revealed a stronger than expected round of November gains that included hefty boosts from gasoline, vehicle sales and building materials, but with a modest over-performance in the remaining "core" components that contribute to the consumption component of real GDP. This followed largely offsetting back revisions for September and October.

U.S. retail sales (ex-auto) showed headline gain for November.

For the specifics, the big 1.3% November headline gain follows a 1.1% (was 1.4%) October increase, but a 2.0% (was 2.3%) September drop. The 1.2% November ex-auto gain followed a prior flat (was 0.2%) October figure, and a 0.7% (was 0.4%) gain in September. If we exclude both autos and gasoline, we saw a 0.6% November increase, following prior gains of 0.1% (was 0.3%) in October and 0.6% (was 0.3%) in September.

ISM-NMI posted a surprising November drop.

The U.S. ISM-NMI posted a surprising November drop to 48.7 that extended the October downturn to 50.6 from the recent-high of 50.9 in September. Similarly, the ISM-adjusted figure fell to 48.1 in November, after falling in October to 49.1 from the recent-high of 50.2 in September. The headline is still well above the 37.4 all-time low from last November, though the climb has been modest, and the headline only spent two months in the narrow 48.8-53.5 range seen in all but one of the fifteen months ending in September of last year, before falling back below that range now. The service sector is seemingly enjoying much less of a lift from the post-bankruptcy rebound in vehicle assemblies than the factory sector.

The Fed believes economic activity has picked up, but policymakers remain cautious.

The Fed commented at its December meeting that economic activity has picked up and deterioration in the labor market is abating. However, policymakers noted that economic activity is likely to remain weak for "a time." The FOMC will maintain the target for the federal-funds rate at 0 to 25 basis points as it anticipates that low rates of resource utilization, subdued inflation trends and stable inflation expectations are likely to warrant an exceptionally low federal-funds rate for an extended period.

Statements from FOMC meetings suggest limited concern over headline inflation's continued firmness.

The dovish statements following the past two FOMC meetings suggest only limited concern over continued firmness in headline inflation given core price restraint, as policymakers remain focused on downside financial sector risks and the upward climb in the jobless rate.

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