

We expect GDP growth will remain restrained.

The first round of third-quarter GDP growth has now been released, and we saw a larger-than-expected 3.5% headline gain that likely seals the deal on the assumption that the recession ended in June. Yet, we believe the overshoot in growth reflected a bigger add from inventories and government than we had assumed, which "pulls growth ahead" from future forecasts. The mix reinforces our assumption that growth will remain restrained now that we are past the one-off third-quarter GDP boost from the emergence of the auto sector from bankruptcy, with GDP gains of 2%-3% through 2010 and 3.2% in 2011.

Prospects for business investment remain weak.

We believe consumer spending should continue to drift higher with income as the jobless rate reaches a peak near 10% at year end, but prospects for business investment remain weak, and this downdraft will fight against the inventory reversal and big export gains early in the expansion. Though inflation is not a near-term problem, we believe upside risk by 2011, alongside massive new supply, should drive 10-year Treasury yields toward 4.2% by late 2010 and 5.0% by late 2011, while strong global demand puts upward pressure on current \$80 oil prices.

The U.S. jobs report revealed mostly downside surprises.

The U.S. jobs report revealed mostly downside surprises, with a big 190k October payroll drop—albeit with upward back-revisions—but a failure of the workweek to bounce from its 33.0 cyclical low, leaving a 0.2% drop in hours-worked, alongside a sharp rise in the politically-sensitive jobless rate to 10.2% with a huge 589k drop in household employment, and a larger than expected 0.3% gain for hourly earnings. The full set of figures remains consistent with a positive but lean trajectory for real GDP as we enter Q4.

Payroll declines weakened slightly.

For payrolls, the 190k October drop followed an 91k net upward bump to the prior two figures that left declines of 219k (was 263k) in September and 154k (was 201k) in August.

The jobless rate has climbed sharply.

Today's jobless rate surge to 10.2% further extends the huge up-trend in the jobless rate that has left gains in all by one of the last eighteen months, and an average gain of a full percentage point per quarter since the 6.2% rate seen as recently as last September. Indeed, the rate has climbed sharply from 4.9% at the start of the recession and the 4.4% cyclical low in March of 2007.

U.S. Forecast Summary

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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%	3.5%	2.3%	2.3%	2.6%	2.8%	0.4%	-2.5%	2.4%	3.2%
Change in Inventory (2000\$,bln)	-\$76.5	-\$46.3	\$29.4	\$75.3	\$29.5	\$12.5	\$31.8	-\$45.4	-\$89.2	\$122.6	\$35.3
Civilian Unemployment Rate	8.1%	9.2%	9.6%	10.0%	10.1%	9.9%	10.0%	5.8%	9.2%	10.0%	9.1%
Capacity Utilization	70.4%	68.7%	69.8%	70.9%	71.7%	72.8%	73.7%	77.6%	69.9%	73.3%	77.4%
ISM Index	35.9	42.6	51.5	55.2	55.0	55.5	55.5	45.5	46.3	55.4	55.5
ISM Non-Manufacturing Index	41.8	44.9	48.6	51.4	53.5	54.7	55.3	47.3	46.6	54.9	56.0
Retail Sales	-5.5%	-1.4%	6.4%	2.8%	3.1%	1.6%	1.7%	-0.7%	-6.3%	2.7%	4.0%
Michigan Consumer Sentiment	58.3	68.2	68.4	70.4	72.0	75.0	78.0	63.8	66.3	76.5	87.6
Total Vehicle Sales (mln units)	9.7	9.8	11.7	10.6	10.7	11.0	11.4	13.5	10.4	11.3	13.3
Housing Permits (millions)	0.531	0.529	0.572	0.600	0.662	0.714	0.759	0.895	0.558	0.736	0.998
New Home Sales (millions)	0.338	0.372	0.411	0.435	0.475	0.513	0.552	0.481	0.389	0.532	0.670
Existing Home Sales (millions)	4.583	4.757	5.300	5.723	5.857	5.930	6.020	4.893	5.091	5.979	6.348
S&P Case-Shiller C-20 (Y/Y)	-19.1%	-14.9%	-8.4%	1.1%	10.5%	8.5%	5.7%	-15.8%	-10.7%	7.4%	7.2%
WTI Oil Price	\$42.96	\$59.54	\$68.20	\$77.77	\$80.08	\$80.90	\$81.75	\$99.57	\$62.12	\$81.12	\$83.85
CPI	-2.4%	1.3%	3.6%	3.3%	2.4%	1.4%	1.3%	3.8%	-0.3%	2.3%	1.7%
CPI (Y/Y)	0.0%	-1.2%	-1.6%	1.5%	2.7%	2.7%	2.1%	0.1%	2.9%	1.6%	2.0%
CPI Core (Y/Y)	1.8%	1.8%	1.4%	1.7%	1.7%	1.5%	1.6%	1.8%	1.8%	1.5%	1.9%
PPI	-6.2%	1.7%	4.9%	3.8%	2.7%	2.4%	2.7%	6.4%	-2.6%	3.1%	2.8%
PPI (Y/Y)	-1.9%	-4.3%	-5.3%	0.8%	3.1%	3.3%	2.8%	-0.9%	3.3%	2.5%	2.7%
Fed Funds Rate	0.16%	0.22%	0.07%	0.13%	0.13%	0.25%	0.75%	1.88%	0.17%	0.43%	2.08%
2-Year Note Yield	0.81%	1.11%	0.95%	0.95%	1.20%	1.55%	1.95%	1.94%	0.96%	1.60%	2.94%
10-Year Note Yield	2.71%	3.53%	3.31%	3.60%	3.70%	3.85%	4.10%	3.61%	3.30%	3.90%	4.48%

We believe housing starts will rise modestly in October.

The revised 0.9% decline in housing permits to a 0.575 million (mln) unit pace in September (originally reported as a 1.2% permits drop to 0.573 mln, figure was revised on October 27th) was troublesome, as these figures continue to lag gains in starts. We now assume that starts will rise only modestly in October, to the 6.00 mln area, and perhaps 0.630 mln by year end, as these figures react only cautiously to the ongoing improvement in most real estate measures from a Q1 trough.

Housing permits continue to underperform starts despite previous growth consistency.

More generally, housing 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.

Overall U.S. retail sales (ex-auto) were weaker than expected.

The U.S. retail sales report revealed the expected headline reversal, with a 1.5% September drop that followed the 2.2% (was 2.7%) August surge, following a -0.1% (was -0.2%) July figure. Vehicle sales fell, largely as expected, by 10.4% in September following the 7.8% (was 10.6%) August gain and 1.7% (was 1.5%) July increase, alongside the 35% September drop in light vehicle sales that reversed the 25.3% August gain and 16% July increase. Retail sales ex-autos rose 0.5% in September, following a 1.0% (was 1.1%) gain in August and 0.5% drop in July, with the ex-auto figure receiving continued gasoline sales boosts, with gains of 1.1% in September, 4.7% (was 5.1%) in August, but a 1.7% (was 1.5%) decline in July. In total, overall sales were a bit weaker than expected, though each "core" sales measure that excludes some combination of autos, gasoline, or building materials modestly beat expectations.

The October manufacturing index surge has re-established an up-trend.

The U.S. ISM surge to 55.7 in October more than reversed the September drop to 52.6 from 52.9 in August to re-establish the up-trend that left an eight-month string of gains from the cyclical-trough of 32.9 in December. The index has now surpassed the 53 long-term average to enter the 55-60 range typical for the early years of recoveries. The figures are now well above the narrow 48.6-50.8 range that prevailed over the thirteen months ending in August of last year—before the financial market meltdown. Previously, the Q2 figures were in the 40-45 recession-range, while the Q4-Q1 figures sat below this range alongside out-sized GDP declines.

ISM-NMI down-tick is still above last November's all-time low.

The U.S. ISM-NMI down-tick in October to 50.6 from 50.9 translates to a drop on an ISM-adjusted basis to 49.1 from 50.2 in September. The headline is still above the 37.4 all-time low last November, though these service-sector figures are recovering only slowly, and have now spent only 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.

Inflation is not a near-term problem.

Inflation is not a near-term problem, but headline figures should climb through the remainder of 2009 to a December reading of around 2%.

Fed fund rates are expected to remain low.

We believe the Fed remains unlikely to change its zero to a 0.25% target rate anytime soon. Nonetheless, we expect ongoing changes in the FOMC meeting statements toward a balanced risk assessment and a focus on the exit strategy from quantitative easing.

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