

We believe recovery from a June cyclical trough is proving anemic.

The economic reports in the fourth quarter have reinforced concern that the recovery from a June cyclical trough is proving anemic, with likely restrained growth through at least 2011. The vehicle sector boost to U.S. output and sales in the third quarter following the May-June bankruptcies for GM and Chrysler proved temporary as feared, leaving only a reduced pace of inventory liquidation to fuel further growth in the fourth quarter. We believe prospects for U.S. growth in 2010 will hinge on the willingness of business to reverse the sizable current downdraft in business investment spending in the face of sluggish consumption growth.

We expect bond yields to climb over the coming years.

We expect downside economic risks in this cycle will switch to inflation concern by late 2010 and beyond. The speed of transition to an exit strategy at the Fed will determine how smooth the transition will be. We expect bond yields to climb over the coming years 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-per-barrel oil and a 4.5% 10-year Treasury yield, with restrained equity market gains.

The November U.S. jobs report revealed mostly upside surprises.

The U.S. jobs report revealed a broad swath of upside surprises, with a November payroll drop of only 11k that followed big upward back-revisions, and a two-tick workweek bounce that allowed a big 0.6% November gain in hours-worked. We also saw a restrained 0.1% gain for hourly earnings, and a drop in the politically-sensitive jobless rate to 10.0%—with a 227k bounce in household employment that capped the prior three-month string of jumbo 392k-785k declines. The array of upside surprises is certainly good news for the November economy, though the jobs data are volatile, and the figures are still consistent with a positive but lean trajectory for real GDP growth.

Payroll declines continue.

For payrolls, the 11k November drop followed a 159k net upward bump to the prior two figures that left declines of 111k (was 190k) in October and 139k (was 219k) in September. The workweek rose to 33.2 following the odd drop to 33.0 in October from the 33.1 figures through the three months of Q3. The 0.6% November surge in the hours-worked index followed prior declines of 0.4% (was 0.2%) in October and 0.1% (was 0.5%) in September.

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%	2.8%	2.3%	2.3%	2.5%	2.8%	0.4%	-2.6%	2.3%	3.2%
Change in Inventory (2000\$, bln)	-\$76.5	-\$46.3	\$26.8	\$72.0	\$56.0	\$22.5	\$32.8	-\$45.4	-\$91.3	\$151.5	\$20.1
Civilian Unemployment Rate	8.1%	9.2%	9.6%	10.3%	10.4%	10.3%	10.4%	5.8%	9.3%	10.4%	9.7%
Capacity Utilization	70.4%	68.7%	69.9%	70.9%	71.7%	72.8%	73.8%	77.6%	70.0%	73.3%	77.5%
ISM Index	35.9	42.6	51.5	54.5	54.5	55.0	55.0	45.5	46.1	54.9	55.0
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%	6.0%	4.3%	3.3%	1.8%	1.4%	-0.7%	-6.2%	3.0%	4.0%
Michigan Consumer Sentiment	58.3	68.2	68.4	68.7	69.1	72.0	75.0	63.8	65.9	73.5	84.6
Total Vehicle Sales (mln units)	9.7	9.8	11.7	10.9	11.1	11.4	11.6	13.5	10.5	11.5	13.3
Housing Permits (millions)	0.531	0.529	0.573	0.556	0.600	0.650	0.695	0.895	0.547	0.671	0.880
New Home Sales (millions)	0.338	0.372	0.413	0.435	0.450	0.471	0.504	0.481	0.390	0.491	0.621
Existing Home Sales (millions)	4.583	4.757	5.290	6.217	6.337	6.290	6.230	4.893	5.212	6.257	6.183
S&P Case-Shiller C-20 (Y/Y)	-19.0%	-14.7%	-8.9%	-0.5%	8.1%	5.5%	3.0%	-15.8%	-11.1%	4.8%	2.3%
WTI Oil Price	\$42.96	\$59.54	\$68.20	\$77.51	\$80.05	\$80.90	\$81.80	\$99.57	\$62.05	\$81.14	\$83.93
CPI	-2.4%	1.3%	3.6%	3.3%	2.3%	1.4%	1.4%	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%	2.1%
CPI Core (Y/Y)	1.8%	1.8%	1.4%	1.8%	1.8%	1.5%	1.6%	1.8%	1.8%	1.5%	1.8%
PPI	-6.2%	1.8%	4.8%	5.1%	3.8%	2.4%	2.7%	6.4%	-2.6%	3.6%	2.8%
PPI (Y/Y)	-1.9%	-4.3%	-5.3%	1.3%	3.9%	4.1%	3.6%	-0.9%	4.1%	2.7%	2.9%
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%	0.90%	1.20%	1.55%	2.00%	1.94%	0.93%	1.63%	2.94%
10-Year Note Yield	2.71%	3.53%	3.31%	3.40%	3.70%	3.85%	4.10%	3.61%	3.26%	3.89%	4.45%

Source: Action Economics

We believe the bigger drop in housing starts was partly weather-related.

The smaller 4.0% drop in housing permits to a 0.552 mln unit pace in October reinforces our assumption that the bigger housing starts drop was at least partly weather-related, and we will assume that starts bounce to the 0.560 mln area in November.

Housing permits underperformed starts despite previous growth consistency.

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.

U.S. retail sales revealed a 1.4% boost due to vehicle sales in October.

The U.S. retail sales report revealed a big 1.4% October headline pop due to a boost from vehicle sales. Yet, we saw downward back revisions in both the auto and non-auto components, and a small 0.2% October ex-auto gain, to leave a surprisingly weak report that implies a downward consumption bump in the next Q3 GDP report. The big October headline gain followed a 2.3% (was 1.5%) September drop and a 2.4% (was 2.2%) August gain. The small 0.2% October ex-auto gain followed prior increases of 0.4% (was 0.5%) in September and 0.8% (was 1.0%) in August. If we exclude both autos and gasoline, we saw a small 0.3% October increase, following prior gains of 0.3% (was 0.4%) in September and 0.4% (was 0.6%) in August.

We believe today's data imply downward revisions in real consumption spending for Q3.

Today's data imply a 0.4% nominal PCE gain in October, a 0.2% "real" PCE increase, and a 0.2% headline PCE chain price gain that should match a comparable October CPI increase in Wednesday's report. For the GDP accounts, today's data imply a \$4 bln downward revision in the 3.4% real consumption spending growth figure for Q3 to the 3.2% area, which should join a \$12 bln downward bump in Q3 net exports and a \$6 bln downward adjustment in Q3 construction to leave a 2.8% headline GDP gain for the quarter, versus the 3.5% advance estimate.

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.

We believe there is downside risk for the October jobs report.

The employment component in the ISM-NMI report fell to a notably weak 41.1 in October from 44.3 in September and a 31.1 cycle-low in November, which suggests downside risk for the October jobs report. The drop joined an increase in the comparable component of Monday's ISM report, as well as gains for the two components of the Empire State survey for the month, and one of the Philly Fed measures. Yet, we saw similar declines for the Chicago ISM employment measure and the workweek component of the Philly Fed report, and the full mix of data appear to suggest downside risk, on net.

Headline CPI rose more than forecast in October.

The headline CPI rose more than forecast in October as Americans paid more for fuel. However, core inflation prices held at a pace that supports the Federal Reserve's forecast for tame inflation.

The FOMC expects inflation to remain subdued.

At its November 4th meeting, the FOMC left the short-term target rate range at 0% to 0.25%. The Fed also left in the key words "exceptionally low" level for rates for an "extended period". The committee expects inflation to remain subdued.

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