



An Upeat End To The Year?

With the holiday shopping season almost upon us, there is every reason to sound a cautiously cheerful note. Clearly, consumers appear to be in a more celebratory mood, snapping up the new iPhones and Kindle e-readers like candy and showing a hefty appetite for a broad range of other goods and services, including cars. Consumer spending has been a pleasant surprise since mid-year, as real consumption increased at a solid 2.3 percent annual rate in the third quarter – the fastest of the year – and is on track to at least equal that pace in the current quarter. As goes the consumer, so goes the overall economy. Following a tepid 0.8 percent growth rate over the first half of the year, the economy picked up some speed in the third quarter, growing at a 2.0 percent pace. If consumers keep their wallets and purses open, the broader economy should retain its newfound momentum over the balance of the year.

To be sure, a 2.0 percent growth rate is nothing to write home about. During the first two years of postwar recoveries, the economy grew at an average 5.0 pace, which usually included several quarterly spurts of 7 percent or more that quickly put people back to work. Not only has this upturn failed to reach 4 percent in any quarter, the current growth rate will hardly make a dent in the intolerably high unemployment rate. But as they say, it’s the direction that counts; considering the dire outlook of a few months ago when recession fears ran high, the modest improvement underway looks downright appealing.

The question is, is the recent behavior of households sustainable? It would be one thing if the surprising vigor of consumer spending reflected a surge in hiring and fatter paychecks. But that’s not the case. While the job market is showing signs of improvement, labor income is not. Indeed, disposable incomes edged up by a puny 0.2 percent in the third quarter, the slowest quarterly rate since the end of the recession, and actually declined by 2.1 percent after adjusting for inflation. That means consumers financed their increased spending by saving less, a practice that cannot be sustained for much longer. Hence, the promising holiday shopping season may be followed by a bust, which is not a good omen heading into 2012. Other danger signs are flashing red around the turn of the year. Unless Congress votes to extend them, unemployment benefits for millions of long-term jobless workers will run out, as will some expiring tax provisions that helped fuel growth this year. Meanwhile, the ongoing European debt crisis continues to cast a dark cloud over the economic landscape. Does a winter of discontent loom ahead?

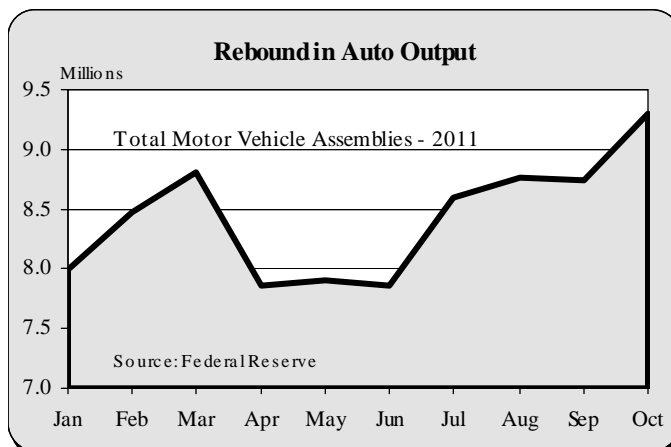
A Lift From Autos

The modest improvement in the economy’s performance is

encouraging for a number of reasons. For one, it moves the nation further away from the recession ledge that loomed so ominously over the summer months. For another, it raises hopes that the momentum will gain traction and finally put the economy on a self-sustaining growth track. This is the “trend is your friend” principle that usually brings optimists out of the woodworks when things are doing better. But if the pattern of this recovery is any guide, the optimists would do well to keep their aspirations in check.

Aside from the fact that a 2.0-2.5 percent growth rate is not strong enough to make a significant dent in unemployment, it is still unclear if the rebound from the anemic 0.8 percent first-half pace is due primarily to the unwinding of forces that temporarily slowed the economy in the spring and early summer months. Recall that the Japanese earthquake and tsunami in March cut off the supply of vital parts that slashed auto production in the U.S. for several months. The supply disruption had a double whammy effect, reducing output as well as auto sales and spurring a temporary price spike on models still available on dealer lots. The price increase reinforced the pickup in headline inflation already under way due to surging oil and other commodity prices.

But by July the supply chain was almost fully restored, enabling the auto industry to ramp up output. Indeed, motor vehicle assemblies surged to 9.3 million units in October, the highest in more than three years, as the industry rushed to replenish depleted inventories and accommodate sales that exceeded expectations. The production rebound had an outsized impact on the economy. From June through October, the output of automotive products accounted for more than half of the increase in the gross value of all goods produced in the U.S.,



greatly exceeding the industry's 8.5 percent share of total output. With production back to full strength and inventories restored, used and new vehicle prices fell in both September and October as well.

The Other Small Sector: Housing

But an industry that accounts for a small slice of the economy cannot do the heavy lifting for long. Even if auto sales remain on the strong side, the catch-up phase is basically over and future gains will be more incremental than substantive. If there is any small sector that can have a sustained outsized influence on the economy's performance it is housing, and that industry has yet to climb out of its prolonged slump. The good news is that housing seems to have found a bottom, so it is no longer weighing down growth as dramatically as was the case from 2006 through last year.

Still, housing has traditionally been a major engine of growth during the early stages of a recovery. Since 1970, real residential outlays have accounted for about 20 percent of GDP growth during the first two years of an upturn, far greater than the 5.7 percent average share such spending has had in the overall economy. The absence of that cyclical thrust is a key reason the recovery has lagged past upturns to such a great extent. Keep in mind that housing's reach extends far beyond just the dollars spent on residential construction. Each home built creates an average of about three jobs a year and generates \$90 thousand in taxes.

As it is, more than two million construction workers lost their jobs between December 2007 and early 2010, a big chunk of the 9 million plunge in total payrolls over the period. Since March of 2010, total nonfarm employment has increased by 2.7 million; the number of construction jobs regained? None. Clearly, reviving the moribund housing market would go a long ways towards healing the overall job market. Sadly, that prospect is still well into the future, thanks to the overhang of homes in foreclosure and an unreceptive mortgage market. The latest report on home sales highlights a particularly troubling trend that may be stifling a housing recovery. In October, fully one-third of all contracts to purchase an existing home were cancelled, up from 8 percent a year ago. A cancellation can be triggered by a number of factors, but is frequently the result of a lender denying a mortgage application because it appraises the underlying home at less than the negotiated price.

Standing in Place

With housing remaining in limbo, the boost from auto production mostly behind us and little help expected from Washington, the economy is likely to remain on a ho-hum recovery pace over the foreseeable future. If that's the case, it will take years before unemployment is brought down to acceptable levels. Many, in fact, believe the U.S. is entering a period that very much resembles Japan's "lost decade". That nation also experienced a major real estate bust and banking crisis beginning in the early 1990s, resulting in high unemployment and stagnant growth for more than a decade.

In many respects, the U.S. is following a similar pattern. Recently, the Census Bureau released figures showing that median household incomes, adjusted for inflation, showed no growth between 1997 and 2010, more than a decade of stagnation. Not surprisingly, the job market has performed almost as poorly. In 2010, total private employment averaged 107.3 million, more than a million below the average for 1999. No doubt, the Great Recession dealt a crushing blow to the employment rolls in 2008 and 2009, but the pace of job

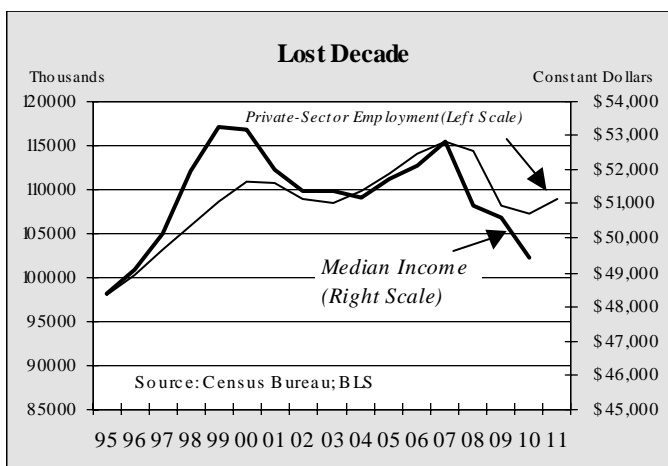
growth during the 2002-2007 expansion was one of the weakest for an upturn in the postwar period.

Although figures for 2011 are not yet available, it is unlikely that real incomes have improved. The job market has turned up, with the number of jobs in the private sector finally rising above the 1999 level. But wages have been stagnant and inflation has increased, which kept a lid on real incomes. The drop in real disposable incomes during the third quarter, noted earlier, followed a smaller decline in the second quarter, completely reversing the modest rise in the January-March period. By these two key metrics, the U.S. is eerily tracking the Japanese experience.

Policy Crisis

The story of the recovery that began in mid 2009 is still being written, and the current chapter is unfolding with a mixture of hope and despair. After a listless first-half performance, the economy appears to be gaining some momentum, fueled by consumer spending and stronger job prospects. Job openings in September jumped to the highest level in more than three years; if actual hiring follows suit, the long drought in wage growth may finally come to an end. Prices of commodities, including oil and gasoline, have retreated from their peaks, which should push inflation lower and boost purchasing power as well.

But villains in the story may have the final say in the confusing tale. These are the politicians, both here and abroad, who are showing an astonishing lack of leadership qualities just when they are needed the most. The European debt crisis seems to be a hopeless case of nations feuding over how to prevent financially-troubled EU members from defaulting on their obligations, with no prospect of a solution in sight. In the U.S. the feuding is just as intense among Democrats and Republicans, who have taken hard-line positions on taxes and spending that have put policy decisions in the dumpster. The so-called Super Committee that was charged with finding \$1.2 trillion in deficit-cutting measures came up empty and the intense acrimony between the two parties threatens to take \$150 billion out of the economy beginning in 2012. That's the amount workers and unemployed folks would have less to spend if Congress does not extend the temporary Social Security tax cut and emergency unemployment benefits scheduled to expire at the end of December. That's not a hit the economy can easily absorb, and is probably the major threat that could short-circuit the promising events of recent months.



KEY ECONOMIC AND FINANCIAL INDICATORS

FINANCIAL INDICATORS*

	<u>October</u>	<u>September</u>	<u>August</u>	<u>July</u>	<u>June</u>	<u>May</u>	<u>April</u>	<u>12-Month Range</u>	
								<u>High</u>	<u>Low</u>
Prime Rate	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25
3-Month CD Rate	0.37	0.33	0.29	0.24	0.22	0.21	0.23	0.37	0.21
3-Month Treasury Bill Rate	0.02	0.01	0.02	0.04	0.04	0.04	0.06	0.15	0.01
5-Year Treasury Note Rate	1.06	0.90	1.02	1.54	1.58	1.84	2.17	2.26	0.90
10-Year Treasury Note Rate	2.15	1.98	2.30	3.00	3.00	3.17	3.46	3.58	1.98
20-Year Treasury Bond Rate	2.87	2.83	3.24	3.95	3.91	4.01	4.28	4.42	2.83
Tax-Exempt Bond Yield	4.13	4.01	4.02	4.52	4.51	4.59	4.99	5.28	4.01
Corporate Bond Yield (AAA)	3.98	4.09	4.37	4.93	4.99	4.96	5.16	5.22	3.98
Dow Jones Industrial average	11516	11175	11326	12512	12097	12580	12435	12580	11175
S&P 500 Index	1207	1174	1185	1325	1287	1338	1332	1338	1174
Dividend Yield (S&P)	2.17	2.39	2.19	2.06	2.00	1.95	1.90	2.39	1.83
P/E Ratio (S&P)	13.2	11.9	13.3	14.2	14.5	15.3	15.5	15.6	11.9
Dollar Exchange Rate (vs. Major Currencies)	71.6	71.2	69.1	69.1	69.6	69.7	69.6	73.8	69.1

* Monthly Averages

ECONOMIC INDICATORS

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								<u>High</u>	<u>Low</u>
Housing Starts (In Thousands)	628	630	585	615	615	553	549	636	518
New Home Sales (Thousands of Units)		313	296	297	303	308	316	331	281
New Home Prices (Thousands of Dollars)		204	211	231	240	222	225	241	211
Retail Sales (% Change Year Ago)	7.1	7.9	7.7	8.4	8.2	7.9	7.2	9.1	7.1
Industrial Production (% Change Year Ago)	3.9	3.1	3.4	3.7	3.4	3.4	4.5	6.7	3.1
Operating Rate (% of Capacity)	77.8	77.3	77.4	77.5	76.7	76.7	76.6	77.8	75.8
Inventory Sales Ratio (Months)		1.27	1.27	1.28	1.28	1.28	1.27	1.29	1.25
Real Gross Domestic Product (Annual % Change)		2.0			1.3			2.3	0.4
Unemployment Rate (Percent)	9.0	9.1	9.1	9.1	9.2	9.1	9.0	9.8	8.8
Payroll Employment (Change in Thousands)	80	158	104	127	20	53	217	235	20
Personal Income (% Change Year Ago)		4.4	4.3	5.0	5.3	5.3	5.6	6.0	4.3
Savings Rate (Percent of Disposable Income)		3.6	4.1	4.5	5.3	5.0	5	5.3	4.1
Hourly Earnings (% Change Year Ago)	1.6	1.9	1.8	2.1	2.0	2.0	2.1	2.5	1.6
Consumer Credit (Change in Mil. Of Dollars)		7386	-9682	11809	11321	5993	3715	11809	-9682
Consumer Prices (% Change Year Ago)	3.5	3.9	3.8	3.6	3.6	3.6	3.2	3.9	1.1
CPI Less Food & Energy (% Change Year Ago)	2.1	2.0	2.0	1.8	1.6	1.5	1.3	2.1	0.8
Wholesale Prices (% Change Year Ago)	5.9	6.9	6.5	7.2	7.0	7.3	6.8	7.3	3.5