Economic Analysis

Economics | United States
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A daily snapshot of market moving developments

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- Equity Markets Bounce From Oversold Levels …
- … But Leadership is Fading (Down to Energy)
- Credit Strains are Intensifying
- SPR Release Coming? Congress Contemplates It
- No Luggage Sales = No Travel Plans
- Deflation Pressures Intense in the Retail Sector
- Recession Spreads to Service Sector
- June Payrolls Weak … Will be Even Weaker in July
- Oil Prices Triggering Huge Change in Behavior
- Will Corporate Profits Slide 50% this Cycle?
- Retail Vacancy Rate Rises to Six-Year High
- Steelmakers Facing Resistance to Price Hike for First Time This Cycle

Overseas Overnight Market action

Equities are strong today; bonds have a slight bid; commodities and gold are off a little as are the resource-based currencies; US futures point to a solid open. After five weeks of decline, the global MSCI index edged up fractionally today. Europe is up 0.6% and Asia is up right across the board too (Nikkei +122 points or +0.9% to 13,360; the Hang Seng rose 474 points or 2.2% to 21,897; China was up more than 4%; India by 2% – but we did see the cyclically-sensitive Korean Kospi lag well behind with just a 0.2% gain. It is quiet on the data front, but what we saw was soft – UK manufacturing output fell to an 8-month low in May via a surprising 0.5% decline (consensus was flat); and April was revised down a notch to 0.0% from +0.1%. And, we see that the BoJ left its downbeat assessment on the regional economic landscapes intact in May. As for this morning's press, have a read as to how the leader board is narrowing in the equity market on page C1 of the WSJ – "Bear Trap Opens for Resource Stocks". This is important because since the October 9th peak in the S&P 500, the only two sectors not in the red column are energy and basic materials – but as of June, we were down to just one (energy – materials fell 1.5% during the month) as the old Agatha Christie classic goes.

The #1 near-term downside risk for the oil bulls

Oil bulls should take note of the #1 near-term downside risk – the prospect that we see some drawdown from the SPR (see page A6 of the WSJ). The SPR has 706 million barrels in reserve, and there is growing talk of a release of 2 million barrels a day for at least a month (don't think for a second that such would not have a dramatic even if brief short-term impact on the price). The House, apparently, is now weighing legislation to force release of the oil reserves and support for such a move is also gaining ground in the Senate.

Trichet proved he's not a bluffer

ECB hiked rates 25 bps on Thursday to 4.25% as Trichet proved he's not a bluffer. But the press statement was fully neutral and hinted at a "one-and-done" tightening – hence the euro dropped from its lofty ten-week high perch (there had been two more rate hikes being priced in). Keep in mind that what makes Euroland different than the USA is the strength of the unionized workforce and the recent slate of wage settlements over there – and the ECB seemed to be firing a warning shot that wage-price pressures will not be accommodated. Sweden also tightened by 25 bps to 4.5%.

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Emerging market monetary policy is unsustainable

The really big problem is in emerging markets where monetary policy is tightening but still insanely accommodative and completely unsustainable. Take Indonesia for example – it just raised rates by a quarter-point as well to 8.75% but the inflation rate there is 11% – so real policy rates are still very negative. Chile is the next central bank on the potential tightening list and it's policy rate, which was boosted 50 bps to 6.75% in May, is 375 basis points below its 14-year high inflation rate of 9.5%.

Japan is coming off a 12-day 8.4% selloff

And, this has occurred despite the fact the foreign investors have been (unhappy) net buyers of stock in six of the past seven weeks.

The UK is on the precipice of a bear market

The UK is on the precipice of a bear market with the FT-SE down 19.6% from the peak and trading at is lowest level since November 2005 (a profit warning from Marks & Sparks didn't help). Retail investors have been net sellers of European stocks now for 15 months now.

Euroland data has weakened sharply

The data in Euroland has weakened sharply of late and we see some investment houses are calling for recession (i.e. Soc Gen) – German manufacturing orders declined 0.9% (the consensus was looking for +0.9%) and -2.0% YoY; this was the sixth month in a row of decline. Intense softness is evident across both capital and consumer goods categories. And, it continues to rain in Spain where industrial output printed -2.7% MoM (-5.5% YoY) in May.

Emerging markets remain in disarray

Emerging markets remain in disarray – Facing four consecutive weeks of heavy net equity outflows. The Kospi sank 6.3% last week alone and Thailand was off by 4% as both counties saw their inflation rates soar to 10-year highs. Sector wise, steel is now coming under sharp downward pressure in a lagged response to the spreading problems in the US automotive industry.

Credit stress remains intact

Credit stress remains intact, underscored by the 8 bp rise in the Markit iTraxx Crossover index of junk-rated credits last week to levels last seen in April. Oh yes – in case you missed this, the BSC assets the Fed agreed to take on in mid-March are now valued roughly $1 billion lower than at the time of the transaction ($28.9 bln now). By the way, Moody's cut Toll Brothers' credit ratings to junk status (Ba1 from Baa3).

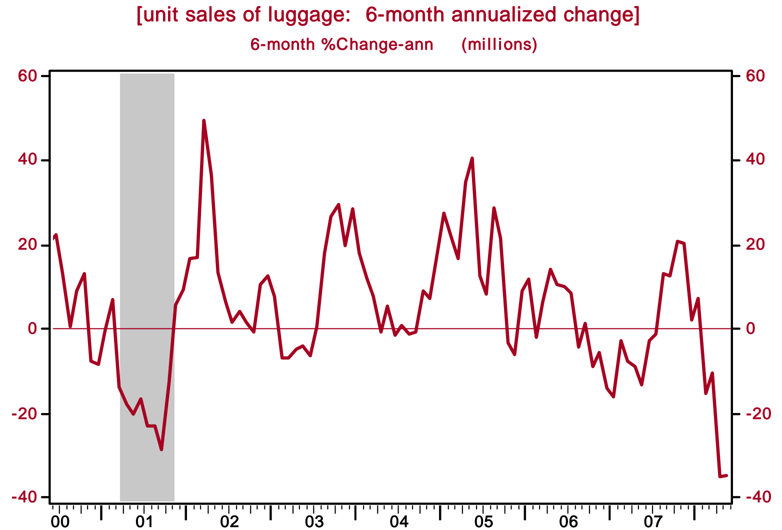
Legislation getting stalled in Congress

One would think that with all the economic angst, that Congress would be turning words into action at a much more frenetic pace: Instead, the housing bill did not get passed for the pre-vacation target date; there is bickering over how to handle the commodity price boom with the Democrats seeking to get the CFTC to move more forcefully to curb 'speculation' while the GOP favors a bill to allow more oil drilling. What seems apparent is that the Democrats may not be in such a big rush to do much because the Republicans seem to be bearing a larger share of the blame – the latest Pew poll shows that 57% have a favorable view of the Democrats despite the escalating economic problems while only 39% feel the same way about the Republicans (for more on this file, see "Economic Worries Sour Mood Towards Congress" on page A3 of the WSJ).

Empty suitcase

We track luggage sales as a barometer of travel plans – and they have fallen in two of the past three months and are running at a near-record 35% annual rate over the past six months. Either people intend to stay close to home (which requires a 'cocooning' theme) or those who do intend to travel are scaling back their suitcase purchases in response to the advent of these airline per-bag fees. Why buy a bag that is only going to be another cash-flow drain? Simply wear everything you would have packed (not comfortable but a lot cheaper).

Chart 1: Luggage sales fall off the carousel



Source: Haver Analytics, Merrill Lynch

Breaking News

This week's events

This week's economic data calendar is fairly light. Nothing is released today though we will be hearing from San Francisco Fed President Janet Yellen (non-voter). She will be speaking on the economic outlook at 11 am. Tuesday, we'll get data on pending home sales and they are expected to sink 2.5% month-over-month in May after rising 6.3% month-over-month in April. Wholesales inventories are also released and expected to rise 0.7% in May on top of a 1.3% increase in April. We'll also be hearing from Chairman Bernanke on financial regulation. And, Richmond Fed President Lacker (non-voter) speaks on the economic outlook. It's pretty quiet on Wednesday. On Thursday, we'll be hearing from both Chairman Bernanke and Secretary Paulson who will be testifying on financial market regulation before the House Financial Services Committee. On Friday, we'll get the May trade balance. The trade deficit is expected to widen to $62.5 billion in May from $60.9 billion in April. Import prices are also released and expected to rise 2.0% month-over-month in June after a 2.3% month-over-month increase in May. And, the University of Michigan consumer sentiment report is expected to drop again, from 56.4 in June to 55.5 in July.

Five phases to the current down-cycle

There have been five phases to this current down-cycle – the first four are still in full swing, but it is the fifth that will very likely emerge as the most difficult stage of this economic downturn and bear market:

- The first wave was the end of the housing cycle when starts peaked and began to roll over in the first quarter of 2006.
- The second wave was the end of the home price bubble when the Case-Shiller index began to deflate in the first quarter of 2007.
- The third wave was the end of the credit cycle when the interbank market froze in August 2007.
- The fourth wave was the employment cycle, which peaked when payrolls did in December 2007, prompting the Fed to reluctantly embark on an aggressive policy easing course.
- The fifth wave will be the end of the consumer cycle and the beginning of what may well prove to be the most significant recession since the mid-1970s, and while delayed by the tax rebates, this phase seems to have commenced in June when U of M consumer sentiment collapsed to its lowest level in 28 years.

Recession probably started in January

We are convinced that when all the revisions come in on the real GDP file, based on the 4 major determinants of the business cycle, which are (i) real personal income excluding government transfers; (ii) employment; (iii) industrial production; and (iv) real manufacturing and retail sales, that the NBER will date the recession as having started in January. We have not backed away from that call. The stock market and bond yields tend to peak six months before the recession begins, which is why making the call to begin with is important – to brace investors for the inevitable bear market in risky cyclical assets.

The ultimate indicator to see when the recession ends

But it is equally important to prepare clients for the timing of the recovery. And, we think we may have found the ultimate indicator – the date that the NBER announces when the recession started has actually taken place within a month of the same recession ending 75% of the time in the past. In fact, the median lag was exactly one month between the announcement of the recession and its termination. It's uncanny – just go back to the last two recessions: the NBER made the determination on November 26th, 2001 that the recession had officially started in March of that year; and the recession ended in November as the NBER was making the announcements (the NBER told us the recession had ended in November on July 17th, 2003 – nearly two years later!). Dial back to April 25th, 1991 – that was the date the NBER notified us that the recession had started in July/1990. And guess what? The recession had ended in March, 1991 – a month before the NBER told us we had recession.

Consumer sentiment tanked again in July

We don't have any "official" data just yet, but we did see the just-released RBC CASH consumer confidence measure come out for July and it printed 14.6 – down from 22.5 in June and 39.0 in May. Imagine what these numbers would look like if not for the tax rebates.

Service sector contracting

The ISM non-manufacturing index fell to 48.2 in June from 51.7, below consensus and the weakest print of the year. The ISM data are consistent with the slump in the private services sector jobs market. Total new orders dropped to 48.6 (lowest since January) while new export orders remained in expansion territory at 52.0 (though down from 54 in May) implying that domestic orders continue to contract. Cost pressures are an increasing issue for businesses. Prices paid shot up to 84.5 from 77.0 (highest in the 11-year history of the series). Not surprisingly, businesses are reacting by cutting jobs (the employment index dropped to 43.8 (lowest ever recorded) from 48.7, and the inventory change index was 53.0 (signaling that inventories are too high). The drop in the employment index is consistent with the surge in jobless claims to 404k reported today for the last week in June suggesting that the pace of job cuts will likely intensify through the summer as firms struggle to contain overall input costs. Only 8 of 18 industries grew in June, versus 13 of 18 industries in May – this outcome of 8 of 18 industries MATCHES the WEAK print in February. Also, 8 of 18 industries contracted in June, versus 4 of 18 industries in May.

ECRI leading indicator faltered again

The ECRI leading economic indicator faltered again, dipping 0.4% in the June 27th week. The annualized growth rate dropped to -6.3% – a 23-week low – from -6.0% the week before. Not too late to be defensive and bond-oriented as the pace of economic activity sags in the second half of the year.

Pricing power in the retail arena is non-existent

Indeed, there are commodity price pressures but what we have been stressing is that pricing power in the broad retail arena is non-existent – this is why there is such a huge gap between total and core inflation: there is hardly any pass-through seven years into this commodity bubble. HAVE A LOOK AT "IN A BRIGHT SIDE TO THE SLOWDOWN, SHOPPING BARGAINS ABOUND" ON PAGE C1 OF THE FRIDAY NYT. There is a huge move afoot to "unload summer gear" – half of the inventory at Ann Taylor "is on sale". Merchandise is "up to 50% off" at J. Crew, Banana Republic, Old Navy and the Body Shop. That's deflationary, folks.

Resistance among manufacturers to big price hikes

Not only that, but we are starting to see resistance among manufacturers to the big price hikes recently announced by primary producers: As we have often asked, is inflation something you charge, or something people are willing to pay? Have a look at page B1 of the WSJ ("Auto Makers Resist Steel Firms' Surcharges"). The opening two sentences say it all: "In an effort to curb the relentless rise in steel prices and bolster their own frail finances, some automakers are starting to push back on price increases, saying they won't pay surcharges on agreed-upon supply contracts. The resistance is one of the first strong signals to steelmakers that their hardest-hit customers have reached a tipping point and may not be able to withstand higher prices".

Retail community turning focus to back-to-school season

And we see that the retailing community is now quickly turning its focus to the back-to-school season – see page B1 of today's WSJ. A consensus is quickly building that sales will be flat to down from a year ago (ahh ... a year ago, when gas at the pumps was only $3 a gallon).

This is one oversaturated market

Part of the deflation story in retail (oh, this is only half of the CPI) is not related to depressed levels of consumer demand as much as oversupply – this is one oversaturated market: See "Vacancies Rise at Retail Centers" on page A3 of the WSJ for why that's the case. According to Reis, the nationwide retail vacancy rate rose to 6.3% in 2Q from 5.9% in the first quarter – the highest since early 2002. Not only that, but open-air retail areas like big-box centers and grocery-anchored strip malls saw average vacancy rates climb from 7.7% in 1Q to 8.2% in 2Q – a 13-year high. This is why the International Council of Shopping Centers is forecasting that 6,500 stores are destined the close this year – a number we last saw in the 2001 recession.

Inflation risks are down, not up

We realize that this is tough for the bond bears and policy hawks to believe, but inflation risks are actually pointed down – not up. The ECRI leading inflation index fell 1.4 points in June to 115.2 – the lowest it has been since January 2004.

Payrolls cut 62,000 in June

This was the sixth decline in a row totaling 438,000 – this has never happened in the past 50 years without the economy being in a recession. There were downward revisions of 52,000 to the back-data. So, we will take that as some vindication for our forecast of a -110,000- headline print. It would be one thing to fade the payroll data but with jobless claims now poking their nose above the 400,000 threshold, we would be more inclined to believe what the employment figures are telling us right now than these preliminary real GDP figures, which are destined to be revised down in the future (as was the case in 2001).

Wage disinflation story remains fully intact

So while the commodity inflation story is still flourishing, the wage disinflation story here in the United States remains fully intact. Average weekly earnings managed to turn in a tepid 0.3% gain after two months of flattish results. This has dragged the year-on-year trend down to a puny 2.8% from 3.4% at the turn of the year and 4.1% in June 2007. With the inflation rate expected to approach the 5% milestone in June, it means that in real terms, personal incomes (net of the tax rebates) are moving deeper into the deflation doldrums. Thursday's data were consistent with unit labor costs running around a 1.2% annual rate in the second quarter which is hardly a backdrop than can be characterized as stagflationary.

Signs of stress in the Household survey

Many other aspects of this report were troubling and we believe that the absence of the oil price surge would have the Fed thinking about another rate cut, not a hike. There is just a wealth of information beyond the nonfarm payroll report that is contained in the Household survey – which, by the way, showed a 155,000 job loss in June. Within that report, we like to look at key measures of labor market stress such as (i) full-time employment, which sank 447,000 – a significant 4.3% slide at an annual rate; (ii) job losers who are not on temporary layoff jumped 3.9%; (iii) the number of folks who were bold enough to leave their jobs voluntarily, a key measure of worker confidence dropped 4.3% (iv) multiple job holders rose 1.5%, and this metric has surged at a 20% annual rate over the three months to June as an increasing number of households are trying desperately to make ends meet as the budgetary strains from food, gas, utilities and debt-service costs intensify; (v) the median duration of unemployment, which rose to 10 weeks from 8.3 weeks and underscores the extent to which labor demand is contracting; and (vi), those working part-time for economic reasons shot up 183,000 or by 3.5% and has exploded at a 50% annual rate over the past six months – a clear sign of economic duress.

Chance of another weak employment report is high

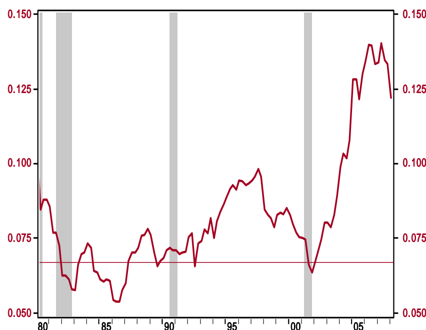
Looking ahead to the next nonfarm payroll report for July (to be released August 1st), the prospect of another very weak employment data-point is very high. When we see downward revisions to the back data, they tend to feed on themselves – very pro-cyclical, in other words. Not only that, but temp agency employment is an excellent leading indicator. After all, if the head-hunters are chopping heads, it stands to reason that the companies that hire these staffing firms are doing likewise. And, this segment of the payroll data plunged 30,000 in June and is down more than 80,000 in the past three months. And, finally, the jobless claims have validated the recession call, having broken above the 400,000 mark (to 404,000) in the June 28th week and if they stay here, then be braced for at least a -100,000 headline payroll print in the next go-around.

Prospects for a profit plunge are palpable

In the final analysis, only two things go into the forecast for the S&P 500 – earnings and the multiple that investors are willing to pay for that future earnings stream. While it is normal to see corporate profits decline 30% in a recession, what makes the current and prospective backdrop more sinister is that we headed into this recession with profit margins at sky-high levels. The ratio of pre-tax profits to nominal GDP has already started to recede from its nearby 55-year high of 14% as we headed into recession to 12.2% currently, but consider that recession troughs usually occur just south of 7% on this metric. If we overlay this with S&P 500 earnings per share, what we are then talking about is the strong possibility that profits end up being cut in half during this bear market – which would mean an ultimate low of around $45 on operating earnings (in other words, we are only one-third of the way through the earnings turndown at a time when the consensus seems to priced for the bottom being right about now!).

Chart 2: What if profit margins hit recession levels?

Corporate profits before tax as a share of GDP



Source: Bureau of Economic Analysis, Merrill Lynch

Now to put this into some sort of perspective, the 4-quarter trailing EPS in the 2001 recession hit a trough of around $38 and in 1991 the trough was jut over $18 so we are not talking about Armageddon here but rather offering up some analysis highlighting the what the risks are the outlook. We will bottom at levels much higher than the troughs in the past, that is the good news. The not-so-good news is that the level of the S&P 500 in the past that tended to coincide with $45 earnings was right around the 1,000 mark; and if we were slap on a typical trough multiple of 10x-12x on that earnings stream, then … well, you do the calculation. Either way, as economists judging the earnings landscape, it is extremely difficult for us to be calling for a bottom in this market outside of the intermediate oversold lows that are the domain of technical analysts and generally prove to be very temporary as we saw back in January and March of this year. One of the biggest fundamental hurdles to the market, we're afraid, is going to be the risk of continued negative earnings surprises, especially with the consensus predicting earnings growth of 13% the second quarter and 59% in the fourth.

The pain from $145 oil is starting to hit home

Have a look at these two articles in the Sunday NYT – "At $100 for Tank of Gas, Some Choke on 'Fill It'" on the front page; and see "Asleep At the Spigot" on the front page of the business section. From the lens of the economist, the move afoot to curb demand is going to cause a major reversal in crude prices in the not-to-distant future. It's all well and good that consumers in Asia have flocked to the drive-ins, but analysts would be well served to estimate the offset from an American public that is about to totally change the way they live and move around. With over 25 million vehicles possessing tanks of 24 gallons or larger, we have reached a point where a plurality of drivers are going to be spending more than $100 on a fill-up (that share is now above 10%) – and nearly 70% of the 21 million barrels of oil the USA consumes every year goes for transportation – and most of that is used for individual transportation. Remember that no country on earth uses as much oil as the United States. And people forget that after the oil shock of the early 1980s, the first fuel-economy standards (CAFE) that were introduced saw energy efficiency of a typical car improve to 27.5 miles to the gallon by 1989 from 13.8 in 1974; oil consumption contracted around 2% annually in per capita terms and against that backdrop, oil prices fell from well over $30/bbl in 1980 to $10/bbl less than two decades later.

All sorts of divergences linked to the oil price story

First, has anyone noticed that while the oil price has hit a new all-time high, that the oil stocks have not made a new peak since May 19th? Even though the price of WTI has soared over that time frame to over $145/bbl from $126.30, the S&P 500 energy index has declined 5.5%. So, the stock market doesn't seem to be a buyer of the view that crude prices are sustainable at these levels. Moreover, as the oil price has jumped almost $20 a barrel over the past six weeks, the S&P 500 consumer discretionary group, which ostensibly represents the part of the economy that uses most of that oil, has collapsed nearly 17%. And look at what the fixed-income market is telling you – while the 10-year note yield made this round trip to over 4% and then back down again, the real rate, which is a proxy for real growth, has plunged 25 basis points in recent weeks.

What is this telling us? That demand destruction is coming. Demand destruction is why emerging market equities have come off their bubble highs, why house prices came off their bubble highs, and why tech came off its bubble highs … and demand destruction will do the very same in the crude market in the future, at least in our opinion. Just consider that if the new CAFE standards had been adopted in 1990, the USA would very likely be consuming 3 million barrels less per day right now. It may take a bit of time, but this is where we are heading, so when we talk about 'peak oil' in the future, it may be in reference to US demand as opposed to global supply.

Rule #4 in Bob Farrell's Market Rules to Remember

No doubt timing is an issue, as we remind ourselves of Rule #4 in Bob Farrell's 10 Market Rules to Remember: "Exponential rapidly rising or falling markets usually go further than you think, but they do not correct by going sideways". Indeed, we are thinking of the going "further than you think" part of that thought process – especially when you read and re-read the article that dots page A6 of today's WSJ ("Oil's Rapid Rise Stirs Talk of $200 a Barrel This Year". It is imperative that US oil demand contracts over the next 10 years so long as emerging market oil demand continues to expand anywhere near the rate it has against the backdrop of a very constrained oil supply equation. The fact that there are no clear near-term alternatives to oil in transportation puts the onus of price

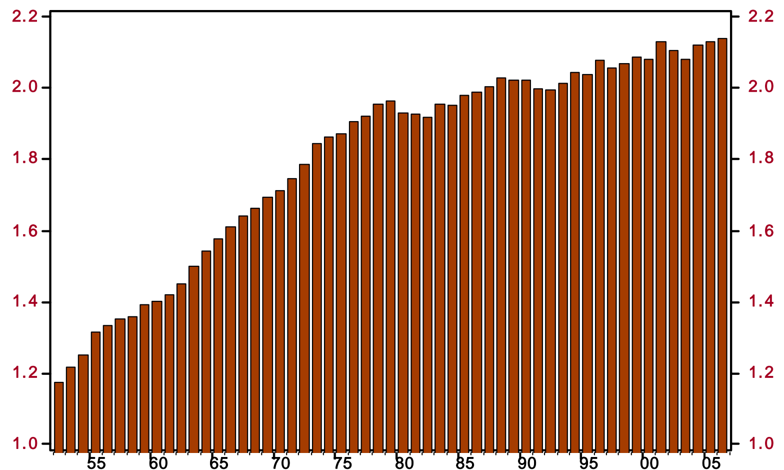
containment or reversal at the hands of demand destruction – which we are seeing now unfold here at home. In addition to that, we have to see EM currencies pegged to the dollar get revalued so as to curb excess monetary creation in those parts of the world, we have to see monetary policy in emerging markets tighten more aggressively, and it does seem as though Asian equity markets are bracing for a significant liquidity squeeze, and fuel subsidies have to fade in order to reduce EM oil demand at the moment.

Americans own too many cars

Thus, while demand destruction could start to kick in soon, a collapse in USD-denominated oil prices may require significant monetary policy tightening in EM (and possibly even in some OECD economies). Our core oil price view of an oil price decline by early 2009 is built around the idea that the world economy will be decelerating sufficiently. This process is already under way in the United States and will prove to be a long and arduous task as Americans scale down to a European-style one-car-per-family deal. Consider that there are now 40% more motor vehicles on the road than there are licensed drives. And also consider that on average, the American household owns 2.2 automobiles – Fido the dog probably owns that extra 0.2, but what is clear is that we collectively own way too many cars. Unfortunately, the automotive sector is still large enough that it represents about 20% of retail sales and 10% of manufacturing production and that doesn't include the ancillary or multiplier effects through the rest of the economy.

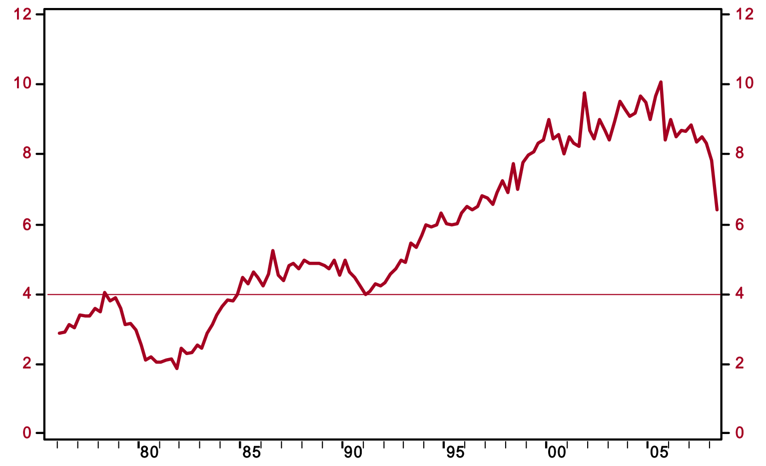
And when we consider the meaning of Bob Farrell's first Rule to Remember – that "Markets tend to return to the mean over time", and apply that to per capita auto/truck sales, we could be taking about 50 to 100 million units being taken off the road in coming years. We realize that sounds pretty radical, but look at what has already happened to the likes of GM – its US workforce has plunged 27% in just the past four years (taking Michigan's unemployment rate to 8.5% or 3 percentage points above the nationwide level) – and it is still churning out some 25,000 vehicles per day. What's the alternative with GM stock at a 54-year low and the company's bonds pricing in non-trivial odds of bankruptcy? Try adding some light rail to the portfolio.

Chart 3: The average American household owns more than two vehicles



Source: Haver Analytics, Merrill Lynch

Chart 4: '08 Suburban about to go the way of the '73 Lincoln



Source: Haver Analytics, Merrill Lynch

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