Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist
Thomas Demas, Managing Director

MACROCOSM

Something For Everyone

Monday, February 4, 2008

David Gitlitz

Recent data supports both optimism and pessimism, but we're still on the upbeat side.

Friday's report of a decline of 17,000 payroll jobs last month predictably fit the media script that it's a foregone conclusion that the economy is slipping into recession. Typically, the *Wall Street Journal* led the way, with the headline on its jobs story declaring "Jobs Data Add Fuel to Recession Fears," and the lead sentence pronouncing the data as "painting the clearest picture yet of a nation headed toward recession."

We are decidedly unpersuaded by the one-dimensional analysis positing that the initial estimate of payrolls for one month amounts to such a strong recession indicator. Most press reports on the jobs data were replete with references to the reported decline in payrolls being the first such negative month in four and a half years. But payrolls last August were first reported as being down by 4,000. That has since been revised to a healthy gain of 74,000. The weak-looking 18,000 job increase initially reported for December was also revised up to 82,000 in the latest report. So it's somewhat premature to take the loss of payroll jobs last month as given. Moreover, last month's reported payroll decline was more than entirely accounted for by a drop of 18,000 government jobs. Private sector payrolls last month were basically flat. That's nothing to celebrate, but neither is it an unmitigated calamity. In the early stages of the last recession in 2001, private payrolls were dropping at a rate of about 140,000 per month. It's also worth noting that the unemployment rate last month *dropped* from 5% to 4.9%, which hardly makes an open and shut case for recession.

Update to strategic view

US MACRO: The latest jobs report fit neatly into the widespread recession narrative, but it's a stretch to base any conclusion based on such a minor decline in jobs in the month's first estimate. Currently, the economic data offer plenty of support for those on either end of the optimism/pessimism continuum, but we remain firmly on the upbeat side. Recessions don't happen with the Fed as easy as it is, and with its open-ended pledge to "act in a timely manner as needed," it's only likely to get even easier. That's likely to set up a day of reckoning when the Fed is forced to respond to both higher than anticipated inflation and considerably faster growth.

[see Investment Strategy Dashboard]

That said, we're not taking a Pollyannaish view of current conditions either. We had anticipated that the rash of key data last week would, on balance, print better than expected (see "Don't Be Surprised If Data Surprises" January 28, 2008). But they turned out to be no better than a mixed bag. In addition to the jobs number, fourth quarter real GDP came in weaker than expected at growth of 0.6%. On the plus side, durable goods orders were strong, and we were particularly

http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com
tdemas@trendmacro.com

Offices:
Menlo Park CA
Parsippany NJ
Charlotte NC

Phone:
650 429 2112
973 335 5079
704 552 3625

encouraged by the 4%-plus rise in core capital goods orders. And the week was rounded out by a very positive jump in the ISM manufacturing index, from 48.4 to 50.7. According to ISM, that's a level of manufacturing activity consistent with 3% real GDP growth.

All in all, the data currently provide a something-for-everyone grab bag of hopeful and downbeat numbers, which is reasonable to expect in an economy enduring a soft patch brought on primarily by the onset of overwhelmingly negative sentiment with the subprime crisis late last summer (see "Fear Itself" November 16, 2007). One thing seems fairly sure at this point, however: the Fed is likely to continue to respond to the economic uncertainty and market skittishness with plenty of easy money. Futures markets are now fully priced for another 50 bp in cuts at the March FOMC meeting, and are showing a one-third chance for a 75 bp cut to 2.25%. Unless circumstances take a decidedly upbeat turn, these expectations are highly unlikely to be disappointed, and it's probably a good bet that the policy choice will come down on the high side of the range.

As noted on several occasions, we have considerable concern about the ultimate inflationary blowback of the Fed's head-long rush into easy-money mode (see, most recently, "Jump! How High? Cut! How Low?" January 31, 2008). But for now, restoration of its surplus liquidity posture is clearly showing results. Stresses in the interbank market which were the Fed's primary rationale for initiating this cycle of rate cuts have been relieved. At 3.14%, three-month LIBOR is posting a spread relative to fed funds that is back to the range seen prior to last summer's turmoil, and is actually tighter than spreads in previous years. One of the more worrisome aspects of the financial turbulence was the retreat from risk it spurred as seen in the spike of high yield spreads to levels above 700 basis points. But in the past two weeks, a period which began with the Fed's emergency 75 bp rate cut, followed by last week's 50 bp cut, the Merrill High Yield Index spread has narrowed from 748 bp to less than 700. With the Fed demonstrating its intent to do whatever it thinks necessary to keep the economy afloat, default risk is coming down. And with the cost of funds centered around the Fed's 3% target, spreads reached a point that was becoming undeniably appealing. These signs of a restoration of risk appetite are a factor pointing toward a more upbeat outlook.

We also have consistently stood against the conventional wisdom suggesting that the financial market upheaval was translating into constraints on credit availability, noting that the data continues to show healthy growth in business lending and credit creation more broadly. Friday's ISM survey offers another positive indicator in that regard. In a special question, respondents were asked whether the financial turmoil was having any effect on their ability to obtain financing. The response was 92.6% no, 7.4% yes. The widely reported credit crunch, it appears, remains largely undetectable to the business community.

As for inflation risk, we are guided primarily by market prices such as gold which, although it has retreated slightly from all-time highs in the past couple sessions, at above $900 continues to flash red with regard to the consequences of the Fed's policy posture. We also have taken note of recent movements in an indicator that the Fed itself is known to give some credence to: the spread between nominal Treasuries and CPI-indexed TIPS. In particular, since the emergency inter-meeting rate cut two weeks ago, the 5-year breakeven spread has widened by nearly 25 bp to 215 bp, and the Fed's favorite TIPS indicator, the 5-year forward 5-year breakeven, has moved to new highs at 268 bp. While the absolute levels of these spreads probably do not give the Fed much pause, their recent turn higher at least indicates that the bond market is beginning to catch on to the inflationary implications of this monetary setting.

BOTTOM LINE: The latest jobs report fit neatly into the gloom-and-doom recession narrative of the media and parts of the economic establishment, but it's a stretch to base any conclusion on such a minor decline in jobs in the month's first estimate. Currently, the economic data offer plenty of support for those on either end of the optimism/pessimism continuum, but we remain firmly on the upbeat side of things. Recessions just don't happen with the Fed as easy as it is already, and with its open-ended pledge to "act in a timely manner as needed," it's only likely to get even easier. Looking somewhat further out, that's likely to set up a day of reckoning when the Fed is forced to respond both to higher than anticipated inflation and considerably faster growth. But for now the primary significance is that it renders the deep pessimism that currently dominates the economic consensus considerably overdone.