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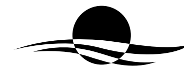

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1 – RECESSION THIS YEAR?

Gary Shilling has been forecasting a recession in the US this year, arguing that weakened consumer spending – the key to the economic outlook – will tip the economy back into a downturn. His analysis, available at www.bloomberg.com, is as follows.

The US economy is being fueled these days by strong consumer spending, which increased in February by 0.8%, its best showing in seven months, after rising 0.4% in January. Retail sales rose 1.1% in February – the fastest pace in five months – while same-store sales advanced 4.7%. But Shilling doesn't see this pace continuing. Personal-income growth continues to be weak – up just 0.2% in February – meaning this recent exuberant consumer spending is being fueled largely by increased debt and tapping of savings.

At the same time, pay per employee is rising slowly and continues to fall in real terms. So increased job growth remains the key to any increases in real household after-tax income, which declined in February for a second straight month and gained a mere 0.3%, compared with February 2011.

SPENDING, SAVING AND DEBT

The support that consumer spending has received from less saving and more debt appears temporary. Household debt – including mortgages, student loans, and auto and credit-card loans – has fallen relative to disposable personal income. In Shilling's analysis, this is largely because of write-offs of troubled mortgages. Nevertheless, revolving consumer credit, mostly on credit cards, is no longer being liquidated.

Non-revolving consumer credit continues to rise in response to growing sales of vehicles – most of which are financed – and in student loans, as the poor job market keeps students in school or sends them back. Tuition increases encourage more borrowing, while interest costs on past-due loans mount.

It would seem, then, that contrary to the belief that consumers are being forced to save more and reduce debt to rebuild net worth, they have been doing the opposite lately. But evidence of consumer retrenchment is emerging, writes Shilling: real personal consumption expenditure growth has been volatile in recent months and falling on a year-on-year basis. Voluntary departures from jobs are decreasing. And consumer spending will no doubt have a big slide if his forecast of another 20% drop in house prices is correct.

In other words, consumer spending is the only major source of strength in the US economy this year. State and local-government spending remains depressed because of deficit woes and underfunded pension plans. Housing suffers from excess inventories and may face a further drop in prices. Excess capacity restrains capital spending. Recent inventory building appears involuntary. So consumer retrenchment will tip the balance toward a moderate and overdue recession.

JOBS

Employment in the US has gained in recent months because businesses have, at least temporarily, run out of productivity enhancements that had allowed them to cover output gains with reduced staff. But according to Shilling, the sustainability

of this trend is questionable. The US has a lot of job openings, but having endured huge layoffs in recent years, employers are being very picky in new hiring. A big part of the problem is structural.

Employers may have jobs available for software engineers or skilled machinists, but unemployed residential-construction carpenters probably don't have the necessary skills to find work. Employment for college graduates is up 5.8% so far in the recovery but jobs held by high school dropouts, generally with low skills, are down 3.9%. And the skills of those out of work for extended periods, as is true of many people today, tend to erode. In February, 43% of the unemployed were jobless 27 weeks or more, and the average number of weeks a person was unemployed was 40.

Furthermore, homeowners whose mortgages exceed the value of their houses can't easily sell their property if they take jobs in distant locations. And if both spouses work, one may be unwilling to accept a job in a faraway city for fear that the other can't get a job there, too. In sum, more jobs are about the only spur to household incomes, and consumer spending is the only source of strength in the economy this year. Yet job creation remains weak.

WHY THEN DO INVESTORS CONTINUE TO HAVE AN APPETITE FOR EQUITIES?

Stocks have been volatile. Yet, despite concerns about the strength of the US economic recovery, the S&P 500 closed the first quarter above the 1,400-point mark for the first time in almost four years while the Dow Jones Industrial Average closed out its best first quarter since 1998 and the Nasdaq Composite Index topped the 3,000 level for the first time in more than 11 years.

It seems that, until recently, investors have been ignoring the big picture of the still-weak economic recovery and focusing instead on the Fed. That is partly what generated the robust first-quarter gains for stocks and other risky investments while Treasuries slumped. The sole focus, it appears, is on liquidity created by the Fed. If investors believe the central bank is about to dump more money into the system, stocks soar. If Bernanke hints that the liquidity tap is closed for now, stocks tank. This narrow focus suggests that investors aren't happy with the fundamental state of the economy.

Apple Inc. offers an example of this narrow focus and the willful suspension of disbelief concerning the uncertain outlook for the economy and corporate profits, writes Shilling. When the market capitalization of that one stock – about $585 billion – exceeds that of the entire retail sector – about $550 billion – is it conceivable that speculation may be afoot?

Is history about to repeat itself? Maybe, just maybe, reality is re-entering investors' field of vision. The payroll employment increase for March – 120,000, or about half the expected gain – was announced April 6, when most markets were closed for Good Friday. There was futures trading, and stock futures plummeted and Treasury bonds soared. And that pattern persisted in subsequent days with Treasuries and the dollar leaping while stocks and commodities nosedived. In a pattern that is very similar to early 2011, concludes Shilling, investor optimism may be entering an agonizing reappraisal.

2 – THE NATURAL FORCES OF RECOVERY

Whenever I need a dose of optimism, I turn to Scott Grannis, the Calafia Beach Pundit. Consider some of his recent blog posts (all thoroughly backed up with charts, graphs and data):

- Last week's increase in unemployment claims is not significant
- The budget deficit will slowly fade away as a

pressing problem due to increased tax revenue and stagnant spending

- The threat of higher gasoline prices is receding
- Bank lending continues to pick up, liquidity is plentiful
- Jobs growth didn't slow down in March
- Eurozone worries resurface, but are probably not significant
- Continued good news from the labor market
- Service sector follows moderate growth path
- Household financial burdens have collapsed
- Auto sales are still very strong
- With no shortage of liquidity, more QE (quantitative easing) is unnecessary
- No more QE is good news
- The recent slowdown in new orders for capital goods is not a reason to worry
- Stocks are still attractive
- Construction spending will gradually improve
- Manufacturing remains healthy
- Optimism is still in very short supply
- Corporate profits continue to impress
- Unemployment claims continue to decline
- Natural gas is becoming incredibly cheap
- Home prices decline but the future is looking bright

At the heart of Grannis' optimism is faith in the strength of the natural forces of recovery. Writes the blogger:

> Fiscal and monetary policy get all the attention these days when discussing the economy's recovery or lack thereof, but they are only a part of the recovery story.
>
> What has driven the recovery to date is the hundreds of millions of decisions made by businesses and workers as they struggle to adjust to a reality that was not what they expected.
>
> Businesses have cut staff in order to reduce costs. Some have relocated or shut down. Some have sold assets for a loss, thus allowing another business to redeploy those assets in a new, more profitable venture. Some have created new products; some have figured out how to make their products better or more cheaply. Some entrepreneurs have taken a risk and started a new business. Some have paid down debt, others have taken on new debt. Some have increased hiring. Some have discovered new ways of finding and producing natural gas while risking their fortunes in the process.
>
> Workers have relocated to find a new or better job elsewhere. Many have decided to work harder or longer hours. Many have tightened their belts and cut back on their expenses. Many have decided to start their own business, or to work part-time, or to accept a pay cut. Many have learned new skills, or taken a job in a different field.
>
> These are the things that make the economy bigger, stronger, more efficient, and more productive; that raise living standards, that create new jobs. Labor and capital need to make millions of adjustments in the wake of a recession, and in response to unexpected shocks. All that fiscal and monetary policy can do is to facilitate those decisions and those painful adjustments.
>
> Unfortunately, fiscal policy has not been helpful in this regard. Extending unemployment benefits only delays workers' decisions to work harder or learn a new job or accept a pay cut

or relocate. Transfer payments reward those who are not working while penalizing those who are; they do nothing to create new jobs. New regulations make it more difficult to start new businesses. The prospect of huge new tax burdens resulting from trillion-dollar deficits reduces the incentive for entrepreneurs to take new risks and start new companies and hire new workers. Increased government spending only saps the economy's limited resources. The uncertainty surrounding the expiration of the Bush tax cuts at the end of this year is a concern for businesses deciding what to do with their profits, and it is a concern for investors wondering whether they should take their profits now, and whether higher taxes will crush the market next year.

Monetary policy has also been a problem. With the Fed and many other central banks now navigating in the uncharted waters of massive quantitative easing, markets are consumed with uncertainty about the future value of currencies, and many investors have sought out gold and commodities for that reason. Zero interest rates have left retired people with a huge shortfall of income relative to what they had expected. A weak dollar has prompted many central banks to buy massive amounts of dollars in order to keep their currencies from appreciating against the dollar, and Treasuries are about the only dollar asset they can buy, and that in turn has contributed to depressing yields.

Lots of adjustments, and lots of problems remaining. But the net result of everything has been an economy that has been expanding, albeit slowly, for almost three years, while creating almost 4 million new jobs in the process. There's still a long ways to go before things return to normal, but we are making progress, thanks to the untold millions of difficult decisions made every day by hundreds of millions of managers, investors, workers, and consumers.

Growth is not made in Washington. Growth happens in the heartland, and it is mainly driven by people who are trying to put food on the table and create a better life for themselves and their families. This is the force that has given us a recovery, and I believe it is an enduring force; it is the unique and dynamic nature of the US economy that should never be underestimated.

3 – WHAT THE CDI IS TELLING US

No one really knows which direction the US economy will move, but you ***can*** know which way US private consumption expenditure will move, and ***private consumption expenditure is a key component of the economic outlook.***

How can you know which way US private consumption will move? The **US Consumer Demand Index** (available by subscription and/or at your Bloomberg Terminal) is the most accurate predictor of US private consumption available. Why? Because we do not measure consumers' "sentiment" or "confidence" but ***their actual spending plans as revealed to us in our monthly national surveys.***

Our February data told us "Consumers are holding back and do not confirm recent optimistic signals about the US economy." Our March data told us that "Consumers are still hesitant" (the purchasing indices for non-durables and durables were both lower than one year ago). ***Our April data and report will be released next week, and should tell us something significant.*** For subscription information, please go to www.consumerdemand.com.