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MACROCOSM

Soft Spot, Not Armageddon

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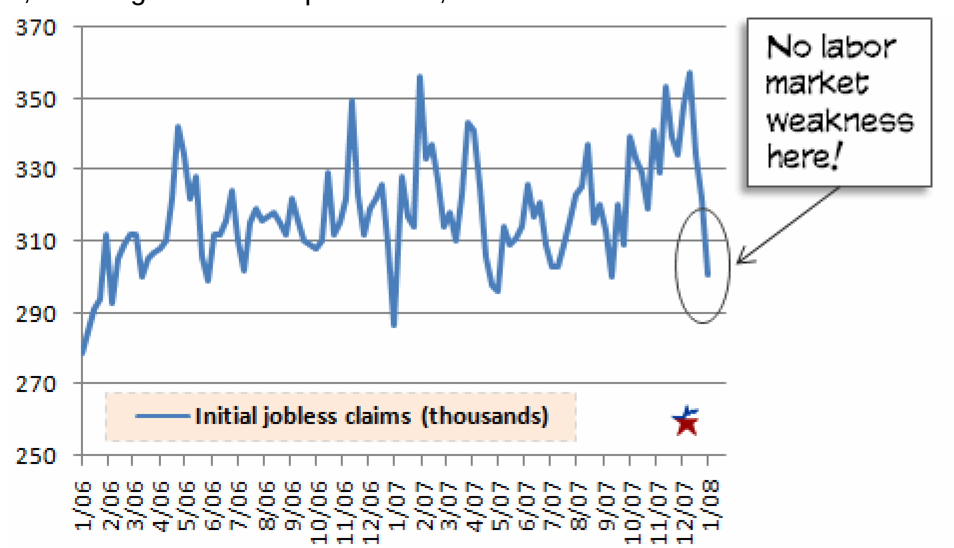
Look carefully at the numbers: the data just doesn't support the end-of-the-world thesis.

If the economy were really as weak as popularly believed, we'd expect to see palpable signals of retrenchment in the labor market, an unmistakable pull-back in business investment and consumption spending, and a clear consensus in the monetary policy community that a downturn was looming. The latest available information reinforces our confidence that none of those premises currently prevail, so while the economy is now going through a likely short-lived sentiment-driven soft spot of the kind we started expecting mid-November (see "Fear Itself" November 16, 2007), we continue to think the dominant sense of economic pessimism is considerably overdone.

Update to strategic view
US MACRO: The latest data belie much of the currently dominant doom-and-gloom mood about the economy. While the economy is currently working through a soft spot in large measure as a self-fulfilling response to overwhelmingly negative sentiment, the fundamentals remain robust. **US BONDS:** Treasuries are on a stupendous run, lifted by expectations of nothing but dark economic skies ahead, an infinitely easy Fed and no inflation. Thus they are priced to perfection, and unlikely to stay so for long.
[see Investment Strategy Dashboard]

Today's jobless claims data, showing another drop -- to 301,000 in the latest week-- offers persuasive evidence that the weak-looking labor market portrayed in the December jobs report was not indicative of an emergent trend. After hitting a recent high above 350,000 last month, claims have fallen back to levels consistent with job market strength, not weakness. It would come as no surprise if the January jobs report reverses much of the



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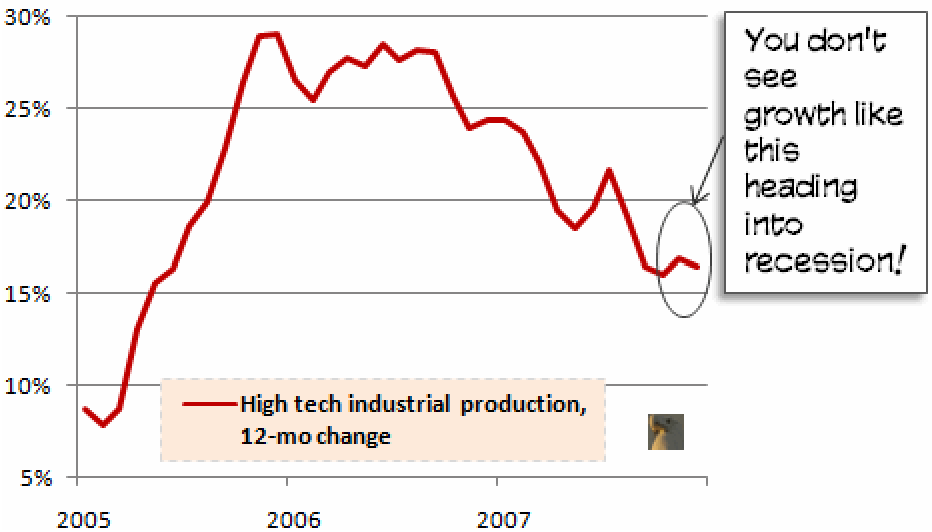
apparent sluggishness seen last month. It's worth noting that there have been other occasions during this expansion when jobless claims briefly rose to the ranges seen in December without foreshadowing any lasting downshift in a vibrant labor market. In the months preceding the last recession in 2001, by contrast, claims steadily ratcheted higher, from less than 300,000 in the fourth quarter of 2000 to nearly 400,000 by the end of first quarter of 2001.



Industrial production was expected to fall last month but instead was flat, according to yesterday's release. While a mediocre month for overall output, we were encouraged that business equipment showed significant strength for the second consecutive month, rising by 0.8%. High-tech production also grew by 0.8% and is up 16.5% on the year. That's not the kind of growth one usually associates with economies heading into recession.

The report this week of a 0.4% decline in retail sales in December occasioned another round of hand-wringing about the death of "the consumer," but it would be highly premature to begin reciting his funeral orations (see "Throwing the Baby Out with the Kitchen Sink" January 16, 2008). For one thing, there have been five other occasions in the last two years when monthly sales fell by at least 0.3%, none of which foretold an end to the expansion. Retail sales excluding autos, building materials and gasoline, so-called "core" sales which feed directly into GDP, were up 0.2% last month, and averaged 0.5% growth the past two months. All in all, real personal consumption spending for the fourth quarter will likely be clocked at an annualized growth rate of 2.5% to 3%, not the stuff of which recessions are made.

Perhaps the most intriguing new development came with yesterday's release of the Fed's Beige Book, as is customary two weeks in advance of an FOMC meeting. The compilation of anecdotal reports from the Fed's 12 reserve bank districts said growth "increased modestly" through the end of December, but displayed considerably less urgency about the economy than has been conveyed recently by Fed chairman Ben Bernanke. The survey found that manufacturing activity "varied," but that demand in nonfinancial services industries was "robust." As for jobs, the Beige Book said, "Reports suggest that labor markets remained relatively tight overall, and especially for skilled workers." This is the latest indication that there may be less consensus within the Fed on the outlook, and appropriate policy response, than is apparent in its policy announcements. The reserve bank presidents have networks of business contacts in their regions and generally keep their ears closer to the ground than do the board members in Washington.

The latest Beige Book offers a glimpse of the outside-the-Beltway perspective that may be informing a contrast in views between a number of presidents and the board. For example, it was disclosed last week that in advance of the December 11 FOMC meeting, two presidents -- Thomas Hoenig of Kansas City and Richard Fisher of Dallas -- argued against a cut in the discount rate because their concerns about the economy were "offset by continued inflation pressures." They also said growth was no worse than they expected. Changes in the discount rate come at the request of the regional presidents. Similarly, Philadelphia Fed president Charles Plosser gave a speech just days before Bernanke's ultra-dovish rendering last week with a very different take on things. "I am concerned that developments on the inflation front will make the Fed's policy decisions more difficult in 2008," he said. "I see more worrisome signs of underlying price pressures. Although I am expecting slow economic growth for several quarters, we should not rely on slow growth to reduce inflation. Indeed, the 1970s should be a sufficient reminder that slow growth and falling inflation do not necessarily go hand in hand." At this point, the reservations of the reserve banks about the current policy course are being kept at low volume, most likely in the interest of presenting an apparently unified front to the world. But should the Fed remain in easing mode, and the economy not markedly worsen from here, a split could become more public and pronounced.

BOTTOM LINE: The latest data belie much of the currently dominant doom-and-gloom mood about the economy. While the economy is currently working through a soft spot in large measure as a self-fulfilling response to overwhelmingly negative sentiment, the fundamentals remain robust. At some point, that probably will become clear even to super-doves like Ben Bernanke. By that time significantly more inflation damage will probably be done, unless he can be persuaded to make a quick course shift by some of the more hawkish reserve bank presidents. One way or another, though, the bond market's current stupendous run on expectations of nothing but dark economic skies ahead, an infinitely easy Fed and no inflation is not likely to end happily.