Building a Solid Base

Despite high unemployment and concerns about 2013, economic players continue to set the stage for a stable, long-term expansion.

by Steven R. Cunningham, PhD, Director of Research and Education

Hurricane Sandy disrupted the entire eastern seaboard, causing massive destruction in New York and New Jersey and impacting 24 states. In the U.S., over 100 people were killed, and property damage is estimated at over $60 billion. It was the largest Atlantic hurricane on record. The losses of income to individuals and revenue to businesses were huge. Bank of America Merrill Lynch analysts estimate that airlines alone lost about $500 million in revenue, as nearly 20,000 flights were canceled. Railroads and subways closed. An estimated 8 million homes lost power. As many as 250,000 cars were destroyed. Tens of thousands of businesses were washed away; hundreds of thousands more were unable to operate for weeks.

Given this, the observed downtick in some economic measures for October and November seems reasonable, and likely does not reflect a change in the trend for this recovery.

A closer look at the underlying economy reflects real strength. Despite some problems, this economy is functioning normally. All the players are doing exactly what they are supposed to do—a refreshing change from the financial crisis of just a few years ago. Just beneath the surface, improvements are evident. The economy continues to build a strong, stable base for long-term expansion and prosperity.

The Federal Reserve continues to ensure that the financial sector remains strong and that credit conditions are conducive to recovery. On Dec. 12, the Fed announced that it will maintain short-term rates in the 0-0.25 percent range until unemployment reaches 6.5 percent, as long as inflation stays under 2.5 percent.

For all the talk about the fiscal cliff, consumers seem unconcerned. They have the will and the means to buy goods. Although the University of Michigan’s Preliminary Consumer Sentiment Index fell to 74.5 percent in the latest month from 82.7 the month before, that is still in expansionary territory.

Consumers have reason to feel good about the economy. Jobs are coming back. The U.S. added 146,000 jobs last month, despite the devastation of Hurricane Sandy. The unemployment rate has fallen to 7.7 percent. House prices are rising, and with them household wealth. More consumers have the potential to borrow against home equity.
True, income growth is sluggish. After accounting for taxes and inflation, incomes fell at a compounded annual rate of 1.4 percent in October. This was probably influenced by the storm, but month-to-month declines are fairly common. To make sense of the data, we need to look at trends. Incomes are still up 1.2 percent from a year ago, and up 1.4 percent for 2012. In October, real disposable personal income was $12.3 trillion, only 0.4 percent off its all-time high.

Slow growth has left consumer prices fairly stable, and import prices fell 0.9 percent from October. Oil costs led with a decline of 3.6 percent, but non-fuel prices also fell. Despite sluggish income growth, paychecks are going further. This gives households buying power for something besides fuel oil and gasoline.

Another underlying trend that bodes well for the economy is consumer lending. Consumers have brought their debt loads and loan payments down to the lowest levels in years, and interest rates are at rock bottom. Households are becoming more willing to borrow. They have rebuilt a foundation to support expanding consumer demand as incomes rise and unemployment continues to fall.

Nevertheless, dragged down by Sandy, consumer spending is 0.3 percent off the September high. But it still is up 1.3 percent year to year. Black Friday sales were good, and the outlook for holiday sales is optimistic. Durable goods purchases are up 3.6 percent year to year, slowing from the 7 percent September rate. People are probably less inclined to buy refrigerators when their houses have been washed away.

Sales of cars and light trucks are up 15 percent compared with a year ago. The seasonally adjusted annualized sales rate was 15.5 million—the highest rate since January 2008, just before the Great Recession got into full swing. Pent-up demand is the main force behind the auto industry’s strong performance, advancing sales despite the slowdown caused by Sandy. Quality used car inventories are thin, and consumers need to replace vehicles that are, on average, 11 years old.

Across the board, business is showing growth, with growth in manufacturing at the lead. According to the Institute for Supply Management (ISM), manufacturing purchasing managers expect revenue to increase 4.6 percent in 2013, an improvement over 2012’s expected 4 percent rate.

These estimates carry a lot of weight. Purchasing managers’ jobs depend on forecasting sales in order to purchase inventories to support production requirements in businesses.

Non-manufacturers are also anticipating sales growth in 2013. They are expecting 4.3 percent in-
crease over 2012’s 3.4 percent rate, according to the ISM. Given this picture, it is tempting to criticize businesses for not hiring. Actually they are doing what they are supposed to do. They are reacting to business risks by building strong balance sheets, improving productivity with capital purchases, and slowly and strategically hiring.

Preparing for potential dangers, businesses are holding record amounts of cash and have invested in labor-saving, productivity-enhancing capital. They are able to produce more with fewer workers, and as a result have achieved record profits. This means that U.S. firms are more competitive than ever and have built solid financial foundations. Like households, firms are now better poised for future growth.

This intrinsic strength is captured by our proprietary indicators. For a fourth straight month, AIER’s Primary Leading Indicators are holding at 73, strongly supporting an outlook for further growth over the near term. (Any value over 50 suggests expansion.) This is confirmed by 100 percent of our Roughly Coincident Indicators rising. The score for our Primary Lagging Indicators also stands at 100 percent expanding. Absent surprises, the recovery will continue.

Given the real challenges the economy faces, many forecasters have seen only the downside risk of returning to recession. A closer look suggests that things are not quite so scary.

Sure, unemployment has remained stubbornly high, affecting incomes and consumer spending. Fiscal deficits have put upward pressure on interest rates. Both have led to potentially inflationary actions by the Federal Reserve, the Dec. 12 announcement about maintaining short-term interest rates among them.

Congress and the White House also have finally begun to talk about coping with the deficits. Negotiations between the White House and the leadership of the House of Representatives and Senate are proceeding.

The fallback program involves higher taxes—the expiration of the Bush era tax rates—combined with automatic across-the-board spending cuts. Estimates are that falling off this “fiscal cliff” could take as much as 4 percent off the GDP growth rate, easily pushing us back into recession.

But this or more modest proposals for taming the budget deficit may not be as devastating as some think. According to ISM, only 9.1 percent of manufacturers and 7.6 percent of non-manufacturers are concerned about taxes in 2013. While taxes may not directly be an issue, higher taxes and spending cuts could weaken demand, a worry for 37.4 percent of manufacturers.

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Demand may be more driven by consumer confidence and expectations than by the tax environment. No amount of income is going to induce consumers to spend if they are afraid of the future. A credible deficit-reduction program might create confidence and stabilize demand.

A half-empty glass is also half-full.

Government regulation is a concern for 30.5 percent of manufacturers, according to the ISM. This is probably related to Obamacare, which kicks in next year, and other government demands on businesses. More generally, though, it appears that big businesses are more concerned with stability and knowing the regulatory environment in which they will be operating.

Small businesses are more vulnerable. Their finances are a bit more precarious and more sensitive to risks. Therefore, it is not surprising that fears have carried small business optimism back into recession territory. According to the National Federation of Independent Business (NFIB) index, small business optimism fell 5.6 points to 87.5 (scaled so that 1986=100).

According to NFIB chief economist Bill Dunkelberg, “Nearly half of [business] owners are now certain that things will be worse next year than they are now.” The NFIB found that the election, not Hurricane Sandy, was the primary reason for the loss of confidence. This is consistent with the ISM survey result that businesses are very concerned about the regulatory environment under the returning administration.
This is not to say that businesses aren’t also looking at potential tax changes. Some likely tax changes are already making a difference. A significant number of small businesses are selling out or closing down to take advantage of the current capital gains tax rates. Rates are expected to rise substantially under any budget deal next year. Likewise, investors are selling profit positions in stocks and other securities to take profits now. Some of the profits will be reinvested, but some of it will find its way into increased consumer expenditure.

Some people worry that problems in Europe will spill over into the U.S. and derail the recovery. This seems unlikely. At a recent conference, AIER spoke with several people doing research on the euro-zone, including businesspeople, institutional investors, and policy makers. They told us that only Americans have any concern about the potential break-up of the European Union or the abandonment of the euro. The European Union will survive and sovereign debt problems there will be addressed. The political commitment is there to make this work. The only question is how.

There is an old saying, that “markets climb a wall of worry.” Problems abound, but that is usually the case. A closer look at every current concern reveals underlying strength and economic players that are considering every opportunity and every risk, and are making responsible choices.

Season’s greetings from all of us here at AIER

For 80 years, AIER’s proprietary statistical indicators have been helping our economists spot turning points in business-cycle conditions before they happen. To read more about the slow but steady pace of the current economic recovery, visit our website at: aier.org

Primary Lagging Indicators

Average Duration of Unemployment (2) (weeks, inverted)

Ratio of Consumer Debt to Personal Income (1) (percent)

Manufacturing and Trade Inventories (1) (constant dollars, billions)

% Chg. from a Year Earlier in Mfg. Labor Cost per Unit of Output (2)

Commercial and Industrial Loans (1) (constant dollars, billions)

Composite of Short-Term Interest Rates (1) (percent)
AIER Annual Appeal

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