

Forecasts and Trends

By Gary D. Halbert

On May 31, the Commerce Department revised its estimate of First Quarter Gross Domestic Product from +1.3% (annual rate) in its initial report to only **+0.6%**. This was below pre-report estimates. The weaker than expected GDP report, according to the government, was primarily due to sagging business investment in inventories, the continued slump in the housing market, a decrease in federal spending and weaker exports (larger trade deficit) in the First Quarter.

The weaker than expected First Quarter GDP number surprised many analysts. It was the weakest quarterly growth rate in more than four years, and significantly below the 2.5% pace in the Fourth Quarter of last year. Many mainstream analysts are now legitimately pondering whether or not the latest surprising GDP report means we are headed for a mild recession later this year. The gloom-and-doom crowd, of course, is euphoric and would have us now believe that we're not only headed for a recession but a depression. What else is new?

Digging into the Commerce Department's latest GDP report, we find that the much larger than expected trade deficit in the First Quarter shaved a full 1% off of the final GDP number. The higher than expected drop in inventories cut another full 1% off of the number. The continued housing slump reduced the GDP number even more.

The question now is, will there be more negative surprises in the near future? Could we in fact be headed into at least a mild recession in the second half of this year? To answer that (or at least attempt to), let's quickly run through the latest economic data.

More Positives Than Negatives in the Second Quarter

First, let me state the obvious: the First Quarter is now many months in the past. We need to focus on more recent economic data that has been released in the last few weeks. Those data suggest that the economy is rebounding in some key areas in this Second Quarter. Let's start with those numbers.

Housing Market

While the reports above are very encouraging, I would be remiss not to include the latest reports on the housing market. The latest data available are those for April, which show a mixed picture. New home sales in April increased briskly, while sales of existing homes fell modestly. Housing starts actually rose modestly in April over March levels, but building permits fell slightly in April. The median sales price for existing homes fell 1.8% in the First Quarter to \$212,300.

While the latest housing numbers are slightly negative, and there remains a sizable glut of unsold homes on the market, the latest data are a far cry from the horror stories we were hearing late last year. Yes, home prices are down somewhat in most parts of the country, but there has been no collapse in home prices as many predicted. And may I remind you that the "sub-prime" mortgage dilemma has not resulted in a major financial crisis as so many predicted just a few months ago. We rarely hear about this supposed crisis any more, as I have predicted over the last couple of months.

Manufacturing

Manufacturing is definitely picking up as businesses are finally beginning to rebuild inventories. The ISM manufacturing index improved for the third consecutive month to 55 in May from 54.7 in April. The closely watched Chicago Purchasing Managers Index jumped to 61.7 in May from 52.9 in April. Factory orders rose 0.3% in April (latest data available) following a revised 4.1% jump in March. Durable goods orders climbed 0.6% in April following a 5.0% jump in March. Industrial production rose a healthy 0.7% in April. So, the manufacturing sector is getting in high gear to rebuild inventories.

Consumers Still Buying

What about on the consumer side that accounts for approximately 70% of GDP? A good indicator is the ISM Non-manufacturing Index, which is commonly referred to as the “Services Index.” This index hit 59.7 in May, up from 56 in April and the best since April 2006. The Consumer Confidence Index surprised again in May, hitting 108.0, up from 106.3 in April. Personal spending increased 0.5% in April according to the Commerce Department, following a rise of 0.4% in March.

Unemployment

The US unemployment rate remained at 4.5% again in May. A whopping 157,000+ new jobs were created in May, well above expectations. As I will discuss below, the labor market remains very tight, and wages are on the rise – not only in the US but also around the world. This is a good thing and not indicative of an economy that is headed for a recession, provided inflation doesn’t heat up.

Where the US Economy Goes From Here

While most of the above economic reports are encouraging, let me emphasize that the US economy is still not out of the woods. The Index of Leading Economic Indicators (LEI), which I follow very closely, was down 0.5% in April. For the year, the LEI was +0.1% in January, -0.5% in February, +0.1% in March and -0.5% in April. Overall, this is a negative reading and is indicative of an economy that is still in a slowdown.

While the US economy is starting to mount a comeback, the most likely scenario is that we will see another couple of quarters of slow growth, especially in light of the weaker than expected First Quarter GDP report and the latest LEI report. But barring any significant negative surprises, we should not fall into a recession this year or next year. Rather, we should start to see more encouraging signs on the economy over the summer and heading into the fall. I suspect that the disappointing First Quarter GDP number will have been the low point. That does not mean there won’t be the occasional negative report as we move forward – certainly there will be. But with manufacturing already on the clear upswing, with consumer spending remaining strong, and with the housing slump not becoming a disaster, I continue to believe that the US not only avoids a recession, but sees a modest economic rebound next year.

The Bank Credit Analyst agrees. Here are excerpts from BCA’s latest June issue:

“The trend in the labor market remains the key issue for consumer spending – far more important than what happens with gas prices, housing or the stock market. As

long as people have jobs, their incomes will rise and spending will be supported [meaning the economy will continue to grow]...

While U.S. growth seems likely to be stuck at a below-trend pace for another couple of quarters, most other regions are barely pausing for breath [ie – booming]... Strong global growth will provide a boost to U.S. exports, providing some offset to weak domestic demand.

How long can this perfect environment of sustained growth and low inflation go on? The forces keeping inflation down are structural, and we do not anticipate a change anytime soon... In sum, we expect that the favorable investment climate will persist at least until the end of this year. The environment clearly favors stocks over bonds.”

Clearly, BCA does not believe the US economy is headed for a recession. While the US is likely to remain in a “soft-spot” economically for another couple of quarters, there is no reason to believe we are headed into a recession later this year, barring some major unexpected negative surprises.

BCA continues to believe that the US equity markets are in a bull market that has further to run. That should sound very familiar to regular readers with my own advice over the past several years. But I should caution readers that BCA also believes that the US equity markets have become overheated on the upside this year, and that a downward correction is overdue. **We may be seeing that downward correction unfold as this is written.**

Gary D. Halbert is the president and chairman of Profutures, Inc. Subscription rates for Forecasts & Trends is \$197 for 12 issues and may be obtained by visiting his website at www.profutures.com.