

The Economy in Slowdown Mode

by Gary D. Halbert

The US economy continues to slow down, but there are no signs that we are headed for a recession. The current modest slowdown is being led, predictably, by the slumping housing market and high energy prices, which in turn are also negatively affecting consumer confidence. None of this should come as a surprise to readers of my weekly E-Letter.

The Commerce Department reported that Gross Domestic Product rose at an annual rate of 2.9% in the second quarter, up slightly from its previous estimate of 2.5%, but still far below the first quarter pace of 5.6%. In the same report, the government also announced that consumer spending - which accounts for over two-thirds of GDP - rose at an annual rate of only 2.6% in the second quarter versus 4.8% in the first quarter.

The government's Consumer Confidence Index plunged 7.4 points in July (latest data available) to the lowest level in over a year. Not surprisingly, orders for durable goods fell 2.4% in July as consumers continued to cut back on big-ticket items. The University of Michigan's Consumer Sentiment Index fell to 78.7 in August, the lowest level since just after Hurricane Katrina, over a year ago.

As noted above, the slump in the housing market is dominating the economic front. New home sales fell another 4.3% in July and are down a full 21.6% from the same period one year ago. Sales of existing homes dropped another 4.1% in July. Despite the continued drop in home sales, the average sale price of existing homes managed to record a minor gain of 1.17% to \$232,000 in the second quarter on the national level; however, it was the smallest quarterly increase in home prices in over 30 years. On a regional basis, existing home prices are actually falling in some areas.

The most troubling aspect of the housing slump is the sharp increase in the inventory of unsold homes. According to the National Association of Realtors, the inventory of unsold homes (new and used) soared to a record **3.86 million** units in July. That is an increase of 40% in the last 12 months and represents a 7.3-month supply of unsold homes on the market, the largest since 1993.

As with every housing slump, there is a big debate regarding whether we are in the early to middle stages of a full-blown "bust" or whether the recent retrenchment is merely the inevitable "correction" following the housing boom of the last decade. No doubt, there are strong arguments on both sides of this debate.

While it is certainly possible that either scenario could play out, I tend to believe what we are seeing, and will continue to see, is more along the lines of a correction rather than a bust. The last two major housing slumps were in 1978-1982 and 1988-1992. In both of those periods, we had a recession which exacerbated the housing slump. That is not the case today, as we will discuss at more length below.

While I do tend to believe the housing slump is more of a correction than a bust, it is clear that we are not close to the end of this downward cycle, and some regions of the country will fare considerably worse than others. As noted above, the overhang of unsold houses is the largest in over a decade, and it will almost certainly get at least somewhat worse before it gets better. But provided we avoid a recession, I don't see a major bust in the housing market.

No Signs of a Recession Yet

While growth in GDP slowed dramatically in the second quarter to 2.9% - that is still a solidly positive number which certainly does not suggest a recession. Job growth in the US remains quite strong with the unemployment rate falling to 4.7% in August. The ISM manufacturing index, while down fractionally in August, is still solidly above 50 (54.5 actually), and any reading above 50 is an indication that the economy is expanding.

The Index of Leading Economic Indicators (LEI) fell only fractionally (-0.1%) in June and July, which while negative does not suggest a recession. For all of 2006 (Jan - Jul), the LEI is down only 0.7%. The LEI is consistent with an economy that is slowing down as I have suggested for several months, rather than one headed into a recession.

All this can change, of course, especially if consumers continue to put the brakes on spending. The government reported that personal consumption expenditures rose at an annual rate of only 2.6% in the second quarter versus 4.8% in the first quarter, again consistent with a slowdown in the economy. Yet in June and July, retail sales increased 1.7% and 1.8% respectively according to the Commerce Department, another good indication we're not headed for a recession.

BCA Believes the Fed is Done

In their September issue, the editors at **The Bank Credit Analyst** make it clear they believe the Fed is finished raising rates. The Fed's Open Market Committee voted to leave interest rates unchanged after two years and 17 consecutive rate hikes. In its statement that accompanied the announcement, the Fed predictably left the door open for more rate increases in the future depending on the inflation data.

The Fed also made it clear in an earlier statement that it feels core inflation is still too high. The latest GDP report pegged core inflation (minus food and energy) at 2.8% in the second quarter, well above the Fed's target. Based on the Labor Department's Consumer Price Index, core inflation rose 2.7% for the 12 months ended July, also above the Fed's target. But in its August 8th statement, the Fed suggested that it expects inflation to cool down with the slowdown in the economy. Thus, they left rates unchanged.

As usual, there is a great debate regarding whether the Fed will hike rates again or if they will elect to stand pat once again. The consensus among most market analysts seems to be that there will be one or two more rate hikes before the Fed is done. That is probably true, if inflation continues to rise.

BCA, on the other hand, believes the Fed is done raising short-term interest rates. The editors at BCA believe the Fed is very concerned about the slumping housing market and the general slowdown in the economy, and that Bernanke & Company will not risk making matters worse. So BCA predicts no further rate hikes from the Fed this year - unless, of course, inflation surprises on the upside.

BCA also predicts the Fed will begin to cut rates early next year and will likely do so on several occasions. This forecast is based primarily on BCA's view that the economy will continue to be in a slowdown for the next two to three quarters, and that inflation will come down. In this scenario, BCA believes the Fed will soon be more preoccupied with the slowing economy and avoiding a recession than fighting inflation.

A Challenging Environment for Investors

The prospect for a continued slowdown in the economy for at least another couple of quarters does not present the most optimistic of backdrops for the investment markets.

While a few equity indexes have recently moved to new highs, the Dow, S&P 500 and Nasdaq are still below their record highs and remain in broad trading range.

At the same time, volatility remains extremely high in the stock markets. For example, from May 1st through August 31st, the S&P 500 had 19 days when the Index had a daily gain or loss of 1% or more, with two of these being moves in excess of 2% in a single day. These big moves were almost evenly split, with 10 positive days and 9 negative days.

This is a reminder that high volatility cuts both ways - up and down - especially recently, and this pattern could well continue for the foreseeable future. In the near-term, for example, if it becomes clear that the broad market is not going to follow-through to new highs, we could see a significant correction on the downside.

If the outlook I've outlined above continues to be generally on target, the major investment markets are likely to remain very volatile for some time to come. While a recession does not appear to be the most likely scenario, keep in mind that things can change. The Fed could throw us another curve or two, thus hurting the economy. The energy markets could surge again. The threat of more terrorism is still out there. Surprises happen.

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