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ECONOMIC NEWS UPDATE

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Big Mo' vs Strong Headwinds

Headwinds vs. momentum. That just about summarizes what is going on in the US economy. Some weather watchers say the headwinds are close to gale force. The uproar in the subprime mortgage market has the rating agencies becoming more picky; lenders are taking a longer look at borrowers before handing over money; and even the red-hot private equity deal makers are paying a bit more for the loans that finance their takeovers. That's a headache they definitely don't need while lobbying to fend off congressional attempts to raise taxes on a large portion of their earnings.

Oil and gasoline prices remain at levels that are pinching consumers' pocketbooks, and driving up the costs of doing business. Inflation is tame (up only 1.9% from last year) if you look at the "core" prices, excluding food and energy, as Federal Reserve Board chairman Ben Bernanke continued to do last week in a speech that economists at Goldman Sachs characterized as "very academic". But members of the Fed

apparently neither eat nor drive, according to consumers who find that inflation in food and energy prices is hurting them.

Then there is the housing market, with foreclosures rising (up 87% from last year's level), and prices falling. Consumers notice when gasoline prices rise because they have to fill their tanks every week, and they notice when house prices fall because they have less to boast about at dinner parties. Those prices continue to fall under the pressure of rising unsold inventories. The spring selling season proved a damp squib: potential buyers are holding back in anticipation of still lower prices, and higher mortgage rates are making home ownership more expensive. You don't have to be a statistician to know all of this: just look at the proliferating "for sale" signs in your neighborhoods or those you pass through en route to work or the mall.

High gasoline prices, falling house prices, the rising cost of food, and a generally unsettled mood resulting

from continued problems in Iraq -- those are the headwinds, and they are blowing with enough force to have stalled the economy earlier in the year. But the economy seems to have absorbed their force, allowing its momentum to reassert itself. Some 132,000 new jobs were created last month, including 12,000 in the construction sector as the commercial property market continues to flourish. In the past year, 1.75 million workers have been added to the nation's payrolls. The unemployment rate, at 4.5%, remains close to a six-year low.

The service sector showed strength in June for the third successive month. And the manufacturing sector, which was very soft in the first quarter, is growing at its fastest rate in over a year. Most important: new orders are showing real strength, and the weaker dollar has exports booming.

Which may explain the general optimism among economic forecasters. On average, the sixty economists surveyed by the Wall Street Journal expect the economy to grow at rates of 2.5% and 2.8% in the third and fourth quarters, respectively, and 2.9% in 2008. The 51 forecasters surveyed by Blue Chip Economic Indicators are making a similar guess, forecasting that the economy will grow at a rate of 2.8% in the final two quarters of the year. With even the ten gloomiest of this crowd expecting growth to come to a not-unhealthy 2%, analysts no longer expect the Fed to cut rates soon, despite the slump in housing. As we have been saying in this space, Bernanke and most of his colleagues are worrying more about the danger of renewed inflationary expectations than about an impending recession.

With just about every American who wants to work having a job, many businesses are finding that they have to increase pay in order to bid workers away from other firms, or to induce those not in the active work force to come off the sofa and take a job. They are also finding that it gets harder and harder to offset rising pay by increasing productivity, so unit labor costs will soon head up.

That will add pressure on businesses to raise prices. Restaurants, for example, have been hit not only with rising wage bills, but with soaring food costs, in part because misguided energy policy has diverted acreage from food production to fuel production, as benighted politicians seek to grow our way out of dependence on foreign oil, rather than drill, dig, build and tax our way out. So restaurants are raising their prices – and getting away with it. Consumers now find it costs more to fill their tanks for the drive to their favorite eatery, where prices on the menu are well above last year's level.

Equally worrying to the Fed is that signs of pressure on capacity are mounting in several important sectors. Boeing has announced that capacity to produce its new 787 Dreamliner is booked solid until 2014 (677 are on order, and there may be a new emphasis on passenger amenities: JAL's 35 planes will be outfitted with bidets), refining capacity is stretched so far that it is unlikely that gasoline prices will drop even if crude oil prices recede from current levels – an unlikely occurrence since there is insufficient excess production capacity to provide a comfortable cushion against supply interruptions in trouble-spots such as Nigeria and Venezuela.

In the past, American consumers could count on the world markets to provide workers and production capacity to supplement that in the US. That is no longer certain. Tighter border controls seem to be reducing the flow of cheap labor from Mexico, and more vigorous enforcement has employers somewhat more reluctant to risk jail by hiring low-paid illegal immigrants. Labor costs are rising in places such as India, reducing the cost-saving possibilities of outsourcing. The recovery of the world's major economies is sopping up overseas production capacity.

In sum, house prices are down, but share prices are up. The prices of some things consumers buy are up, but so are incomes. The credit market has its problems, but the ratings of only a small portion of the bonds backed by subprime mortgages has been downgraded. And defaults on junk bonds are at a historic low.

It looks as if momentum, at least so far, is overcoming the headwinds.



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