Current Economic Conditions

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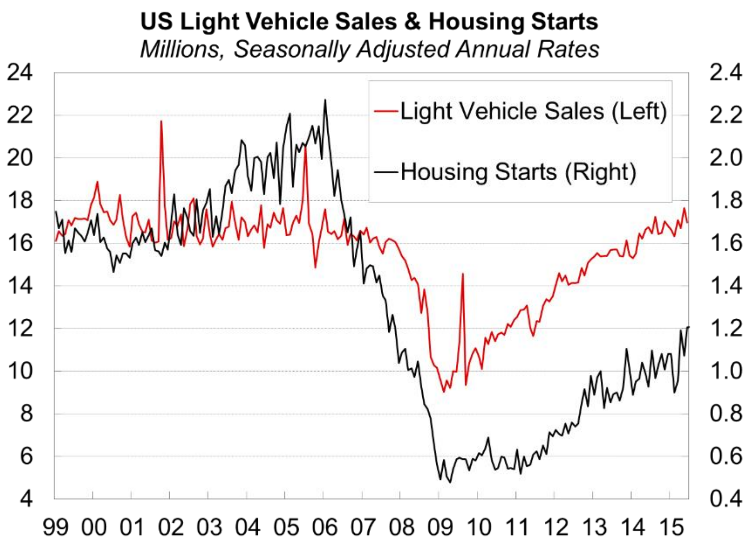
U.S. ECONOMY BREAKING OUT OF SLUMP; STOCKS GOING THE OTHER WAY

The U.S. economy is off to a good start in the third quarter, continuing an acceleration that began in the spring. Industrial production in U.S. manufacturing, which was essentially flat from November to June, jumped 0.8% in July. A rise in the Institute of Supply Management's New Orders Index for manufacturing to 56.5 – the highest since December – suggests growth will continue. The non-manufacturing Business Activity Index – the ISM index with the best correlation with GDP growth – surged to 64.9, its highest level since 2004. Retail sales and payroll employment both posted solid gains. Motor vehicle sales exceeded a 16.9 million annual rate for the fourth time in five months, and the three-month moving average rose to its highest level since 2005. Housing starts rose to their highest level since October 2007, with a big jump in single-family starts offsetting a decline in multi-family starts. Real Gross Domestic Product rose at a 0.6% annual rate in the first quarter, held down by bad weather, the West Coast dockworkers' strike, and a big decline in oil and gas drilling. Second-quarter growth was originally reported at a 2.3% rate, but recent data suggest growth will be revised up to more than 3%. July data suggest growth will remain above 3% in the third quarter.

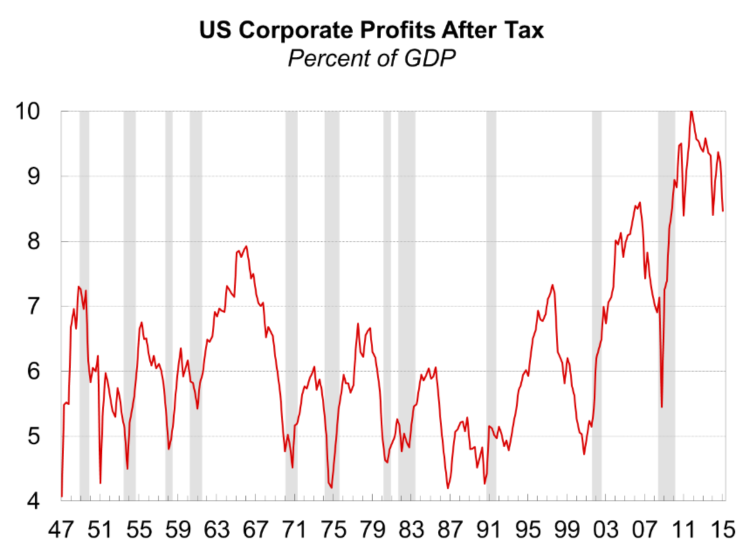


The timing of the recent acceleration reflects the normal lag from oil prices to economic activity. Although lower prices for oil and petroleum products leave more money for consumers to spend on other goods and services, spending doesn't increase much until consumers are convinced that prices will stay down. Until recently, it seemed that consumers were spending their savings from lower gasoline prices solely on gasoline and food consumed at bars and restaurants. In late 2014 and early 2015, the meager boost to consumer spending wasn't big enough to offset the decline in drilling activity, and growth slowed. But with oil prices resuming their decline and falling to new cyclical lows, consumers have become convinced that prices will remain lower for longer and have boosted their purchases of houses, motor vehicles, and other goods and services. Historically, the lag from oil prices to economic activity, i.e., the lag that maximizes the correlation between economic growth and changes in oil prices, has been 12-15 months. Oil prices turned down in June 2014. The recent pickup in growth is right on schedule.

The apparent acceleration in the U.S. economy has yet to be reflected in other economies or in commodity prices and financial markets. Outside of Central Europe, notably Poland, Hungary, and the Czech Republic, there is little evidence of strong growth anywhere in the world. Industrial production in manufacturing has been rising slowly in Western Europe and has been relatively flat in Japan and Korea. It has fallen sharply in Thailand, the Philippines, and, most notably, Brazil. China's "official" measure of industrial production was up 6.0% year-over-year in July, but data on individual industrial products suggest that actual growth is close to zero. Recent data show big year-over-year declines in the iron and steel industry (iron ore output down 8.0%), building materials (cement down 4.7%), capital goods (machine-cutting tools down 10.7%), and high-tech electronics (mobile phones down 5.8%, computers down 11.7%). Perhaps more notably, motor vehicle production was down 11.7% year-over-year in July, and power generation was down 6.5%. If you really believe that Chinese growth is in the 6-7% range shown by official data for real GDP and industrial production, I have a bridge in Shanghai to sell you.

Accelerating growth in the United States has failed to halt the decline in the prices of oil and other commodities. Even though oil demand is picking up, prices have fallen to new cyclical lows as production has continued to rise despite the drop in drilling activity. While some attribute the decline in oil prices to weak economic growth, especially in China, the decline in oil prices is primarily a supply story. Weakness in China plays a more important role in the decline in the prices of copper and iron ore. China affects commodity prices not only through current demand, but also through inventory behavior. Much of the upward pressure on commodity prices over the last decade – including the big rise in oil prices in advance of the 2008 Beijing Olympics – has been due to Chinese accumulation of "strategic" inventories. As growth has slowed, inventory building has stopped or even reversed, removing an important source of upward price pressure. Inventory management is hard to get right even in a free-market economy where decisions are based on prices and other market signals; it's even harder in a centrally-planned economy where bureaucrats decide what to accumulate.

Accelerating growth has also failed to bolster U.S. stock prices. In fact, the recent improvement in economic data has coincided with a 11% decline in the S&P500 stock price index since July 20. For a number of reasons, corporate profits are likely to underperform U.S. economic growth this year. Obviously, lower oil prices are slicing oil industry profits. Less obviously, lower oil prices hurt chemical-industry profits because they reduce raw material costs for overseas competitors, which use oil as their primary feedstock. For U.S. companies, which use natural gas liquids as their primary feedstock, this means lower prices and squeezed margins. The slowdown in China and weakness elsewhere in the world also hold down the profits of multinational companies, many of which have grown too dependent on China for growth. The impact of slower growth abroad has been compounded by the strong U.S. dollar, which reduces the dollar value of foreign-currency earnings. The recent devaluation of the Chinese yuan – an implicit admission that growth has slowed more than official data indicate – could make matters worse by leading to another round of competitive devaluations. More fundamentally, corporate profit margins are simply unsustainable. The ratio of corporate profits to nominal GDP – the macro-economic analog of profit margins and once the most mean-reverting series in economics – has risen to record levels in this century. At these levels, profits are likely to grow less rapidly than GDP, which suggests that profits of most companies will grow less rapidly than revenues. The resulting squeeze on profit margins will hold down stock prices even as the economy improves.



Looking forward, the big decline in oil prices will continue to boost growth in the United States and other oil-importing developed countries, with most of the benefit accruing to housing and related industries, motor vehicles, and travel and hospitality. However, the strong dollar and weak growth abroad, particularly in China, are suppressing pricing power and earnings growth for export-dependent manufacturers and farmers. Fears of slower earnings growth, more than fear of a quarter-point hike in the federal funds rate, are pushing down stock prices, but remember, U.S. real GDP grew at a 4.0% annual rate in the eight quarters including and following the 28% stock price decline in October 1987.