

The Buffalo regional economy continued to expand in July. The seasonally adjusted PMI of WNY increased by 1.6 points to 54.6. The rise was primarily driven by a 5.6 point rise in the index of new orders. The 1.6 point increase in the region's PMI followed a 3.4 point decline in the preceding month. We also see a small decrease in the seasonally adjusted employment index (-0.3).

The regional manufacturing continued to expand in July, and even posted a slightly higher level of activity relative to June. But it is worth noting that this recovery in the index started from a lower base, as the index pulled back in May and June. In July, the three-month moving average has declined to its lowest level since April. All of this suggests that the regional manufacturing sector's expansion continues to level off after reaching its highest growth in April – May.

Perhaps the most optimistic and important characteristic of the July survey is the jump in new orders. We observed a significant rebound in new orders as 50% of survey participants indicated higher new orders. It is also interesting to note that an almost equal number (42.9%) of participants indicated lower levels of new orders. The new orders indicator in our survey tends to contradict the national measure, which posted a more than 5 point decline in July. It is also interesting to note that the three-month moving average in new orders slightly retreated in July.

The production index also posted a small rebound in July, but failed to return to the May level. The number of responders indicating higher levels of production fell slightly in July: from 46.7% in June to 42.9 in July.

The employment index continued to decline for the third consecutive month. Commodity price index dropped to its lowest level since June of 2009. The strong dollar and the uncertainty in the Euro Zone helped push down the commodity prices in June – July.

Looking forward the outlook remains the same. The regional economy is expected to continue to expand throughout the second half of 2010, but at a decreasing rate. A return to negative growth in 2010 in the regional or national economies is highly unlikely, but the rate of growth is likely to continue to slow down.

Last week some of the uncertainty about the macro economic picture was redefined when the GDP numbers were released. The GDP statistics painted a somewhat uncertain picture in terms of growth and employment, but did reinforce the notion that a pull back into a recession is unlikely in 2010.

There was one positive development in the GDP statistics released last week, the Structural Non-residential investment returned to positive growth. This component is correlated with employment growth, and its return to positive levels suggests that job creation is here. However, given the low level of growth and the weak starting base due to the meltdown in this investment component during the course of the recession we can conclude that the job growth will continue to lag the sufficient strength to meaningfully

reduce the unemployment rate. The US economy needs to create 100-150 thousand jobs a month just to keep up with the growing labor force. Any level less than that will continue to contribute to the discouraged worker phenomenon and cause the labor force participation rate to decline. Although, the unemployment rate is a lagging indicator, at such high levels its ability to feed back into the GDP determination should not be underestimated.

However, the GDP also contained some negative factors. One was the 0.59% contribution to growth due to residential investment. We saw continued residential investment growth early in the quarter due to the homebuyer tax incentives. This growth is not expected to be present in the second half of the year. Without the residential component, the GDP growth would have been only 1.8%. It is also interesting to note that out of the 2.4% GDP growth, 1.05% was caused by the ongoing inventory buildup. In fact, the business inventory rebuilding has been one of the primary engines of growth so far in this GDP recovery. This engine cannot operate indefinitely. Another interesting point to note is the direct government contribution to the GDP growth. In the second quarter it constituted 0.88%. The government accounted for more than a third of all growth directly. This, together with the residential investment growth suggests that 1.47% of all growth in the second quarter was clearly government induced. Without this support the growth would have been only about 0.9%. The cost of this government driven growth is the enormous budget deficit.

On a somewhat positive note we can also see the impact of the strong USD in the second quarter. The dollar appreciation caused a jump in US imports. The imports growth caused the GDP to pull back by 4%. The total effect of net exports on the GDP was a 2.78% reduction in growth. The reason this can be viewed as a somewhat positive factor is because it is not expected to last into the second half of the year. As the USD pulls back a little, the net exports effect will decline.

The macro economic picture exhibits signs of a slowdown in growth. Growth will likely remain between 1.5 – 2% in the second half of the year. This will still be an economic expansion, but it may lag the strength needed to create any meaningful dent in the unemployment rate. It is also becoming increasingly likely that the Bush tax structure will get extended for two more years. But if it does take place, such a temporary extension will not produce any meaningful results on the economy. The FED will continue with its monetary support, but it will be interesting to see if these steps will cause inflation where the policy makers need it (housing and asset prices) as opposed to where it is much more likely to appear (commodity prices).

Our regional economy will continue to expand in line with the national economy in 2010. The jobless recovery has indeed ended and a small positive private sector job growth has returned. This growth will likely be insufficient to cause the unemployment rate to fall significantly, exposing us to the pressure from the consumer.

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