

June 2010: Expansion on Track

The regional economy continued to expand in June, but at a decreasing rate. As expected, the economic growth is slowing. The seasonally adjusted regional PMI declined to 53 points from 56.4 in May. The pullback was widespread as Production, Inventories, Deliveries, and Employment indicators all retreated. June marked the tenth month of the current expansion, since August of 2009 and the seventh consecutive month of the index remaining above the 50 point level.

The region's manufacturing production continued to expand but at a decreasing rate. Our production index edged down from 62.9 to 61.3. 20% of all survey responders indicated lower production levels, slightly up from 18.8% in the previous month. 46.7% of responders reported higher production levels, slightly down from the 50% level seen in May. The production remains strong with nearly half of the responders reporting higher levels, but the leveling off is also clearly being observed.

The New Orders index slightly advanced in June (48, up from 47.6 in May). However, the survey results indicate that fewer businesses report higher new order activity. In June 33.3% of the survey responders indicated higher new order levels, down from the 43.8% reading we got in May. We also observed an equal decline among the responders indicating lower levels of activity. This helped keep the index about unchanged in June.

The Inventories index declined by nearly 7 points. This decline helped increase the forecasting index in June. However, the number of responders indicating lower levels of inventories was roughly unchanged at 40% of the survey responders (37.4% in May).

Perhaps the most alarming was the pullback in the employment index. The index declined by 4.5 points to 53.6. Only 20% of survey responders indicated increased employment levels, down from 37.4% in May.

The regional indicators suggest that the region's economy and the region's manufacturing sector continued to expand in June, but at a slightly decreasing rate. The macro economic conditions worsened further in June and added additional uncertainty going forward. The uncertainty about the sustainability of economic expansion not only in the US, but across the planet once again helped boost the demand for the US Treasuries and hence for the USD. This, coupled with the inability of the price of oil to return into the 80 dollar range helped keep the Canadian dollar below parity. Although this was fully anticipated, it is not a particularly good development for our regional economy with its dependency on Canadian consumers.

Going forward I continue to believe that a double dip this year is highly unlikely. Economic indicators suggest that the US and the regional economy (seen in our indicators), remain well entrenched in the expansionary part of the cycle. However, a return to recession in 2011 and its continuation into 2012 is highly likely. The macro picture is worsening. The economic growth is clearly slowing down. Employment growth is simply missing. We need at least 100-150 thousand additional jobs a month just to

keep with the growing population, and with the current unemployment level, that growth should be over 300 thousand a month to see stabilization in unemployment. Instead, we see virtually no private sector job growth. The business confidence level, the one that truly matters for job creation, seems to be very low. The uncertainty about the future is just too high to warrant any meaningful expansion at this point. Government stimulus packages seem to have added more to the national debt than to the economic expansion. Our national debt is starting to approach the GDP level. All of this suggests that tax increases are inevitable in the near future. Ultimately, the printing press solution to the national debt issue may be a foregone conclusion, but its postponement will lead to tax increases in the meantime.

All of this is starting to seriously affect the future outlook. The unemployment rate is too high to be sustainable over a prolonged period of time without seeing serious consumer spending pullbacks. The discouraged worker phenomenon is on the rise. Just in May the Labor Force Participation rate in the US declined by 0.2% to 65%. This mark is higher than the first quarter average of 64.8%, but is 0.8% higher than in May of 2009 (source: BLS). From the historical perspective, we are in the lowest range of labor force participation rate in recent US history. The participation rate was never at 65% after the recessions of 1990-91 and 2001. The monetary and fiscal policies have already been extensively implemented. It is difficult to think of an interest rate below 0%, although the FED did come up with that in the form of interest paid to banks on their reserve deposits.

Fiscal stimulus packages appear to confuse the markets. Just as the cash for clunkers program that caused a jump in demand just to be followed by a pullback in demand after the end of the program, the first time homebuyer credit did the same thing in the period after April. These programs seem to be shifting the demand instead of stimulating new demand, and yet the cost of these programs is real. Next year in the first and second quarters the government revenues will suffer the consequences of this program. The monetary program also appears to have confused at least some markets. The volatility in the commodity prices was one of the consequences of increased liquidity.

Nearly every state and local government is in budgetary crisis. The rise in local and state taxes has already began. This, coupled with cuts in spending is a classical example of fiscal contraction.

In this environment would you be willing to expand and bet on a strong and continued recovery? Or would you rather recall the old saying: "In recessions, cash is king." It seems to me that most business owners and CEOs go with the old and proven wisdom. This is the real threat to recovery in the US. The government policies are not just about stimulating the economy, they are about embedding confidence and trust into the future, and that is where the current fiscal policy may not be sending the right messages to the markets. This lack of business confidence will keep job growth from accelerating to meaningful levels.

The confusion of the markets can be seen in the strange signals the stock market, the Treasury Yield curve and the price of my favorite, gold show. The flattening of the yield

curve clearly shows that the bond market expectations of inflation are very low. In fact, the bond market appears to expect a depression. Then why would gold soar so high? Gold is becoming increasingly not merely a hedge against inflation but rather a hedge against a collapse. In this case, the gold and bond signals start to coincide. But if that is the case, the message is alarming. The stock market on the other hand seems to ignore the negative factors and remains near 10K level (DOW Industrials Index).

For our regional economy the uncertainty surrounding the global economy and the run for safety out of the Euro and into the US dollar and subsequently into the Treasuries has one more unpleasant consequence. Slowing down economic growth will keep the CAD from appreciation. Fortunately we expected the Canadian dollar to remain below parity in the summer, a point argued in the previous reports. At this point, it is worth reiterating that the likelihood of CAD appreciating against the USD is very low, which suggests that we will have a limited boost to our regional economy from the Canadian shoppers.

Again, I expect the expansion to continue in 2010 but at a gradually decreasing rate. 2011 will be more challenging when negative growth is likely to return and a flip/flop growth behavior is likely. 2012 at this point does not seem to be an improvement either, making this a prolonged low positive to negative growth environment with a high sustained unemployment rate. But while we are in 2010, we can still continue to enjoy this expansion.

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This uncertainty and the lack of upward movement in oil and other industrial commodities helped keep the Canadian dollar from appreciating.