



INVESTMENT UPDATE

The US economy has taken a decided turn for the worse over the past couple of months, as is obvious from a recent spate of weak economic figures. The weakest of all were the April figures for the US labor market, which showed an unemployment rate rising back above 9% and only about 50,000 net new jobs created in the month. After losing approximately eight million jobs during the recent recession, adding only 50,000 is not going to make much of a difference.

Amid the winding down of the Fed's second quantitative easing program, which exchanged 600 billion newly-minted dollar bills for Treasury bonds and notes, investors can be forgiven for feeling a bit wary about the prospects for US economic growth. Treasury prices have jumped and yields have fallen, in some cases to levels as low as they were in 2008, as the marginal investor is choosing safety over risk.

In recent speeches, members of the Fed's Open Market Committee have admitted to "disappointing" growth figures, but point out that it's only a "soft patch" brought about by three main factors: higher prices on food and (especially) gasoline this Spring, supply disruptions of manufactured goods from the Japanese tsunami and nuclear power crisis, and tornados and flooding here in the US. These factors are temporary, we're assured, and "economic growth will pick up enough in the second half of 2011 to sustain a moderate economic recovery," according to NY Fed President William Dudley.

That has been the hope for nearly three years—namely, that the special programs put in place by the Fed, the Treasury, and other US policymakers following the financial meltdown in 2008 would shore up the global financial system and the US economy until the point where "organic" growth could take over. Now that the last of these financial training wheels is being removed, there is considerable concern that we might not be able to keep this thing upright as we pedal forward.

One of our favorite economists, Torsten Slok of Deutsche Bank, has written about how the US economy, to switch metaphors, is

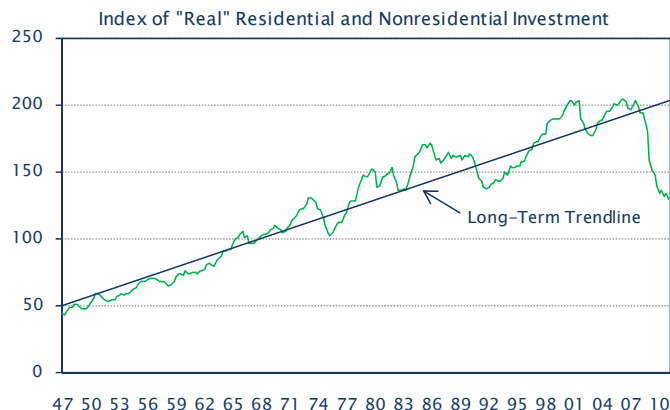
currently supported by only two of its four legs. Over the past few decades, investment in the US has been pretty equally divided among four major components: residential investment, non-residential structures, consumer durables and business equipment/software. Unfortunately, right now, there is precious little investment in either residential real estate or in non-residential structures. New housing starts, which had been running at a rate of over two million per year before the crash, are now at an annual rate barely above 500,000, down by more than 75% from the peak reached in 2006. New housing starts have fallen to their lowest level since this data series began more than 50 years ago.

The chart on this page shows just how little investment is going into residential and non-residential structures. This data, from the Bureau of Economic Analysis, shows that the upward

trend of real, inflation-adjusted, investment in private and commercial structures, a trend that's been in place since the end of World War II, has turned down dramatically and is now more than 35% below where long-term trends would predict. The reason is simple: too many new homes and commercial buildings were constructed during the boom, leaving a glut of supply to-

day (an estimated 10 million vacant homes, 1.5 million more than is considered "normal"). What's more, the number of "household formations"—created by young people entering the work force as well as immigrants and other new candidates for home ownership—is even lower than the new homes being built. According to the US Census Bureau, in a healthy economy household formations should be in the neighborhood of 1.25 million per year; as the top chart on the next page shows, it's been averaging around 400,000 since 2009 (again, the lowest levels in five decades). As a result, the housing market is still not in "equilibrium," with an estimated two years' worth of excess inventory, according to Moody's Analytics.

With new spending on structures, both commercial and residential, running at decades-low levels, it falls on the other two components of US discretionary spending to pick up the slack.



But this is economically impossible; the sheer size of the deficit of investment in new structures cannot easily be replaced by either private or public sources (not even the federal government!). But what makes the deficit even more challenging to fill in the current environment is that at least one of these other "legs" of investment, durable goods, is dominated by auto sales, which are highly sensitive to energy prices. As the bottom chart on this page shows, the motor vehicles and parts segment of industrial production is on-course to show its biggest drop in recent history, with a month-over-month decrease of 30% expected in May. Clearly, higher gasoline prices kept car buyers away in droves over the past couple of months while supply disruptions from Japan made it impossible for some buyers to get the cars they wanted. This has been an unwelcome and highly significant factor in the recent slowdown. Purchases of durable goods by consumers, including new cars and trucks, had been a major contributor to the recovery over the past few quarters, and we need a pickup in this category in order to have a meaningful resumption of economic growth.

The fourth leg is capital expenditures, ex-structures, made by businesses, and here we do have some positives to report. Investment in computers, software, communications and medical equipment has been a solid area of growth since the depths of the recession. Capital expenditures by businesses have been running at a 15% to 25% growth rate over the past couple of years, and are expected (in the absence of a severe economic shock) to grow at the low end of this range over the next few quarters. Profits and cash flow in corporate America are healthy, and healthy companies are able to reinvest in the equipment they need to remain competitive.

There's every reason to believe that the so-called soft patch will prove to be temporary. Clearly, the tsunami in Japan was a unique event, and had a devastating impact on their manufacturing and transportation base. Factories supplying parts for

cars and trucks, both for the Japanese domestic markets and abroad, were shut down for weeks. Toyota claims that domestic production is now back to 90% of normal levels and expects to be at 100% within three months. Likewise, energy prices spiked in the wake of the Mid-East political turmoil, with benchmark crude oil prices nearing \$114 per barrel, but have pulled back to their year-end 2010 level of \$95. The turnaround of these two factors alone will provide a big shot in the arm to the durable goods sector, as auto sales are poised to regain the momentum they lost in the Spring.

And there may be more good news. Home prices have fallen enough in certain areas of the country that it's immediately cash-flow positive to buy a house and rent it out. Vacancy rates

on rental property are declining, and with people losing their homes to foreclosure, there's likely to be continued demand for housing for investment/rental purposes. That will help absorb the excess supply. Meanwhile, recent studies indicate that a big contributor to the historically weak level of household formations is due to young adults moving back in with their parents. Even a modest strengthening of the US labor markets would have a positive impact on this demographic, and would unleash pent-up demand for primary residences, especially rental property. Eventually, the excess supply of homes will get absorbed, and with many homebuilders having cut their operations to the bone since the housing crash, construction spending will be coming off a

very low base and will provide a strong contribution to economic growth.

Of course, full recovery in the US housing market is nowhere on the immediate horizon; the resulting weak investment in the building sector makes the US economy vulnerable to external shocks. And with the conversation in Washington turning towards fiscal restraint, we can't expect help from any new stimulus programs. The soft patch may have passed, but we're still dealing with our long-term problems. This economy will continue to struggle to walk on its own two feet.

