



Lombard Street Research

www.lombardstreetresearch.com

Daily Note: 1 February 2008

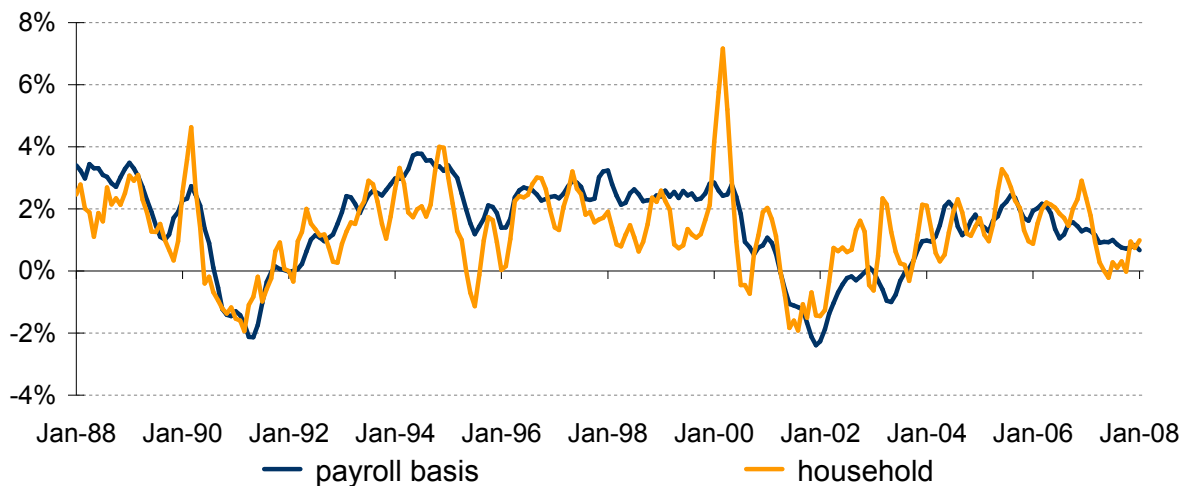
US data still point to low +ve. growth

WE SUGGEST: Balance of risks tilting against Treasuries

SUMMARY: The jobs data are consistent with real GDP growth of 0-1%, as were the construction spending numbers and the U-Mich consumer confidence. The risk of resilient inflation looks larger than that of slumping output.

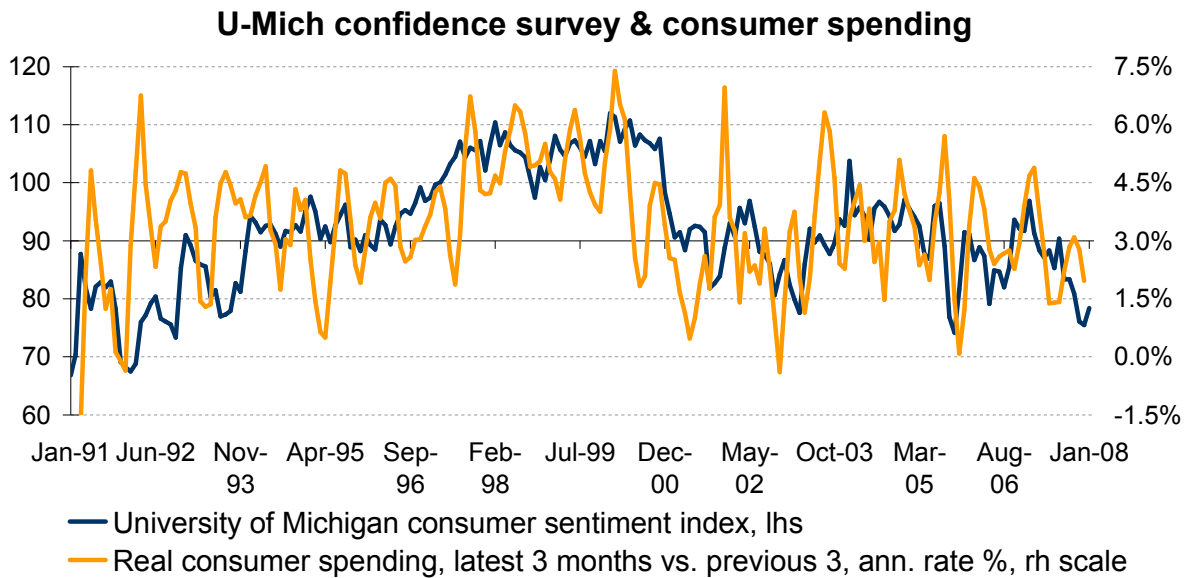
The market may pretend to be worried about the economy, but it is really worried about the market. This remains primarily a financial market crisis so far, though a US economic hard landing is highly likely. Expectations of recession are ahead of reasonable forecasts, requiring a collapse of consumer confidence. With house prices falling at 7% this could well happen, but has not yet. Fed policy is even ahead of expectations of recession. With inflation risks worsening as China booms and the yuan appreciates, the yield curve needs to steepen. 10-year Treasuries in the 3.5-3.6% yield range may be ahead of themselves.

US employment measures, 3-mth/3-mth % change, a.r.



The jobs data jump around from month to month, and from indicator to indicator (payroll versus household measures being different). But the 3-month/3-month chart above gives a fairly clear pattern of major slowing, short of recession. Job growth fluctuates around its long-run average less than GDP (productivity growth absorbing more than half the variance) so the current rate of $\frac{3}{4}$ -1% corresponds to GDP growth at about the same rate, at least in the 0-1% region, above zero. Today's construction spending numbers saw the end of the splurge of business construction that has mightily contributed to GDP growth during 2007. This means that as the housing slump becomes less acute during 2008 business cap-ex will probably fall instead, while a consumer recession seems likely. But this recession

of private spending will be offset by much of the pain being siphoned off abroad in lower imports, some growth in export volume (helped by the weak dollar), and in election-year government spending. Also the Q4 GDP numbers included a small inventory liquidation, so much of the pain of the stock cycle may already be in the numbers.



The University of Michigan's consumer confidence survey is certainly still at a weak point, but not yet even pointing to a consumer recession, let alone one for total GDP. There are plenty of reasons why real consumer spending could do worse in 2008 than the 1% growth implied by the latest U-Mich reading. But the budget stimulation due soon is a factor on the other side.

Resilient inflation, with the current rate at 3½-4%, looks a bigger risk than recession right now. Prolonged stagflation is the worst prognosis for financial markets.

Charles Dumas

charles.dumas@lombardstreetresearch.com