



Daily Note: 5 February 2008

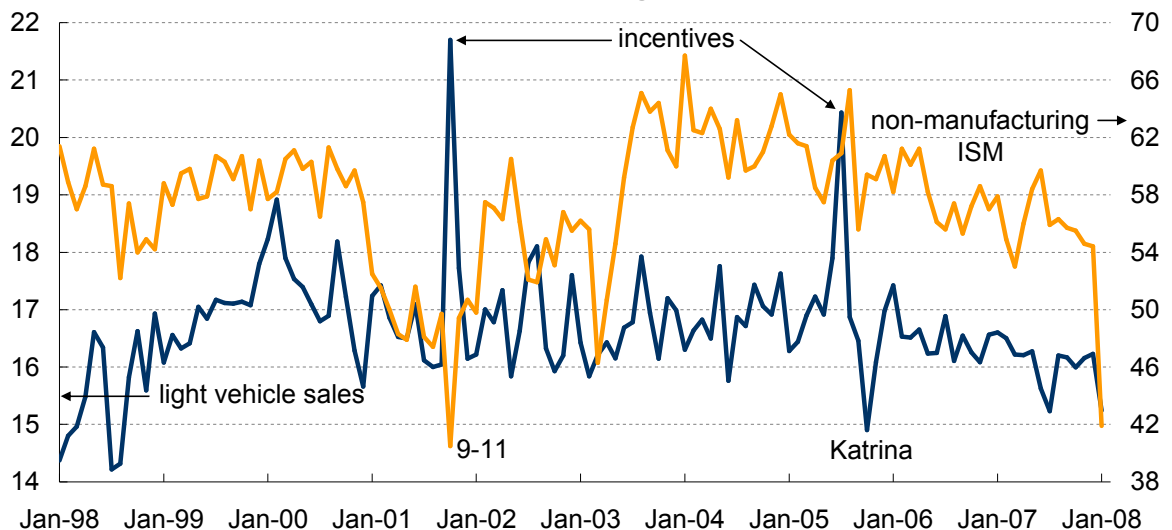
US tipping point

WE SUGGEST: Stocks not yet cheap enough to pull in needed capital flows

SUMMARY: Car sales, the non-manufacturing ISM, U-Mich consumer sentiment and perhaps the payroll jobs number all combine to suggest that the winter tipping point for the US economy – the natural result of labour income depending so heavily on annual bonuses and stock option profits – has started. Fed ease is unlikely to help recovery, which could depend on stocks getting cheap enough to recapitalise America.

The slow-burn phase two of the US housing-led downswing seems to have started in earnest in January. The trigger had to be weakness of income combined with falling house prices to induce debt deflation. As bonuses and stock option profits have been the chief contributors to real labour income growth in 2006-07, the bonus season was always likely to see the dawn of reality rather than denial. Perhaps East Hampton house prices are adding the *coup de grâce*. Recent indicators look like the tipping point.

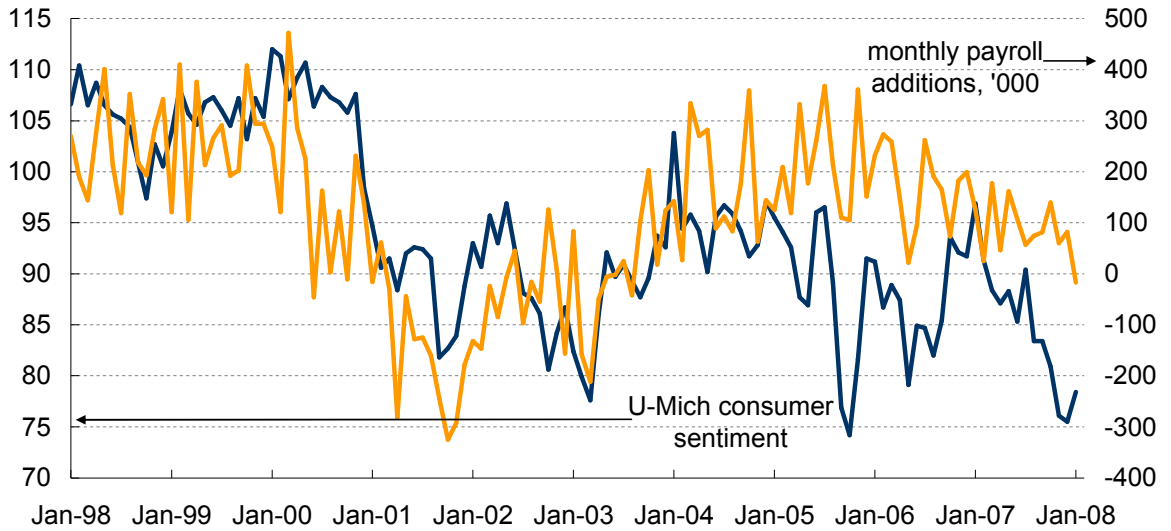
This week's tipping indicators



This chart shows how car sales and the non-manufacturing ISM have plunged. Leaving aside major fluctuations from car price incentives, Katrina and 9-11, both are strikingly weak. The non-mfg. ISM is erratic anyhow – moves of as much as five points can often be ignored – but a 12-point plunge to an all-time low (excluding 10-11) has to be significant. The key numbers, for new orders and employment, are particularly gruesome, as is the continued high reading for prices paid. Car sales are no worse than last July's number, but the overall gradient of this leading element of consumer spending has been clearly and

increasingly downward since autumn, 2005 – as one might expect, that having been the high point for realised house prices (ie, the median prices of new and existing home sales).

Last week's tipping indicators



Last week's U-Mich consumer sentiment index looked reassuring at the time, as it rebounded. But viewed over a longer time-frame it is also clearly heading downward. As this is a consumer-led downswing, it is little surprise that recent lows have been below those of the 2001 "recession", which was focussed on business spending. It is likely to head lower – below the Katrina-driven downward spike of October, 2005 – as current levels are consistent with growth in real consumer spending, at a low 1% admittedly, while we forecast real consumer spending falling between end-2007 and end-2008. The payroll employment number for January being negative for the first time since August, 2003, is less significant, as these numbers are lagging indicators, get heavily revised and the monthly change jumps around a lot. But it points in the same direction. The odd thing is that payroll growth was relatively weak in 2007 Q2 and Q3, when GDP grew at 4-5%.

Manufacturing ISM



The indicator that has not tipped over is the manufacturing ISM, though its trend too is downward. This probably reflects the chief positive aspect of the current economy, exports. The shift into inventory liquidation in Q4 may also have left manufacturing less likely to recede in the immediate future. For the four quarters to 2008 Q4, our forecast of significant consumer and fixed-investment recession just offset by fiscal stimulation from the government and positive net exports remains in place. It required a significant worsening of the economy during the winter months, and that seems to be happening.

The Fed's interest rate cuts may help the burden of debt service in a private sector with zero incremental debt capacity, but is unlikely to provoke much recovery and could worsen inflation prospects. Who would want extra private sector borrowing to cure an economy whose chief problem is too much debt? And the foreign lenders that US borrowers must depend on may well be deterred by obvious debasement of the currency. The real work of inducing recovery next year will be done in the stock market. Americans need to sell stock – in grand style, say \$500 billion net a year – to recapitalise, reduce debt ratios and cover the current account deficit. Has the combined reduction of stock prices and the dollar gone far enough to start this process? It seems unlikely.

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