Tea Leaf

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Your guide to understanding today's economy and financial markets

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Bumps in the Road

Written by Jeff Thredgold, CSP, President, Thredgold Economic Associates

Conventional wisdom within the economic forecasting community suggests that a modest U.S. recession is currently underway. Such wisdom (the term used loosely) also suggests that a return to noticeable U.S. economic growth is likely during 2008's second half, with a return to still more impressive performance during 2009.

To use a driving analogy, the consensus of economists saw the economy cruising comfortably at a 50 mile per hour speed during 2004-2006…saw it slow to around 30-35 mph in 2007…and see it currently stalled by the side of the road undergoing "repairs."

To extend the driving connection, the consensus sees growth at perhaps a 25-30 mile per hour pace during 2008's second half…with perhaps a 40-45 mph pace in 2009.

Bad Tires

I think the conventional wisdom may be a bit too optimistic. I also see the economy currently stalled by the side of the road. Unfortunately, the car has two flat tires and one tire severely under inflated.

The first flat tire of declining home prices in many markets is one that will limit a return to a reasonable speed for perhaps the next year on most highways. Constant housing market negativity by the national media simply makes this issue worse.

Ongoing domestic and global credit market anxiety and frequent credit market paralysis represent the second flat tire. Such a breakdown has led to tens of billions of dollars of loan and investment write-offs for U.S. and global commercial banks and brokerage firms, as well as for investors around the world. This issue continues to deprive many qualified borrowers of the funds necessary to purchase or refinance a home, or to borrow to start or expand a business.

Painful declines in U.S. employment over the past few months represent an under inflated tire. Such declines could give way to modest employment additions by the fourth quarter.

Potholes

The combination of sky-high oil and gasoline prices, costly commodities of all types, and rising food prices represents a series of potholes that will limit forward progress. Low consumer confidence levels will also limit how fast consumers dare drive when capable of modest acceleration.

To the Rescue

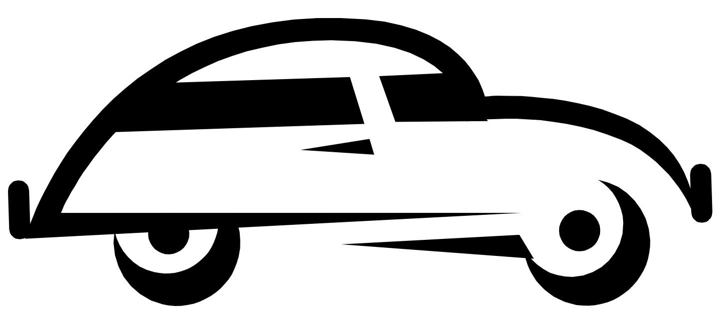
Rest easy, however…

A new Commissioner of Highways has been addressing automotive needs in recent months in the form of better road surfaces and lower tolls. Fed Chairman Ben Bernanke has been working crews overtime to enhance the quality of our roadways. A seventh new layer of asphalt (another interest rate cut) could be laid next Wednesday.

At the same time, auto junkies in the White House and the Congress are about to release the latest "new & improved" auto fuel…in the form of tax rebate checks. Such stimulus will boost miles per hour—a bit—during the year's second half. It will also add to the massive weight in the trunk known as the deficit.

Movin' on Down the Road

We should be moving forward by the end of the year or early next year. However, our minimal speed for awhile may be less than the consensus view…and less than worth writing home about.



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Inflation Ugly

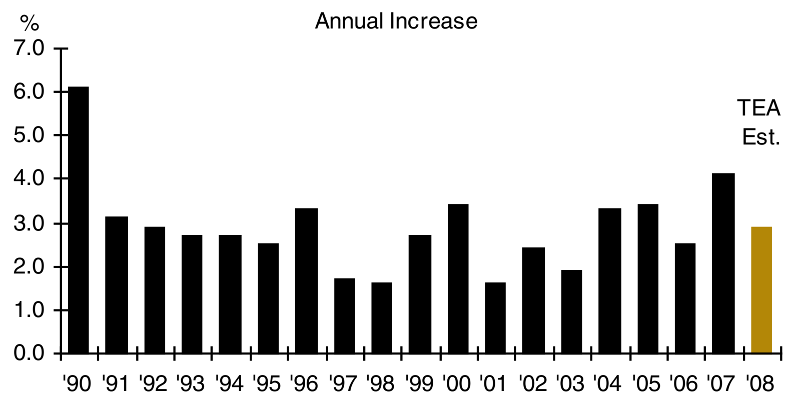
Recent readings of U.S. inflation pressures provide little in the way of comfort for consumers or for the Federal Reserve. However, a reasonably clear message from the Fed that its current primary objective is supporting (or returning to) U.S. economic growth makes it clear that the Fed will need to face the inflation demon later on.

Consumer Prices

The Consumer Price Index (CPI) rose 0.3% in March, matching economists' consensus forecast. Consumer prices were unchanged in the prior month.

The CPI has risen 4.0% during the most recent 12 months. The overall CPI rose 4.1% during 2007, the largest gain since 1990. Most economists have consumer prices rising around 3.0% this year.

U.S. Consumer Price Index



As one might logically surmise, rising inflation pressures are tied to higher energy costs and rising food prices. Energy prices within the CPI have risen 17.0% during the past 12 months, while overall transportation costs have risen 8.2%. Food costs have risen 4.5%, while medical care has risen 4.0%.

Apparel costs have actually declined by an estimated 1.7% over the past year as retailers have found the need to be more aggressive in pricing in a slowing economy. Housing costs have risen an estimated 3.0% over the past year.

The "core" CPI, which excludes volatile food and energy costs, rose 0.2% in March, also matching expectations. The core rate has now risen 2.4% over the past year.

The core CPI is the more closely watched inflation number by both the Fed and financial market players. The core rate is most applicable to those of us who do not eat, drive, or heat/cool our homes… (sorry, a modest attempt at humor).

Producer Prices

Inflation at the wholesale level was also discomforting, led by (you guessed it) rising food and energy prices. The Producer Price Index (PPI) rose 1.1% during March, far exceeding estimates projecting a 0.6% rise. Wholesale or producer inflation has now risen an alarming 6.9% over the most recent 12-month period, not exactly in line with the Fed's desires.

The core PPI was less painful, with the 0.2% March rise matching expectations. By comparison, the prior month's increase was 0.5%. Still, the 2.7% gain in core prices during the past year was the largest year-over-year rise since July 2005.

Even Higher Oil

Oil prices, which have since risen to nearly $120 per barrel in recent days, will only aggravate inflation measures in coming months. A greater share of consumer spending being devoted to higher gasoline and food costs—combined with rising anxiety about housing values and declining U.S. employment totals—will simply leave less for more discretionary spending, such as entertainment and dining out.

As Rosanne Rosannadanna, a character played by Gilda Radner on *Saturday Night Live* years ago, used to say…"It's always something."

Jeff

"TEA"ser

"90% of life is half mental."

—Yogi Berra

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