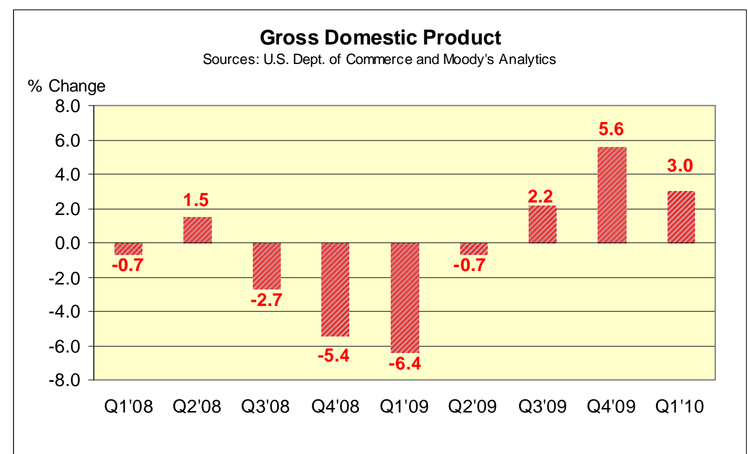
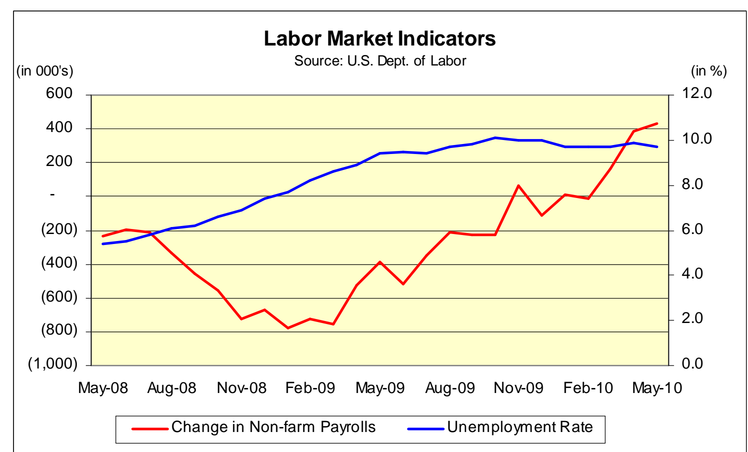
# National Economic Trends – June 2010

After reviewing the past several months' economic analyses and ruminating on the latest indicators we are sorely tempted to write "ditto what we said in May" and leave it at that. Recent economic reports have been a little tepid, but growth in economic output is still likely running at a decent 3% pace during Q2. Consumption growth has been okay, employers have started hiring (albeit tentatively) and both business investment and industrial production are growing healthily. Despite the generally positive outlook, however, the general public mien is gloomier than representatives of BP contemplating another public apology to "the small people" (whom they loved so much they wanted to give free oil. Free oil mixed with seawater and pelican feathers, granted, but free nonetheless.) It's all that other stuff – fear of another financial crisis, worries over government fiscal and monetary policy, uncertainty over changes in financial and economic policies, disgust and concern over the Gulf oil spill – that has created such a foul mood amongst the populace. We think the grim mood is overdone and that the recovery is on track, unless it results in a widespread loss of confidence that becomes a self-fulfilling prophecy. Or unless the government makes some serious public policy mistakes. And the odds of that happening are…okay; now we're depressed too. No, seriously, this month we shall use some of this space to philosophize on the dangers of relying too much on conventional wisdom, particularly near low and high points in economic cycles.

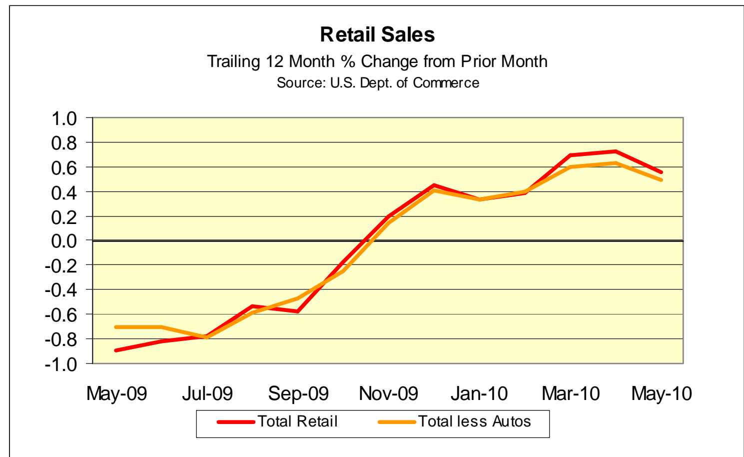
But first, we'll take a jog through the latest data. GDP growth for Q1 was revised downwards to 3.0% from a previous estimate of 3.2%. Revisions downwards to personal consumption and net exports (imports were tweaked upwards more than exports) accounted for the decrease. The lower estimate is not terribly significant in economic terms – it was still a decent quarter – but was a little disappointing in that most forecasters (including yours truly) expected an upwards revision.



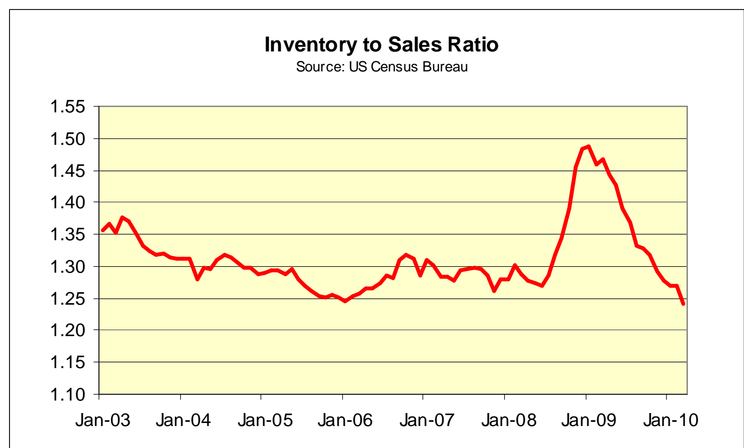

The latest monthly employment report was a more profound disappointment. On the surface it looked great, with an increase of 431,000 jobs in May and a drop in the unemployment rate to 9.7%. Strip out the addition of over 400,000 temporary census jobs, however, and the private sector only added about 41,000 positions. And the drop in the unemployment rate was more about workers becoming discouraged and dropping out of the labor force than it was about hiring. The soft report, interestingly enough, was seized upon by both sides of the political aisle to bolster policy positions. Liberals argue that this proves that we need more stimuli, particularly aid to the unemployed and to states, and conservatives argued that this proved that stimulus isn't working and that recent policies have discouraged hiring. We think the facts tend to be



more on the conservatives side – there is substantial empirical evidence that extending unemployment benefits tends to lead to a rise in unemployment rates, for example, and policymaking uncertainty in financial reform and carbon legislation is definitely inhibiting business decision making – but we also think that the May report was just one of those things. Historically employment recoveries tend to be a little zig zaggy, particularly in the initial, later to be revised reports. We think that future months are likely to look better ex-census (which will turn into a large negative this summer from a large positive this spring.)

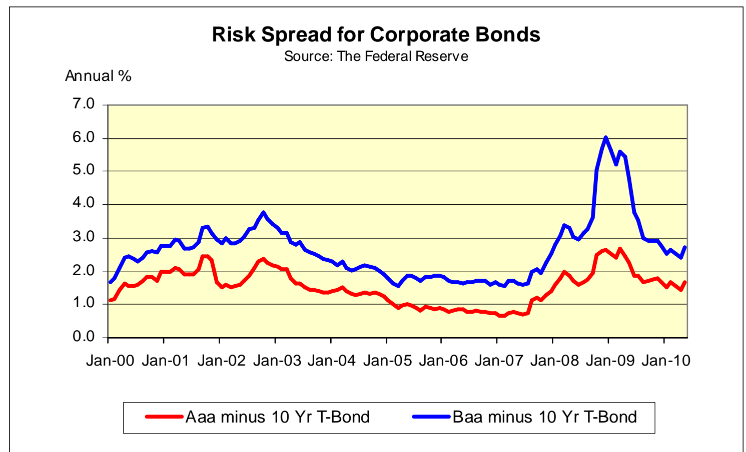



If the employment data has been disappointing, the latest retail sales report was a downright stinker on the surface, with sales dropping 1.2% in May from April. The key phrase once again is "on the surface", because there were some one-offs and strange things going on in this report. The main one-off was a 9.3% decline in sales at building materials stores, which was a direct result of the expiration of the latest housing tax credit at the end of April. People rushed to buy homes in March and April to take advantage of the credit, which pulled sales forward from future months. As home sales subsequently declined in May, so did sales of appliances, furniture, big honking riding mowers and the like. Two other items were likely just wrong – sales at gas stations supposedly dropped 3.3% and auto and auto parts sales dropped 1.7%. We don't think either of those things actually happened – unit car sales actually increased 3.8% – so we think it was instead one of those funky seasonal adjustment issues rearing its ugly head again. Stripping out these three items, the balance of retail sales actually increased a bit from prior month, which likely better represents the underlying trend.




On the positive side, industrial production continues to rebound smartly from the deep pits into which it fell. In May, manufacturing output was 0.8% higher than prior month and 8.4% higher than prior year. On a year-to-year basis, most segments of interest to Entergy are higher, ranging from 2.9% for refining (despite recent struggles) to 49.5% for primary metals (the first half of last year was not kind to metals producers). Still, manufacturing output remains about 8.5% lower than the pre-recession peak. And a good follow-on question is how long the positive trends last. We think awhile, because the basic drivers remain mostly intact – auto sales are still improving and inventories continue to be too low, although exports have recently been flattish. We offer as evidence the inventory to sales ratio, which is now lower that it was during the boom years despite the fact that the numerator (sales) is substantially lower. We are now in the sweet spot of the cycle where businesses

need to keep working harder to not only get inventories back to a healthy level, but also to catch up to improving end demand.




So far, the European financial crisis has not shown signs of spiraling into a 2008 redux. Risk spreads for financial instruments have ticked up lately (although it's hard to see in this graph) and there has been a mini-stampede into safe haven assets such as gold and treasury bonds. But we aren't yet seeing signs of serious distress in the financial system. The direct impact on U.S. exports, through both reduced European demand and a weaker Euro, will play out through time. But it is not likely to have a major impact because Europe only accounts for about 20% of total U.S. exports and has been growing more slowly than Asia for years. And although the Euro has weakened about 25% versus the dollar since last December that really only brings it back to the levels that existed when the Euro was first created. It's not like we are in uncharted territory here.

We've attempting to quantify the potential impacts of the oil spill on the national and regional economies and we'd love to tell you of substantial progress. But, instead, we'll have to rely on the "ditto" response again. The short-term moratorium on new drilling permits has now been extended to at least six months (some think it actually might be a year or more) for deep water drilling while a Presidential panel assesses safety practices and looks for (to paraphrase the chief executive) tushies to kick. Drilling in shallow waters has ostensibly been allowed to resume, but no new permits have been issued since the announcement due to a predictable snafu in clarifying new drilling guidelines. The deep water moratorium is going to cost some jobs in both our Texas and Louisiana jurisdictions, although there are some mitigating factors. There will be a migration overseas of some of the deep water drilling that would have been done in the Gulf of Mexico which will result in a loss of field positions. But local project management, engineering, manufacturing and support personnel should be able to stay employed. The ban is also likely to accelerate onshore drilling for oil, which was starting to happen anyway due to improved technologies for working older onshore fields and to the already high costs and risks of deep water drilling. The biggest driver of drilling lately has been for unconventional natural gas anyway, and that area of the industry should stay strong if natural gas prices don't collapse. In fact, only about 3% of the total North American rig count was working in the Gulf of Mexico at the time of the explosion, and of that only about 20 rigs were working in the deep water. Longer term, the impact of a more stringent regulatory regime and restricted access to new areas remains to be seen, although it will undoubtedly raise costs enough to make many prospective projects uneconomic.

The net impact on fishing and tourism likewise is difficult to assess. The fishers aren't fishing and some tourists are going elsewhere, but the overall impact is being blunted by the wads of cash that BP and the Feds are throwing at the remediation effort. Longer term, there is now a $20 billion pot of money to pay claims, and BP has agreed to compensate rig workers for lost wages due to the drilling moratorium (up to $100 million, anyway.) We've seen a number of anecdotal reports that suggest that many fishers and charter boat operators are making more money from BP than they typically do

from their usual businesses. In general, it's good during the early stages of a crisis like this to take a deep breath (unless you're standing right next to the Gulf of Mexico) and discount any economic predictions emanating from politicians, special interest groups, or lawyers. The bigger the financial motivation involved, the larger the discount rate to apply.

Not that we're letting BP off the hook, you understand. Even after all that's happened, their corporate obtuseness still astonishes. They might as well let Lindsay Lohan be CEO; at least she's an entertaining train wreck. On our last taxi ride into New Orleans the cab driver told us a story about a relative of his that got a job cleaning the beaches. It turned out that he was part of the crew that was rushed to the beach for the now infamous photo op with the president. The brother-in-law was provided with a nice set of white overalls, gloves and boots. At the conclusion of the photo op, BP took back the equipment, told him that he could report for work on another cleanup crew the next day, but would have to provide his own gear. They were actually making this poor schmuck pay for the boots he needed to help clean up the mess that they created. If we worked in the oil industry for another company, we would be sorely tempted to fly to London, go to BP headquarters, and kick Lindsay Lohan's predecessor right in the jumblies.

Now that we've gotten that off our chest, we'll turn to our philosophical musings for the month. We'll be the first to tell you that forecasting is a tricky business. Actually forecasting is easy – the trouble is that reality often refuses to cooperate. Because forecasting is such a tricky business, the tendency of forecasters the world over is to assume that whatever is happening now will continue to happen in the future. This is an interesting simplifying assumption to make, because in real life current performance of anything is more often than not a lousy predictor of future performance. Take GDP trends for example. If you were sitting at the end of Q2 of 2008 and assuming that the rest of the year was going to be just like the first half (as many economists did), then you would have experienced what we forecasters refer to as a significant negative forecast variance. Which takes a lot of the fun out of forecasting, trust us.

So it's generally a good idea to bet against conventional wisdom. Current conventional wisdom is that we will continue to muddle along over the next few years and possibly flirt with another recession, but won't quite get there. Given history, that isn't likely to happen – either things will get substantially better or we will go back into the tank big time. We think that the odds favor substantially better. But we have been accused of being overly optimistic at times, so feel free to come to your own conclusions.

We've harped on this theme of ignoring conventional wisdom before, but somehow we don't think you believe us. So we shall close with some concrete examples of forecasters who got it about as wrong as they could, although they sounded very convincing at the time:

> Whatever caused it, the institutionalization of inflation – along with structural changes in communications and psychology – have killed the U.S. equity market for millions of investors. "We are all thinking shorter term than our fathers and our grandfathers," says Manuel Alvarez de Toledo, of Shearson Loeb Rhoades Inc.'s Hong Kong office.
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> Today, the old attitude of buying solid stocks as a cornerstone for one's life savings and retirement has simply disappeared. Says a young U.S. executive: "Have you been to an

American stockholders' meeting lately? They're all old fogies. The stock market is just not where the action's at."

– from *The Death of Equities* article in *Business Week* magazine, August 13, 1979
– Compound annual growth rate in S&P 500 Index, 1979 to 1999 = 14%
– Long-term average growth in S&P Index = 7%

The trends I foresee in the stock market over the next two decades convince me that the (Dow Jones Industrial Average) will reach 40,000 by 2016

– from *Dow 40,000: Strategies for Profiting from the Greatest Bull Market in History* by David Elias, June 1999
– Current DJIA = 10,170
– Compound annual growth needed to reach 40,000 by 2016 = 26%

Federal Reserve Chairman Ben Bernanke said Thursday that there will be "significant losses" associated with subprime mortgages but that these losses should be regarded as "bumps" along the road of market innovation… "We'll see how this works out," Bernanke said… Bernanke said there were going to be "significant losses" in subprime-mortgage paper, citing estimates ranging from $50 billion to $100 billion

– From a *MarketWatch* story on Bernanke's Senate testimony, July 2007
– Current estimate of losses sustained from subprime lending = approximately $2 trillion