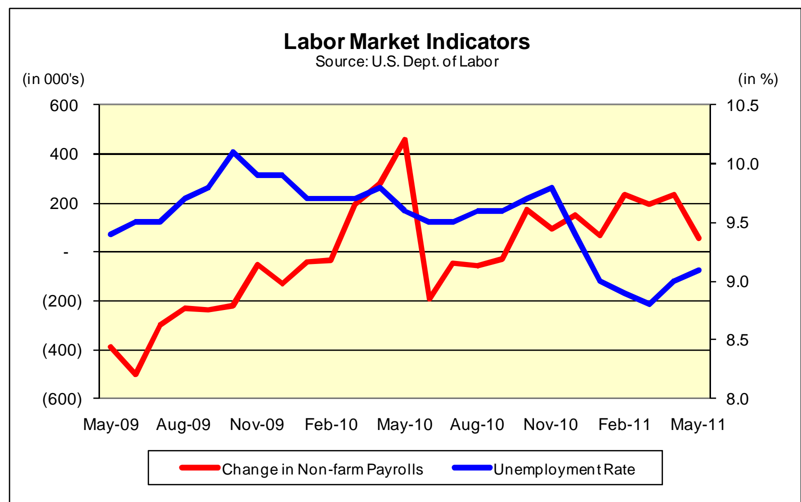
A no doubt about it slowdown has hit the U.S. economy, with recent economic reports ranging from so-so to borderline dreadful. We continue to maintain that a raft of temporary factors – most notably surging commodity prices (temporary because we think they are in the early stages of unsurging), the impact of supply chain problems from the Japanese natural disaster and the inability of our elected leaders to tear themselves away from Tweeting naughty pictures of themselves long enough to solve the budget mess – will eventually abate and that economic vigor will reassert itself before the end of the year. In the meantime, during Q2 we'll be lucky to match that 1.8% GDP growth rate we knocked down in Q1, and in a world of 9.1% unemployment that isn't good enough.

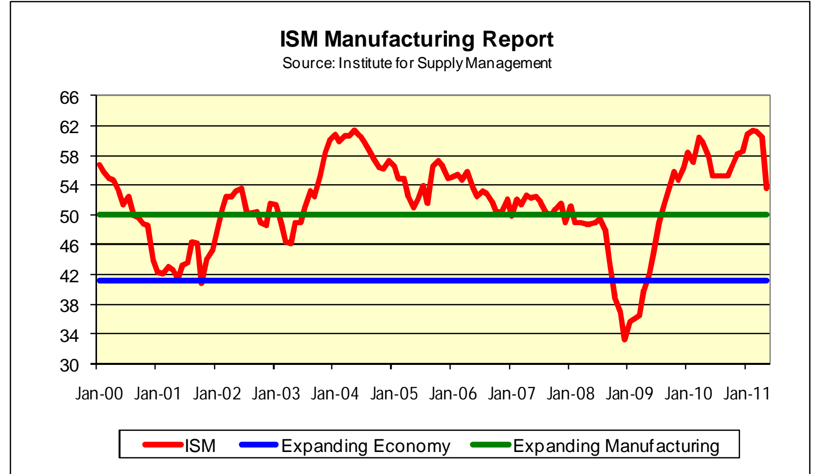
Recent trends make it harder to be an optimist, but the flip side is that we also believe that there's been an overreaction to recent events owing to what we like to call Dryer Lint Syndrome. Those of you old enough to have grandparents who lived through the Great Depression know that their behavior was so permanently altered by that event that they tended to take frugality to extremes. Although nobody in our family took to saving dryer lint to knit into sweaters (we've heard stories) we did have one relative who saved gift wrapping paper for re-use and insisted on buying out of date grocery items, cake mix in particular. Dessert at her house was not always the festive ending to a meal that you'd like. Similarly, the trauma from the Great Recession will linger for quite some time for this generation, notably manifesting itself by hair trigger reactions from both consumers and businesses to the slightest whiff of a hint of a touch of a problem. Exhibit One being the swift retrenchment by consumers in reaction to $4.00 per gallon gasoline and Exhibit Two being the almost instantaneous pullback in hiring by businesses as soon as they saw consumers getting green around the gills about said gas prices. Until we get some distance from the financial crisis we expect Dryer Lint Syndrome to periodically reassert itself in times of perceived duress. What's going to be interesting is how permanent a change the Great Recession wrought in American psyches. After all, we were still suffering from out of date cake mixes 40 years after the Great Depression was just a sepia tinged memory.

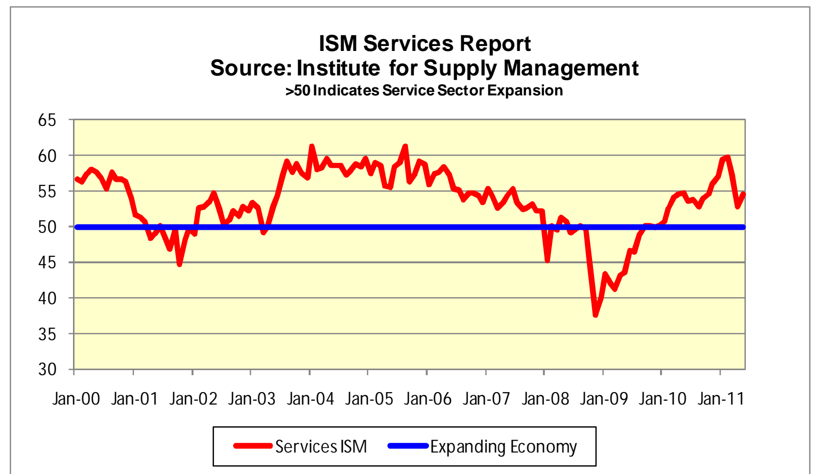


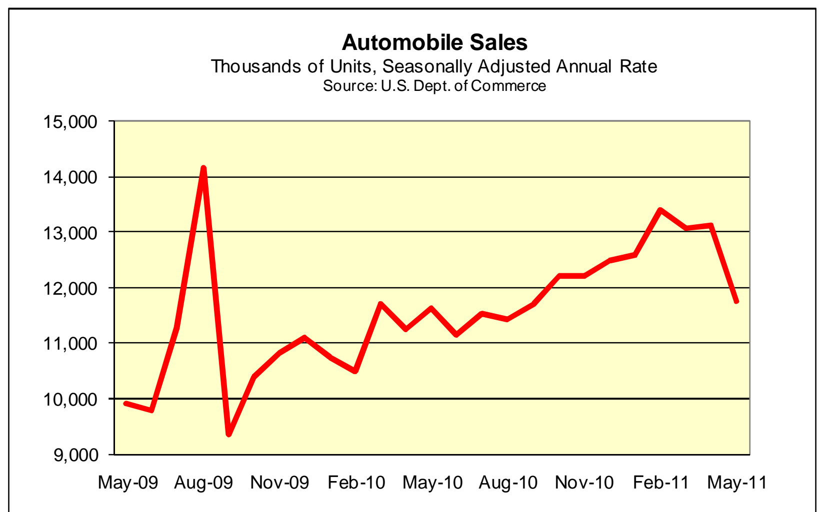
The biggest kick in the pants from recent economic data came from the employment report, which was one of those borderline dreadful affairs. Although it was widely expected that the report would be soft, the net gain of only 54,000 jobs created a definite "oh shoot" moment for economists, especially those closest to the White House and Federal Reserve. The unemployment rate also ticked back up to 9.1%. As usual, the report abounds with caveats. The temporary shutdown of a number of auto production plants due to the inability to get certain parts out of Japan (particularly electronic engine control modules, which apparently even a lot of the domestic manufacturers use) led to a small decline in manufacturing employment after six consecutive months of increases, a drop that likely will be recouped by the end of the summer. The unusually severe weather that struck large swaths of

the South during the survey period also likely had a temporarily depressive effect on employment. Average hourly earnings also increased by 0.3%, which is likely a function of a job market that is tightening somewhat, at least for skilled workers who can demand wage increases. But, for all that, it was a soft report and showed that business executives can suffer from Dryer Lint Syndrome as much as anybody.

Also on the list of dreary reports was the latest Institute for Supply Management's manufacturing survey, which took a vertiginous drop from 60.4 to 53.4 in May. The decline was principally due to a drop in new orders, inventory and production, all suggesting that manufacturers went back to their favorite hobby of liquidating inventory as soon as trouble lifted its head above the horizon. Now 53.4 is still a decent number and reflects a manufacturing sector that continues to expand. But we went from "woo hoo" to "oh shoot" (there it is again) in one month, which is never good. Especially since we've been counting on manufacturing to carry water for the economy while the services sector and real estate wander around the woods. Speaking of which, we come to one of the few recent pieces of good economic data, which is that the non-manufacturing ISM actually rose last month from 52.8 to 54.6, with new orders and employment both trending positive. This news would be really cheery if the index hadn't been near 60 only a few months ago, but we'll take what crumbs we can manage. The divergence of the manufacturing and non-manufacturing sides indicates that the supply chain issues we mentioned earlier were substantial enough to be genuinely noticeable and a source of at least some of the recent economic swoon.



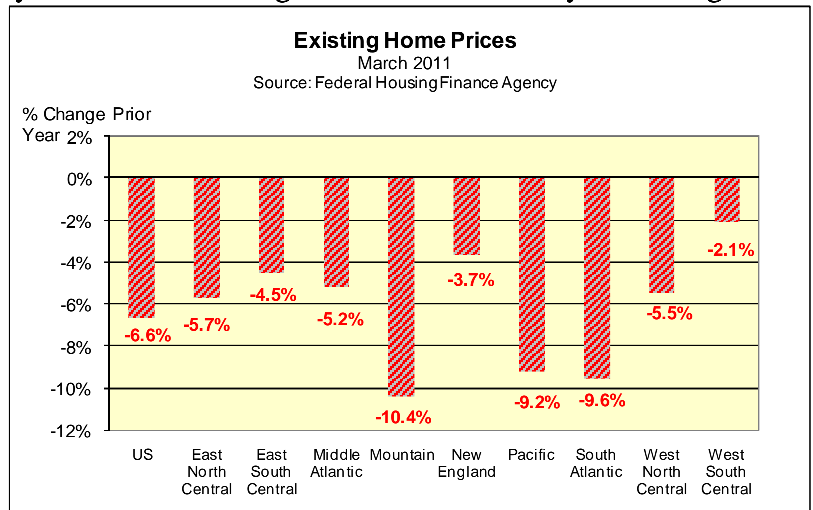


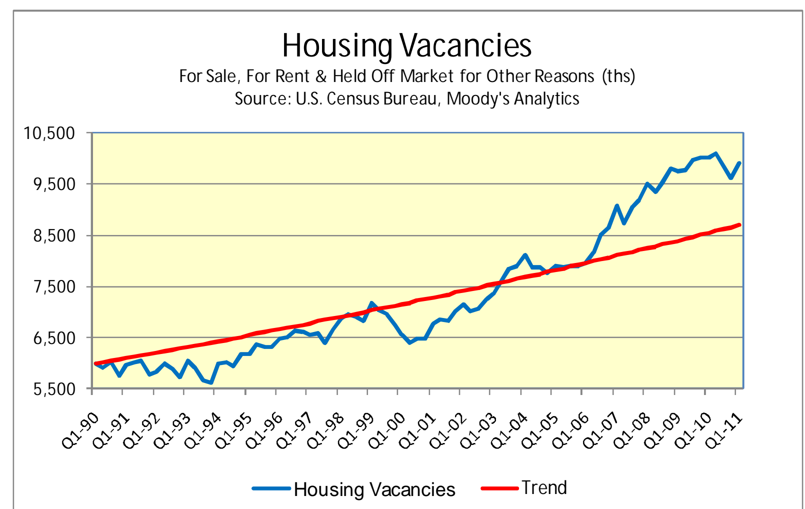


Interesting thing about auto sales. A few years ago, if the Japanese manufacturers had been caught short of product you

would have seen the domestic manufacturers step up the incentives to gain back market share. Not this time kemo sabe. The domestics held the line on incentives and although they gained market share from (particularly) Toyota and Honda, the net result for the industry as a whole in May was a drop in the annualized selling rate of about 10% from April, down to below 12 million units. This reflects three things: 1) the industry has inventories right where it wants them and are willing to accept short-term sales declines in order to protect profit margins, 2) the domestic industry really isn't your father's Oldsmobile anymore and no longer needs high sales and production rates to cover it's outlandish overheads, and 3) the industry can no longer rely on artificial demand from the Ohio State football program, which is obviously going to hurt. We're originally from Ohio, by the way, and our home boy sources tell us that they have a new name they call Jim Tressel and Terrell Pryor, and it isn't kemo sabe. Kemo sabe, as we continue to digress, means "trusted friend" or "trusted scout" according to Wikipedia. Nobody really seems to know for sure, however, since another impeccable internet source claims it derives from a Navajo phrase that means "soggy bush." Which seems unlikely but would explain the Lone Ranger's mask – it's got to be embarrassing when your sidekick calls you a soggy bush on national television.

Speaking of obvious hurts, we've been avoiding discussion of the real estate market for awhile now because we didn't want to depress you unduly, but its continuing travails are certainly not doing those suffering Dryer Lint Syndrome any good. We are well and truly into a deep double dip in home prices, which through March were down 6.6% from last year's tax credit enhanced levels. Finding a bottom to the housing market would sure do the economy a powerful lot of good, since housing is usually one of the sectors that rebounds earliest and strongest from recessions. The obvious source of the ongoing distress is the overhang in foreclosed properties that continues flooding the market. The flow slowed for awhile because of the scandal regarding the "robo signers" of foreclosure documents at some large financial institutions, but is back at full crest now. The downturn in household formation from the recession and its subsequent painfully slow recovery hasn't helped a bunch either.





Even in a best case scenario, it figures to be at least into next year before the foreclosure overhang abates. Moody's Analytics calculates that the number of

vacant homes on the market is about 1.5 million units above what would be considered normal given long-term trends. New home construction at today's depressed construction rates is adding around 600 thousand units annually to the available housing stock. To get back to a reasonable inventory of vacant properties, therefore, we need to create enough demand to burn through a bit more than two million units of excess inventory. At current absorption rates, including new household formation, houses lost to obsolescence and second homes, that will take over a year. It might be a little less than that due to the recent surge of speculators moving into the market to purchase homes to use as rental properties. On the other hand, the recent move down in home prices has also increased the number of strategic defaults, where homeowners have the ability to continue to pay their mortgage but decide to walk away because they are so far underwater (the mortgage is higher than the market value of the house) that they don't see the point of throwing good money after bad. Leaving aside questions of ethics and long-term financial planning, this might well lead to another burst of unexpected foreclosures and further delay the market reaching equilibrium.

Of course one of the prime motivations for the Federal Reserve's dalliance with quantitative easing was to help the housing market. Mission unaccomplished on that score. Actually, it is arguable whether QE 2 has had much of any positive effect other than to drive up stock prices. It's also been one of the principal forces behind the commodity price spike, but unless you're a commodity producer or price speculator that's been a clear negative for most of the rest of the economy. So now that we are reaching the end of the cycle of central bank bond purchases it's prudent to ponder next steps. We've got a camp that is pushing for QE3, we suppose on the grounds that if you keep pounding away at something long enough it has to work sometime. But recent comments by Chairman Bernanke indicate that even the Fed Board of Governors is cognizant that such a course would be borderline insane. Instead, many market participants are now touting an alternative they are dubbing QE 2.5 (we're not making this up, honest) which would keep the Fed balance sheet at or near its current bloated state for an indefinite period of time rather than beginning to unwind it as soon as QE 2 concludes. We suspect that this is the course that the Fed will take, as it is the course of least resistance and will not force them to actually tighten at a time when the unemployment rate is increasing.