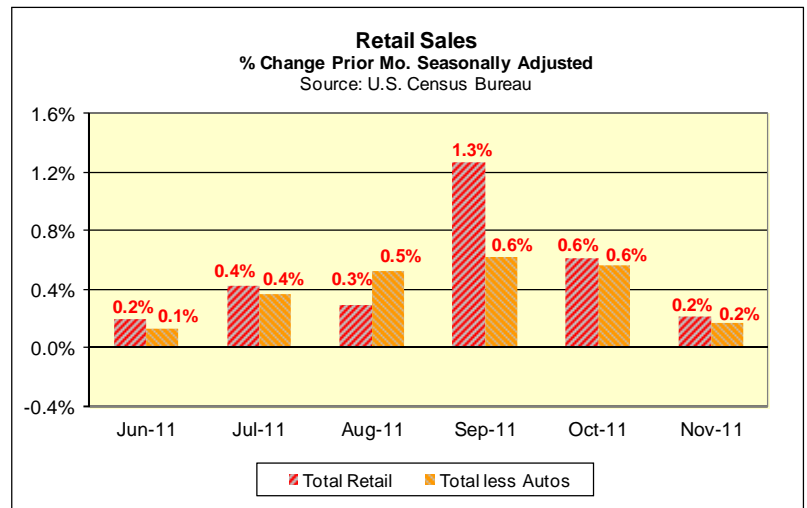


## Entergy's Economic Trends Analysis – December 2011

The U.S. economy is slowly shaking itself awake after its mid-summer nap. We're beginning to see improvement in the jobs market, retail sales have been reasonably strong (albeit erratic, which we'll get to in a moment), auto sales continue trending upwards, business investment is puttering along and even the housing market is beginning to smell a little less ripe. The stronger tone to the domestic economy stands in particular contrast to messy news from such exotic locales as Europe (on the brink), China (slowing dramatically), Iran (raising bellicosity to an art form) and Washington (hopelessly bollixed). How much longer the American economy can continue to laugh in the face of serial potential disasters – crumbling global fundamentals, empires falling, politicians bloviating, yet another season of *Jersey Shore* – is not at all clear, but let's enjoy it while it lasts.

This latest economic rally started us thinking. We've been cranking out these little write-ups since Q4 2001, starting with a "one-off" special assignment analysis of the potential impact of the September 11<sup>th</sup> attacks on the economy. Proving, once again, that nothing is quite so permanent as a temporary assignment. Except maybe temporary taxes. Using advanced digital analytical techniques – counting on our fingers – we figure that amounts to ten full years of the good (we were early warning about the potential negative impact of the housing bubble), the bad (we thought the stimulus was going to work, at least a little) and the ugly (a deceased Octopus prognosticator). Through it all we discovered what we believed to be the one immutable law of economics: Americans have an amazing ability to spend money, even if they don't have it to spend. Lately, however, that law looks like it's been repealed, or at least modified. Consumers still embark on periodic spending jags, but they no longer have either the will or the way to sustain these spending binges. So we get a burst of spending for a bit – when retailers get highly promotional, for example, or if pent up demand needs to be sated – but then it all dries up.

This fall has been a good example. Jobs are still relatively hard to get, consumer sentiment is barely off record lows and the savings rate is nearly at recessionary levels, yet we had two consecutive months of borderline robust retail sales in September and October. Sales reports from the Black Friday weekend, which were up between 6% and 9%, indicated the momentum continued into November as well. The final report for the full month, however, poured some cold water on those expectations. It wasn't terrible, just pedestrian, with sales up only 0.2% from prior month, both before and after factoring in auto sales. The Black Friday weekend was highly promotional, and it looks like those promotions pulled sales forward that would have occurred later in the holiday season. That means that December also isn't likely to be very strong unless retailers crank back up the deal machine, a suspicion bolstered by anecdotal evidence that store traffic in the aftermath of the Black Friday hoo hah has been anemic. In addition, to finance their holiday gift spending consumers appear to have pulled back in other areas. Sales at electronics and appliance



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stores, for example, were up 2.1% from October as consumers lapped up the latest toys, but sales at grocery stores and restaurants each contracted by 0.3%.

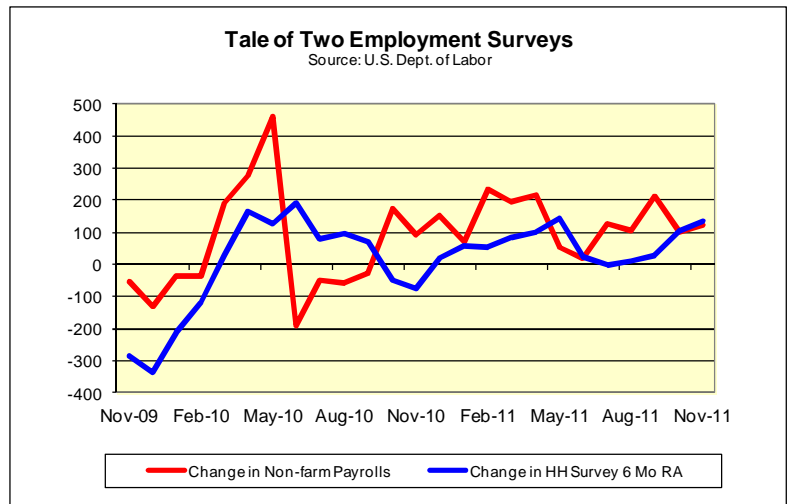
As usual with government reports, there be caveats abounding. It's likely that November sales will be revised upwards in future iterations – there is just too big a discrepancy between what retailers were reporting as their monthly results and what the government was reporting. Which brings us to immutable law number two of economics – when there is a disconnect between what private sector data is telling you about the economy and the government data, believe the private sector. So we think that retail sales were a bit healthier in November than this report suggests.

It's also possible that the suddenly healthy retail sales in September and October (actually, August wasn't bad either, ex autos) were a sign that employment prospects are beginning to pick up. The latest jobs report for November contains hints that this might indeed be the case. The headline jobs number, an increase of 120,000, was not terribly impressive. But the prior months were revised strongly upwards, a pattern that has taken hold recently and is usually indicative of a positive turning point in hiring. The unemployment rate also dropped sharply to

8.6% from 9.0%. Some of that was due to a continued contraction in the number of people actively looking for work, but it also reflected strong gains in employment as measured by the household survey. As we've discussed more than once over the past ten years, there are two surveys that comprise the monthly jobs report. One survey, of "establishments" (businesses), is where we get the headline jobs creation number. The other is a survey of households from whence the unemployment rate calculation is derived. The establishment survey is far superior to the household survey from a statistical point of view, so most economists put more truck in it. The household survey, in contrast, makes economists want to wash their hands or find some sanitizer after handling. You know, kind of like the reaction most people have after watching an Angelina Jolie movie.

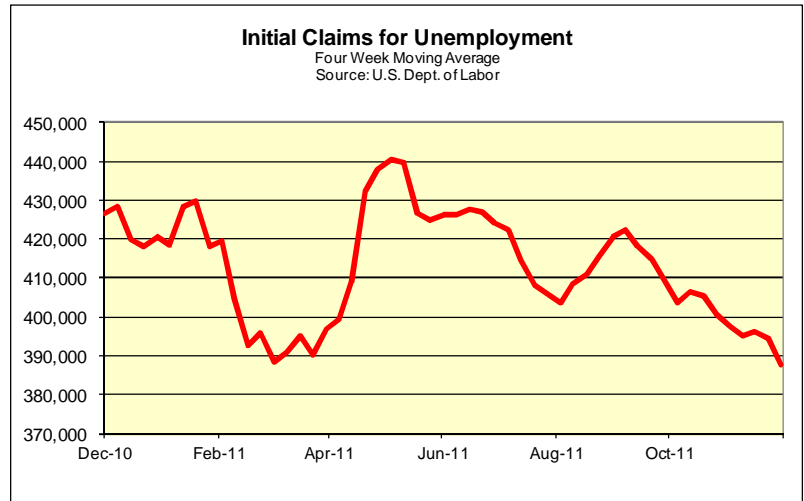
At any rate, the household survey, for all its flaws, tends to do a better job picking up changes in employment at entrepreneurial start-ups than the establishment survey. Over the past four months, the average gain in jobs registered by the household survey has been better than 320,000 monthly, well ahead of the 130,000 or so averaged by the establishment survey. Since the two surveys tend to converge over the long run, there's been some loose talk amongst the cognoscenti that we are starting to see an increase in hiring by small businesses that just hasn't shown up in the headline employment number, but eventually will.

Some support for this view comes from the weekly reports of initial unemployment claims, a good leading indicator of the monthly jobs number (and the overall economy, in fact). A sharp rise in



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claims this spring preceded the summer lull in hiring and the economy. Since about the middle of September, however, the number of claims has been falling steadily and recently breached the 400,000 level on a four-week moving average basis. Ideally, you want to see this number sink into the low 300,000 range, but these levels do at least indicate a reasonably healthy job market. Not yet the kind of boom that's going to put the legions of long-term unemployed back on the rolls, but decent.



Sadly, that's the last undeniably positive news we have for you. Let's first close the loop on the congressional Super Committee tasked with developing a long-term deficit reduction plan: they failed. We now will go to an automatic "sequester" (the government budget meisters like to use words that nobody understands in hopes that the voting population won't notice that they don't understand what they are doing either) that will automatically whack about \$1.2 trillion off of federal spending over the next ten years. The cuts are ostensibly across the board, although in practice they actually are mostly out of defense spending, since so much federal spending is in entitlement programs that are off the board for this particular sequester. Except that none of this will really happen. The cuts won't take effect until January 2013, conveniently after the next election and in plenty of time for further action. We think the real significance of the Super Committee failure is that Congress and the President appear to have jointly agreed to hang metaphorical matching banners saying "Fire Us Now" across either end of Pennsylvania Avenue. We suggest, fellow voters, taking them up on the offer. They can't keep hosing us if we don't allow it.

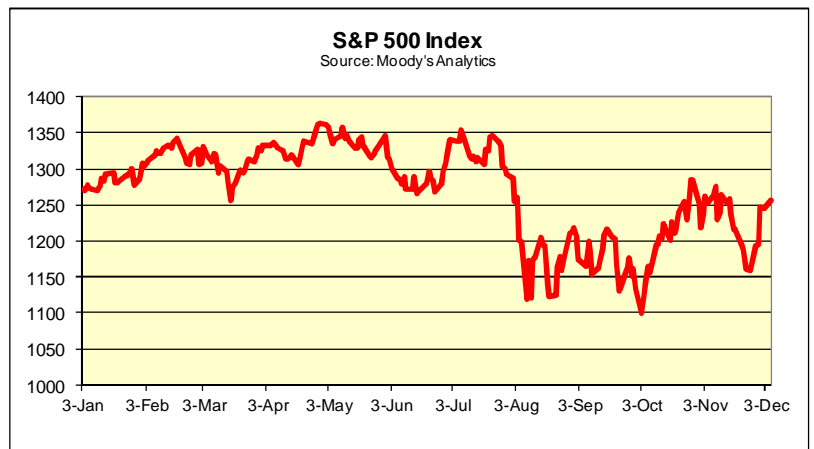
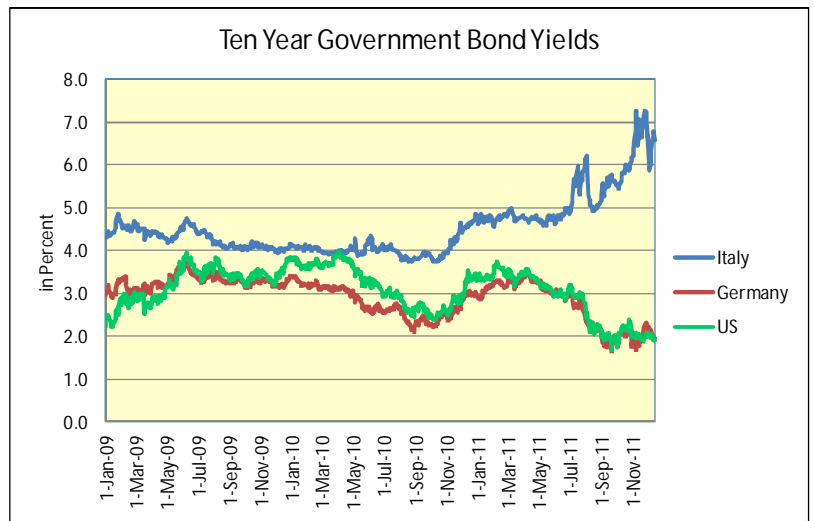
Speaking of trips to bizarro land, there's been a flurry of activity surrounding the European financial crisis. The European Union recently wrapped up summit number 2,467 designed to firmly deal with their looming fiscal and monetary disaster. This time around the focus was on developing mechanisms to enforce budgetary discipline on the rogue free spenders in the family – Portugal, Greece, Italy, Spain, you know the list – and to bolster financial backstops to ensure that credit markets don't freeze. Unlike previous summits, this one actually resulted in something approaching progress, as it moves the bloc forward towards creating more of a United States of Europe (a prerequisite for the continued survival of the Euro.) All but one of the 27 member states of the EU agreed to give up some control of their fiscal policies in the form of automatic penalties for states that run excessive deficits. The lone holdout on the agreement is the U.K., which objects to the possibility of higher taxes and more regulation on their large financial industry. In exchange, the Germans and a few other countries with spare change in their pockets will pony up bigger subsidies for once and future deadbeats. A previous summit had created plans for a new €500 billion "permanent" bailout fund to take the place of an existing €440 billion temporary fund. Plans for finalizing the permanent fund were accelerated by a year (to mid 2012). This newest agreement also

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supplements the previous funds with a new €200 line of credit at the International Monetary Fund, which will serve as a “firewall” against financial contagion.

Unfortunately, as with previous agreements, financial markets seemed to dig the new pact right up until they started to focus on the details. Equity markets staged an impressive Santa Claus rally during the period in early December leading up to the summit and European sovereign bond yields backed off their highs. Since then, however, the verdict has been clear – it still isn't enough. Although the agreement begins the process of fiscal integration, it doesn't do enough to address pressing liquidity and solvency issues, particularly for the banking sector. European banks have so much sovereign debt on their books (ironically, as a result of increased emphasis on risk-based capital requirements, which tend to favor larding up on sovereigns) that many of them are likely technically insolvent due to the recent downwards spiral of European debt markets. So they need injections of fresh capital, but even with the new IMF facility there isn't enough firepower in the rescue funds, particularly since most of that money is earmarked for buying distressed sovereign bonds directly so that the various governments involved can stay open for business themselves.

An unstated objective of the summit was to provide the European Central bank political cover to become more like the U.S. Federal Reserve. In other words, they're being urged to take more aggressive action to mitigate budding liquidity crises (either bond buyers shunning sovereign debt or banks refusing to lend to one another) by firing up the printing presses. They're being aided and abetted in this process by our Fed, which recently agreed to provide essentially unlimited dollar funding to the European central bank at reduced rates of interest. A vast swath of international commerce is denominated in dollars, and with U.S. financial institutions backing away from Europe faster than Mitt Romney from his Massachusetts health plan, the U.S. Fed was needed to provide (it is rumored) funding for several large European banks to open for business recently. These moves are different than the recent QE2 bond buying binge buy by the Fed, which was aimed at juicing a presumed sluggish economy. This is more like the first QE program at the end of 2008 and early 2009, aimed at preventing an out-of-control banking panic. We're no fan of QE2, but QE1 was absolutely the right thing to do and Europe will shortly be at the



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point where it needs something similar from the ECB to forestall being beaten over the head by an ugly stick.

Problem is, the ECB is showing no sign of removing its cranium from its posterior. To some extent, bank management is reticent because they're not sure if they have the authority to act in a lender of last resort role. Like a lot of aspects of European integration, the exact legal authority of this particular institution is a bit hazy. Their attitude is also due, in part, to memories of German hyperinflation after World War I, which was one of the proximate causes of World War II. For whatever combination of reasons they remain publically ambivalent about providing the necessary additional support for keeping this thing from getting out of hand. In the absence of that commitment, financial market pressures will continue to mount to the point that something is likely to blow in the not too distant future, either a major bank failure or the inability of a country like Italy to roll over its maturing debt. It may be that the ECB plans to flood the market with liquidity when the time comes. But if they don't signal that intention to the markets, then it may actually hasten the advent of a real crisis. Unfortunately crises are like boulders – easier to stop before they get rolling.

The recent pact also does nothing to deal with Europe's long-term problems of having too little economic growth and overly rigid labor markets. Most of the individual countries seem to be addressing the need for enhanced fiscal discipline by raising taxes. This is more politically palatable than taking an axe to their bloated social welfare programs, but will be counterproductive to boosting long-term economic growth. Which is what they need to bring down their debt servicing requirements to a manageable level (the GDP side of debt to GDP ratios). You'd think that they'd want to take a page from Germany's book, which in recent years has flourished after trimming social welfare programs and taking steps to improve labor market flexibility. But that would require taking on unions and old people and nobody seems to have the stomach for that. So even if a short-term crisis is averted the long term reckoning is still to come.

The European Union at least is having a better month than the television show *MythBusters*. Just as we were lavishing them with praise over their all-American ingenuity in blowing things up they had an unfortunate oopsy moment where a cannonball got loose from their testing grounds and bounced through an adjoining neighborhood. Fortunately nobody was hurt, although the family inhabiting one house had a memorable awakening from a nap when the cannonball bounced through their front door, up the stairs and through their bedroom wall. Not going to fix that with duct tape. Unfortunately, we won't be seeing the event on television – something about the possibility of a pending lawsuit. This month we'll let you create your own metaphors from this event.