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The Six Lessons from Last Week's Action
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The Six Lessons from Last Week's Action

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1) Expect the worst recession in the post-WWII era

First, this is going to be the worst recession in the post-World War II era, in our view. The ECRI leading indicator hit a record low for the fifth week in a row – down to - 29.2 as of the November 21st week versus -28.2 the week before. This index, which leads real GDP by two quarters with a 70% historical correlation, is getting further and further away from the prior all-time low of -19.8 that defined the worst recession of the post-WWII era and saw a six-quarter consumer recession coincide with a 45% peak-to-trough decline in the stock market. Perhaps the fact that this bear market is proving to be even more severe is symptomatic of an economic downturn that will also prove to be deeper and more prolonged. After the flurry of data released just before Thanksgiving, we are now tracking close to a 4.5% QoQ annualized fall in real GDP in 4Q. This would be the largest pullback since the 1982 recession, and we see a similar contraction in the first quarter of 2009.

2) Capex is in a steep decline

Second, capex is in a very steep decline right now. Durable goods orders dropped 6.2% in October, the third decline in a row. Over that time frame, orders have plunged at a 39% annual rate, which is unprecedented. The retrenchment has spread to the tech sector, where order books were expanding at a 7% annualized rate over the three months to June. Currently, that same three-month trend has swung to a negative 13% annualized rate.

3) Consumer spending down sharply; savings rate is soaring

Third, consumer spending fell 1% in October, which was a near-record decline. This, in fact, was the fourth straight monthly decline, which is unprecedented. The savings rate is soaring; it leapt to 2.4% from 1.0% in September, in a sign of heightened risk aversion and cash preservation, and is a shift that we believe should be seen as secular, not merely cyclical.

This was a conclusion that came through loud and clear in the Conference Board's Consumer Confidence Index, principally in the spending intention components of the survey. Auto buying plans dropped for the third month in a row to a record low in October while home-buying plans fell to their lowest level since the 1982 recession. Consumer plans to buy a major appliance fell to a 14-year low as well – down for three months in a row. During this four-month period of unprecedented consumer retrenchment from July to October, spending on discretionary items collapsed at an average annual rate of 18%. Even spending on groceries has declined 6%, toiletries are off by 6% and utilities are down 3%. So, even some of the classic staples are being curtailed.

The only areas that have posted increases in spending over this unprecedented four-month decline in spending have been pharmaceuticals (+7%), telecom services (+3%), medical care services (+5%) and mass transit (+26%) – all other forms of transportation, from rail to bus to air fell at a 19% annual rate.

4) Obama planning a $700 billion fiscal package

Fourth, we learned this week that President-elect Obama's economics team is planning a fiscal package as big as $700 billion over the next two years. We are going to wait for the details to see how this is going to impact our base case macro forecast. Suffice it to say that the cornerstone of the stimulus this time around will likely be infrastructure, not tax rebates. The key for investors is where these outlays will be concentrated, which, in turn, means identifying the areas of the capital stock that have been the most underinvested in recent years. After sifting through the data, we believe that the prime candidates will be hospitals, waste management services and passenger transit.

5) Housing market is not close to bottoming out

Fifth, we learned that the housing market is nowhere close to bottoming out. New home sales dropped 5.3% in November to a 433k annualized rate – the worst since the 1982 recession. Even though sales are now down 69% from the July 2005 bubble peak of 1.39 million units, we believe builders have not been aggressive enough in curbing production because the most critical variable of all, the unsold inventory backlog, rose to 11.1 months' supply from 10.9 in September.

Need to see inventory backlog drop to 8 months' supply

The reality is that even though single-family starts have dropped to 26-year lows of

531,000, they are still running 23% above the prevailing level of new home sales. The worst the inventory-sales ratio ever got in the early 1990s real estate meltdown was 9.4 months' supply. We are currently 18% above that level and almost 40% higher than the 8 months' supply we would need to see before calling an end to the housing deflation phase.

Another 15-20% decline in home prices likely from here

As we saw last week, the Case-Shiller index fell 1.85% MoM or at a 20% annual rate. All 20 cities were down both sequentially and YoY. *Home prices are now down a remarkable 22% from the 2007 peaks*. With the unsold inventory sitting at the third highest level of the past three decades and mortgage approvals for new home purchases falling to their lowest level in nine years, we believe the laws of supply and demand point to a further 15-20% decline from here. So, of all the things that happened last week in the market, retailing stocks up 17%, the bank stocks up 26%, tech up 9%, the one development that probably has the greatest chance of being reversed is the 60% surge we saw in the homebuilding group.

6) Fed has switched December meeting to a two-day affair

Sixth, we learned that the Fed is going to make the December FOMC meeting a two-day affair instead of one (December 15-16). The market is already sniffing out a 50 basis point rate cut. However, now that the Fed has *de facto* embarked on the process of quantitative easing, perhaps the need for a two day meeting is to iron out a more aggressive plan to revive the credit markets and the economy. The only areas that have posted increases in spending over this unprecedented four-month decline in spending have been pharmaceuticals (+7%), telecom services (+3%), medical care services (+5%) and mass transit (+26%) – all other forms of transportation, from rail to bus to air fell at a 19% annual rate.

As Chairman Bernanke suggested in several speeches he gave back in 2002 and 2003, one of the deflation-fighting strategies would likely involve Fed action to nurture lower rates at the longer end of the yield curve. Perhaps this prospect is behind the rally in the 10-year note yield and long bond to cycle lows. This would fit in very well with our ongoing strategy of focusing on equity sectors that have income-generating characteristics like utilities, health care and telecom services; these sectors also screen very well in a negative nominal GDP growth environment.

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