

THE ECONOMIC OUTLOOK GROUP



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ECONOMIC TALKING POINTS

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A Growing Geopolitical Threat Overshadows Soft Economic News

The start of the third quarter brought yet another mixed bag of economic news --- plus one alarming geopolitical threat that promises to loom over all else.

Retail Sales

We got a quick and dirty read on last week's retail sales activity. The International Council of Shopping Centers (ICSC), reported that sales at major department store chains rose 2.2% in the week ending June 28th compared with a from a year ago. A similar read came out of the Johnson Redbook which recorded a 2.9% increase for the week, year over year. These are not impressive sales numbers, especially since retail price inflation (CPI) jumped by 4.2% the past year. So it's hard to get excited by these sales figures, especially since consumers had an extra \$78 billion worth of cash last month as a result of the rebate checks. Nor is it good omens for spending later this summer once the last of those rebate checks is mailed out. Clearly, the soft job market, as well as the high price of both gasoline and air travel, are keeping more Americans at home and this appears to be a key factor curbing summertime spending this year.

Construction Spending

The construction spending numbers for May also came out this morning and there's something curious is going on here. Construction outlays overall fell 0.4% during May and dropped 6% since its year ago level. OK, nothing shocking here. Nor could anyone be stunned by the fact that spending on residential buildings plummeted again. It sank another 1.6% in May and was down 26.9% for the year.

What is noteworthy, however, is that the only sector that has consistently surprised on the high side is lodging (hotels, motels, resorts) construction. The value of lodging construction jumped 2.6% in the latest month and soared by 35.7% for the year!! No other sector --- not educational, office buildings, hospitals or shopping malls, not even power stations --- even comes close. Apparently, the cheap dollar has attracted both tourists and foreign investors into the U.S. hotel industry. And while US-sourced capital is scarce these days, financing for lodging can be obtained from domestic and international sources so long as hotel investors are willing to put up sufficient equity up front. For now, hotel construction is at an all time high, while all other types of construction are falling or showing far smaller gains.

ISM – Manufacturing

Another surprise was the June Manufacturing ISM index which managed to squeak by into the expansion range. The purchasing managers index (PMI) rose to 50.2, the first time it settled on the “growth” side in five months. It has averaged 49.9 the last 12 months. But we suspect this bump into expansion territory may be short-lived. New orders --- which implies future production – slipped to 49.6 from 49.7, and exports to fell back to 58.5 from 59.5. At the same time, enough purchasing managers saw prices increase to 91.5 from 87. The price index now stands at the highest in 29 years! Also disturbing is the surge in inventory. If manufacturers are producing goods that ultimately do not get sold, they will end up languishing on back room shelves. That may already be underway. The inventory index jumped to 51.2 last month from 48 in May. According to the ISM, this is the first time in 25 months they’ve seen inventories expand. The accumulation of unwanted inventory may also explain why the employment level dropped back to 43.7 last month from 45.5. It also assures that we’ll see more layoffs in manufacturing when the employment data comes out on Thursday.

Israel and Iran

Overshadowing all the economic data, however, is growing speculation that Israel is gearing up to destroy Iran’s uranium enrichment plants. We assess the probability of such a military strike to be 85%, and that it will likely occur between September and November. As tension builds in the coming weeks, oil prices will bubble up to between \$150 and \$200 a bbl. The price of crude could easily spike to \$250 a bbl. or more once the assault commences. How oil prices behave afterwards, though, will depend on the speed and effectiveness of the Israeli strike and whether the US manages to keep the Strait of Hormuz open. Between now and then, however, we expect to see a gradual shift in asset allocation on a global scale away from equities and into safer assets, such as Treasuries and gold.