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Slower Growth Means the Fed Will Likely Keep the Money Flowing

By Louis Navellier

The S&P 500 rose for the fourth straight week, reaching a new record high of 1692 on Friday. The S&P has risen 5.3% so far in July, despite several weeks of downbeat growth statistics, which point to slower (1.0% to 1.5%) second quarter GDP growth rates. On the positive side, however, this return to slower growth almost guarantees the Fed will keep its money pump in full force for the rest of this year, since Fed Chairman Bernanke re-iterated last week that Fed policies are "data-dependent."

Stat of the Week: Manufacturing Activity Rises Sharply in July

Second quarter growth will likely be disappointing (see next section), but the third quarter is off to a good start. The stock market surged last Thursday after we learned the Philadelphia Fed's manufacturing index rose to 19.8 in July, up from 12.5 in June, reaching its highest level since March 2011. Economists expected a drop to 10, so this was a big surprise. Shipments surged to 14.3 in July, up from 4 in June. In addition, a big (15-point) drawdown in inventories could spark new manufacturing to restock inventories.

This trend was confirmed by the Fed, which said on Tuesday that industrial production rose 0.3% in June, led by a 2.2% rise in home electronics and a 1.4% gain in automotive products. After May's flat reading and April's revised 0.3% decline, June's increase was a pleasant surprise. Looking ahead, industrial demand should continue to rise due to the heat wave covering much of the Northeast and Midwest, as record high air conditioning demand continues to boost utility output and cause natural gas prices to rise.

Also on Tuesday, the Labor Department announced that the June Consumer Price Index (CPI) rose 0.5%, due largely to a 6.3% rise in gasoline prices and higher costs for clothing, food, housing, and medical care. The core CPI, excluding food and energy, rose 0.2%, so the CPI is up only 1.8% in the last 12 months.

The best news last week was that China is still growing fast. The National Bureau of Statistics announced that China's GDP "slowed" to a 7.5% annual pace in the second quarter, down from a 7.7% annual pace in the first quarter. China's GDP has been under 8% for five straight quarters, but 7.5% is still impressive.

A Preview of Next Week's "Flash" Second-Quarter U.S. GDP

Even though the market is up over 8% since June's lows, the last four weeks have also delivered a series of downbeat economic reports that should put a damper on second quarter GDP growth. Last week was no exception, as he heard about disappointing retail sales and housing starts and flat Leading Indicators.

The first "flash" second quarter GDP figures won't come out until next week, but that number does not look very good due to sputtering retail sales, a big surge in the May trade deficit, and falling inventories.

On Wednesday, the Commerce Department announced that new housing starts declined 9.9% in June vs. May. Building permits fell by 7.5%, the sharpest decline in over two years. A 21% drop in multi-family building led the June decline in building permits. Actual housing starts for buildings with five or more units declined by 26.7%, as rising long-term interest rates are making builders more cautious. Since housing has a big impact on GDP, economists lowered their second quarter GDP forecasts.

Then, on Thursday, the Conference Board announced that its 10 Leading Economic Indicators (LEI) were unchanged in June, falling below economists' consensus estimate of a 0.3% increase. This bad news also caused economists to slash their second quarter GDP forecasts even further, to as low as +1.1%.

The Commerce Department also reported last week that June's retail sales rose 0.4%, but that was due largely to strong vehicle sales (up 1.8%) and higher gasoline prices (up 0.7%). Excluding robust vehicle and gasoline sales, retail sales actually fell 0.1%. This is a disappointment, since economists were expecting 0.9% growth. There were some surprising details in the report, such as a sharp 2.2% decline in home improvement stores, a 1.2% sales drop at bars and restaurants, and 1% lower department store sales.

The positive side of this slow growth is that the Fed is also monitoring these downbeat statistics in even more detail, so these trends will likely convince the Fed to continue with its QE for the foreseeable future.

Bernanke Seeks the "Middle Ground" Between His Previous Extremes

On Wednesday, the Fed released its latest Beige Book survey of economic activity. On the positive side, the Beige Book revealed a hot housing market and strong auto sales in many parts of the country, but some notably weak points in the Beige Book survey included sliding steel prices in Cleveland (due to rising imports), stalled office activity in Providence (due to higher interest rates), and slowing venture capital in the San Francisco region (due to a lack of new IPOs). Since the Fed was expecting 2.9% GDP growth in 2013, and the first half will come in around 1.5%, the Fed "missed the broad side of the barn." (Unless we see 4.5% annualized growth in the second half, the Fed's forecasts have been way too rosy.)

Last Wednesday, Fed Chairman Ben Bernanke told the House Financial Services Committee that, "… because our asset purchases <u>depend on economic and financial developments</u>, they are by <u>no means on a preset course.</u>" He added that there is currently no encouraging economic evidence that will allow the Fed to "tap the brakes" or "taper" the pace of QE. He also said the U.S. economy is vulnerable to shocks, including "the debate concerning fiscal policy issues, such as the status of the debt ceiling."

Even more telling, Bernanke said that although the labor market is improving gradually, the job situation "is far from satisfactory." The broad (U-6) unemployment rate, covering discouraged workers and part-timers seeking full-time jobs, rose from 13.8% in May to 14.3% in June, leading Bernanke to conclude that "a highly accommodative monetary policy will remain appropriate for the foreseeable future."

Since the Fed's policy actions remain data-dependent, the recent downbeat statistics mean the Fed will not likely "taper" its rate of monetary easing from $85 billion per month. Bernanke even said the Fed could increase QE: The Fed "would be prepared to employ all of its tools, including an <u>increase</u> (in) the pace of purchases for a time, to promote a return to maximum employment in a context of price stability."

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