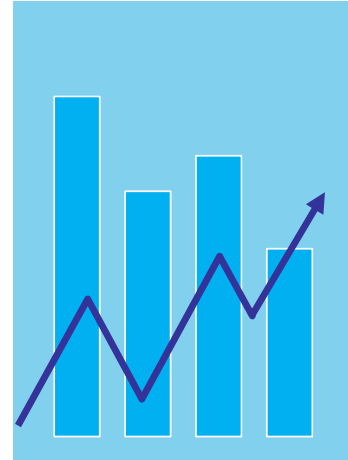




Economic Update

A “Spectacularly Useless” Report



August 2009

Industry Insights

- Overview: Real GDP has declined 3.9% from its peak. This represents the sharpest contraction since the Great Depression. However, Fed Chairman Ben Bernanke in August said that “we have started the recovery process”
- Retail: Outside of autos, little else is selling. Excluding autos and gas, sales have continued to decline
- Motor Vehicles: The White House called Cash for Clunkers “the most efficient piece of economic stimulus done to date”
- Consumer Products: Industrial production continues to decline
- Travel: The Commerce Department reported that US tourism-related spending is contracting faster than the economy as a whole
- Aerospace & Defense: Although production can be volatile, it continues to be one of the brighter spots in the economy. July’s production gain was the strongest since December
- Process & Industrial Products: Production of materials rose but the machinery sector remained in a slump

Economists have been badly beaten up in recent months. Not that we were ever well liked, but lately many have been severely criticized for (a) not giving an adequate forewarning about the worst economic downturn since the Great Depression, (b) the widespread, open disagreements as to who has the better ideas, which led to (c) uncertainty about how best to solve the problem. Articles criticizing the profession have appeared not just in the US, but around the world, including the UK, New Zealand, China, and Japan.

As part of the current debates, long-standing economic theories are being called into question. Econometric models are being discarded. The global economy is being viewed through a different lens. In June, Paul Krugman, a Nobel prize winner in economics, said that most macroeconomics over the past 30 years had been “spectacularly useless at best, and positively harmful at worst.”

One newspaper in Tennessee quoted President Harry Truman who only half-jokingly had asked for “one-handed economists” because his advisors were too fond of saying, “on the one hand ... on the other hand.”

Given that this economy appears to be on the cusp of a recovery, there’s lots of one hand/other hand datapoints out there that some might say are conflicting. Some of the data however are “leading” indicators of where the economy is headed, while others are lagging indicators – they provide insights on where the economy/consumer/industry has been. So some economists, on the one hand, are pointing to things like the rise in new orders, the upturn in housing, and the improvement in the stock market as suggesting that the economy has turned the corner. On the other hand, there are worries that the ongoing deterioration in labor markets, home foreclosures, and personal and business bankruptcies, along with the weakness in bank lending, will keep the economy mired in a recession or at best bumping along the bottom for an extended period. Most of these “other hand” datapoints, however, are lagging indicators for the economy. Still, the vast amount of data is creating confusion and uncertainty.

Yet another issue for the profession is that it takes a while to discern a clear trend. One month’s gain might fall back into negative territory the next month. Major revisions from the government may add to the problem. And often-irrational consumers can make a mockery of the rational mathematical models used to make many forecasts.

It’s no wonder then that economics is often called the dismal science. To get a better sense of the intricacies involved in following the myriad of economic datapoints that are released, move your cursor around this site: <http://www.andyfoulds.co.uk/amusement/economists.htm>

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Consumers Don't Even Know What They Don't Know – But They're Spending Anyway

A June article from a NJ newspaper titled “Economists Don't Even Know What They Don't Know” had little good to say about the profession. And in typical recovery fashion, consumers, not knowing what they don't know about their future financial health, are starting to spend again anyway, albeit cautiously.

Consumers, whose spending currently represents about 70% of real GDP, often are the major force that takes our economy from recession to recovery. As consumers spend more, production picks up because inventories need to be replaced.

More specifically, consumers often open up their wallets first for durable items such as motor vehicles, appliances or other big-ticket items. Less expensive goods such as apparel or toys generally begin to see an improvement in sales somewhat later.

Why historically have consumers started spending again, even as their employment and financial prospects remain dim? One reason is pent-up demand. Things wear out and need to be replaced, even if incomes are suffering. Another reason is that prices become extremely attractive to consumers. Some deals just become too good to pass up. Often, it is the retailers who either sharply lower their prices or offer various kinds of incentives such as layaway or low financing, to entice buyers.

In 2009, the government has been particularly instrumental in offering incentives to the public. Its Cash for Clunkers program has dramatically improved motor vehicle sales. Various analysts expect that August's vehicle sales will be at an annualized rate of 15+ million units, and could end up being the highest in about a year and a half.

Many consumer-facing companies are finding their own ways to entice shoppers. One recent example is a toy retailer that has initiated a “cash for cribs” program modeled after the government's “cash for clunkers” program. Restaurants are offering low-priced meals. Hotels are offering free nights and airfare rebates. The list is long and growing.

Another sector benefiting from government incentives is housing. The government's \$8,000 tax credit for first-time buyers has helped produce a four-month increase in new and existing home sales. Low mortgage rates from the Fed and sharp declines in prices have also made a home purchase attractive to consumers.

Eventually, gains in home sales typically lead to increased retail sales of home furnishings as consumers look to spruce up their new homes. Appliance sales in particular will likely benefit in coming months from rising

Home Sales Are Rising



home sales and the new \$300 million “dollars for dishwashers” federal program also modeled after cash for clunkers. Rebates of between \$50 and \$200 are being offered for the purchase of various energy efficient appliances.

A greater propensity to spend would be most welcome by the retail industry. Retail sales so far in 2009, outside of the very recent gain in motor vehicles, have yet to see any improvement. Year-over-year comparisons remain in record-breaking negative territory. July sales, excluding motor vehicles and gasoline, were down 3.8% from a year ago according to the Commerce Department. It was an unprecedented ninth consecutive year-over-year decline. In comparison, annual sales rose 4.8% on average through the decade ending in 2007.

Year-over-year comparisons however get easier in the second half of the year. Also, consumer confidence is showing signs of improvement and, as discussed, pent-up demand may be high.

Employment-Watching: Almost A Costly Waste of Time

Several publications, including *The Economist* magazine, have quoted others as believing that the study of macroeconomics has been a costly waste of time. The ongoing debates around how best to solve the crisis and where the economy goes from here have left many consumers uncertain and hesitant about spending.

Declining employment, while certainly a concern for those households that are affected, is of minimal value when trying to determine where the economy is headed. As a lagging indicator, it is the end result of companies laying off employees because demand has sagged. In the prior two recessions, employment continued to decline for six months to a year after spending began strengthening. Manufacturers generally only begin hiring workers after their factory utilization rates have sufficiently improved.

What ultimately is more important as a driver of spending is the income of the people who are employed. In the current economy, the July unemployment rate was 9.4%,

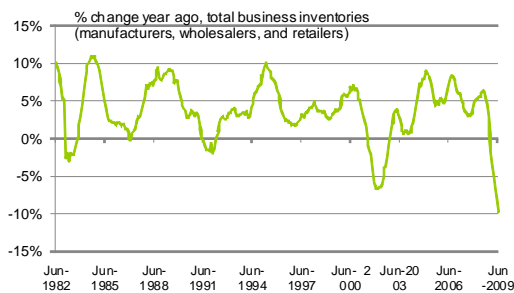
but more relevant to spending was that 90.6% were employed.

Trends in these workers' income however are unclear. The Labor Department publishes real average hourly earnings which has shown strong growth in recent months. Recently revised data from the GDP accounts however show declines in the broader "real personal income less transfer payments" series. The series has been declining for almost a year and a half. This latter series is thought to more closely represent the current state of consumers' incomes. Thus, even though spending gains could soon spread beyond autos and houses, the lack of income growth, coupled with constrained lending from banks, increased savings, and record pay-down of debt from consumers will likely keep spending growth muted into 2010.

Inventories: No Idiocy Here

An April cover story in *BusinessWeek* titled, What Good Are Economists Anyway?, quoted one business writer as referring to "forecasts by idiotic economists." Ouch.

2009 Inventory Liquidation: Fastest Pace on Record



Source: Census Bureau, Haver Analytics

In this recession, companies have been far from idiotic in their management of inventories. Some might argue that corporate executives have been downright brainiacs. In response to the sharp slowdown in demand that began last fall, inventory liquidation since January has proceeded at the fastest pace on record. In June, total business inventories were down 10% from a year earlier.

As a result, some inventories are in need of rebuilding. The Institute for Supply Management's New Orders Index rose in July to a level suggesting recovery in manufacturing. At 55.3%, it was the highest reading in two years. Supporting this data, the Census Bureau reported that the value of manufacturers' new orders has also been improving. Helped in part by government initiatives and improving global demand, orders for such segments as motor vehicles/parts, iron and steel mills, and construction machinery have seen recent upturns, although they remain sharply below their levels of two or three years ago.

Due to the gains in orders, production is starting to ramp up. The Federal Reserve reported that industrial production in manufacturing rose in July for the first time since last October. A large jump in motor vehicle production helped, but even after taking out that sector, manufacturing rose 0.2%. The nonenergy materials component, which includes things like consumer and equipment parts, textiles, paper, and chemicals, had only its second monthly increase in the last year and a half. Not all groups, however, experienced growth. Production of consumer goods (other than motor vehicles and energy) declined 0.2% from June, and machinery production had its 11th consecutive decline.

As a result of the slight improvement in production, capacity utilization has edged up from its dismal low. In July it rose to 65.5%, although this was still 14 points below its long-term average. Sectors whose capacity utilization rates are below the 65.5% figure include primary metals (47.4%), machinery (56.4%), motor vehicles/parts (45.3%), wood products (49.7%), and nonmetallic mineral products (55.2%).

With the sharp swing in inventories in the first half of the year, forecasts for real economic activity in the second half of 2009 are being revised slightly upward. Also, ongoing improvements in capacity utilization should eventually lead to gains in factory construction and generally higher capital spending from businesses as profitability increases. Additionally, the large amount of stimulus money that has yet to reach businesses will likely boost production into 2010.

Travel, Hospitality and Leisure (THL): Maybe Try Winging Darts

An August article in the *Wall Street Journal* discussed the perils of forecasting various industries, including THL. The article commented that "winging darts at numbers on a board" may have more accurate results, particularly with regard to forecasting oil prices.

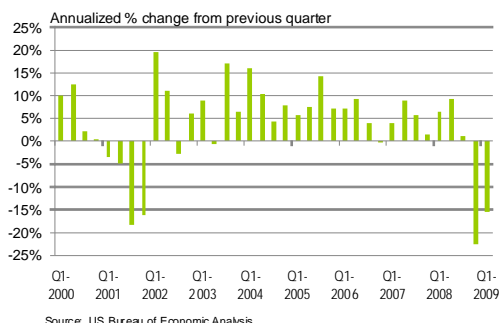
It may also be a better alternative to forecasting travel/leisure demand. There is no recovery in sight for this segment. Various forecasts continue to be revised downward. The latest projection from PKF Hospitality Research indicates that declining hotel demand will not end until the second quarter of 2010. In total, the industry is forecast to experience nine consecutive quarters of declines. RevPAR is expected to be down 18.5% this year and be followed by a 2.7% decline in 2010.

Smith Travel Research (STR) reported that revenue per available room declined 15.7% in July from a year ago. Year to date, revPAR is off 18.2%. Occupancy was down 7.3% for the month and 10.3% year to date.

Economic Indicators				
	2008 Year	May 2009	June 2009	July 2009
Employment (SA change in nonfarm, 000) <i>Labor Dept.</i>	-44*	--303	-443	-247
Unemployment Rate (SA %) <i>Labor Dept.</i>	5.8*	9.4	9.5	9.4
Consumer Price Index (SA % ch. prior period) <i>Labor Dept.</i>	3.8	0.1	0.7	0.0
Consumer Confidence Index (1985 = 100) <i>Conference Board.</i>	58.0	54.8	49.3	47.4
Real Disposable Personal Income (% chg. prior period, SAAR) <i>BEA</i>	0.5	1.6	-1.6	-0.1
Gasoline Price (\$/gal., Reg. unleaded)* <i>Energy Dept.</i>	3.25*	2.27	2.63	2.53
Existing Home Sales (mil. units)** <i>Natl. Assoc. Realtors</i>	4.91	4.72	4.89	5.24
Hotel revenue per available room (% change year ago) <i>STR</i>	-1.9	-20.4	-18.6	-18.2
Motor Vehicle Sales (mil. units)** <i>BEA</i>	13.2	9.8	9.7	11.2
Industrial Production (SA, % ch. prior period): <i>Federal Reserve</i>				
Total Manufacturing	-3.1	-1.0	-0.6	1.1
• Consumer Products, ex energy and motor vehicles	-2.5	-0.1	-0.7	-0.2
• Aerospace and Defense	-2.0	-1.3	0.0	0.9
• Nonenergy Materials	-3.7	-1.3	-0.3	1.2
• Machinery	-6.0	-2.7	-1.5	-0.5
Capacity Utilization, Total Mfg. (%)	78.9	65.1	64.8	65.5
Retail Sales (% change from prior period): <i>Commerce Dept.</i>				
Total (incl. Food Service)	-0.2	0.5	0.8	-0.1
Total, excluding MotorVeh& Gas	1.9	-0.2	-0.1	-0.4
• Motor Vehicles & Parts	-12.6	1.5	1.9	2.4
• Building Materials, Garden	-3.5	0.4	-0.6	-2.1
• General Merchandise Stores	3.3	-0.8	-0.6	-0.8
• Apparel & Accessories Stores	-2.1	0.3	-1.5	0.6
• Furniture & Home Furnishings	-8.0	-0.5	0.0	-0.9
• Home Electronics & Appliances	-0.7	-1.6	-0.2	-1.4
• Food & Beverage Stores	5.1	0.4	0.2	-0.3
• Restaurants & Bars	3.9	0.1	-0.2	0.4

Notes: *Monthly average. **Monthly figure = Seasonally Adjusted Annual Rate. SA = Seasonally Adjusted. SAAR = Seasonally Adjusted Annual Rate. *Italics* = source of data

Spending on US Travel and Tourism Has Plummeted



The Commerce Department's Bureau of Economic Analysis reported that the tourism industry is contracting much faster than the economy as a whole. Total tourism-related spending contracted at an annualized rate of 15.4% during the first quarter and has fallen by \$139 billion over the last two quarters. This represents the largest consecutive-quarter contraction in the industry's history, noted Commerce. Sectors that have experienced the sharpest declines include auto rental, air transportation and lodging. Purchases of tourism-related goods and service reached \$1.35 trillion in 2008.

The falloff in travel has led to a pullback in hotel construction. The July STR/TWR/Dodge Construction Pipeline Report noted that the number of rooms in the active pipeline was down 26.2% from a year ago. The active pipeline includes projects in construction and those in the planning stages. With lending tight and demand expected to remain weak, the pipeline numbers are expected to continue to contract.

The Cruise Line International Association reported that American passenger traffic on cruise ships declined 1.7% in 2008 although total spending rose 2%. The Air Transport Association expects 3.5% fewer air passengers over the eight-day Labor Day period. All around, the various subsectors of THL could use some wings to lift above the depressing news of late.

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