High Frequency Economics®
Daily Data Analysis and Assessment of the Global Economy

Daily Notes on the **United States**

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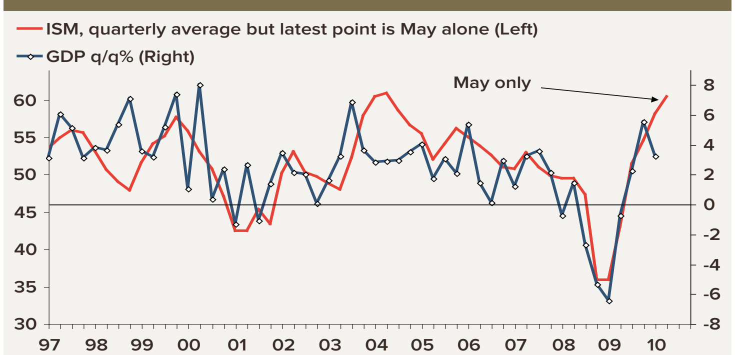
ISM Has Likely Peaked, Though At A High Level

The 0.7-point dip in the ISM manufacturing index in May left the headline number at 59.7, which is still very high. If all companies were performing as well as ISM members, it would be reasonable to expect the economy as a whole to be growing at a quarterly annualized rate of about 7%, as our chart shows. Growth is nowhere near that pace, however—for now, we are sticking to our 2% working assumption for the second quarter—because small firms and businesses in the non-manufacturing sector are doing much less well. ***As the typical U.S. company is a small, service sector business, that's a problem.*** We expect next week's NFIB survey of small firms to show that although conditions are improving slowly, they remain incredibly depressed.

If Only All Companies Were ISM Companies...



We think the ISM manufacturing index has now peaked. *Over the past year the survey has been hugely boosted by the rebound in exports and inventories, both of which plunged in the aftermath of the Lehman failure.* Export orders are still rising strongly, with the export orders index rising a point to a new cycle high of 62 in May. That's consistent with actual goods exports rising at a year-over-year pace in excess of 20%. Right now, that is eminently achievable, because exports are rising from such a low post-Lehman base, but once the anniversary of that rebound arrives, in May and June, it will be much harder to maintain those sorts of rates. *Looking further ahead, the strengthening of the dollar will represent an increasingly strong headwind by the fourth quarter.*

Inventory-building, meanwhile, will continue, but we expect no further significant increase in the rate at which companies are adding to stockpiles. That's a problem, because inventories only add to GDP growth when they are *accelerating*, not rising at a steady pace. The change in the rate of change is what counts. In May, the ISM inventory index dropped 3.8 points to a five-month low of 45.6. That looks too low to be sustained, based on the historical relationship between orders and inventories, but the index shows no sign of trending higher. That is consistent with data showing that the inventory-to-sales ratio in manufacturing is now not far off normal levels.

Yesterday's other economic report, on April construction spending, was startlingly strong, with gains across the board. The biggest single contribution to the 2.7% headline increase came from private residential construction, which jumped a huge 4.4%. *We assume this is due entirely to the homebuyer tax credit, which pulled people into the market.* Transactions have to close by June 30, which means builders have until then to complete the homes for which people have signed contracts. We expect a further big increase in May, little change in June and then a big drop in July and the rest of the summer as the post-credit void in demand hits.

In the non-residential sector, we are unconvinced by the 1.7% rise in private activity, which is very volatile and prone to hefty revisions. The underlying trend is sharply downwards; it is a very long lagging indicator of the economic cycle. But public sector spending was up for the second straight month, after seven straight declines. Residential spending was up for the third straight month, to stand 19.6% higher than a year ago. This looks like stimulus spending to us, and we expect further gains over the next few months. *Public construction accounts for only 2% of GDP, but we are happy to see it rising.*

HFE's Economic Forecasts

GDP	Q3 final	2.2%	2007 year:	2.1%
	Q4 final	5.6%	2008 year:	0.4%
	Q1 second	3.0%	2009 year:	-2.4%
	Q2 forecast	*2%*	*2010 year:*	*3%*
	Q3 forecast	*2%*		

CPI	Apr.: -0.1% (2.2% y/y); core 0.0% (0.9% y/y)
	Jun. 2010 forecast: 0.8% y/y; core 0.8% y/y
	Dec. 2010 forecast: 0.5% y/y; core 0.3% y/y

Unemployment: June 2010, 9.5%; Dec. 2010, 9.4%
Federal budget FY 10 forecast: -$1.75T (12.3% of GDP)

HFE's Financial Forecasts

		End-month:			
	4:30pm Tuesday	**Jun**	**Sep**	**Dec**	**Mar**
Fed funds	0-to-0.25	0-to-0.25 through Dec 11			
2-yr	0.77	0.75	0.75	0.75	0.75
10-yr	3.27	3.25	3.25	2.75	2.50
30-yr	4.18	4.00	3.75	3.25	3.00
Curve 10-2	250	250	250	200	175
Curve 30-2	341	325	300	250	225
Dow Jones IA	10024	10250	10250	10250	10750

Dollar: Euro to sink to new lows, intervention will not help. C$ to get a boost after BoC rate hike.

The Last Hurrah For Pending Home Sales

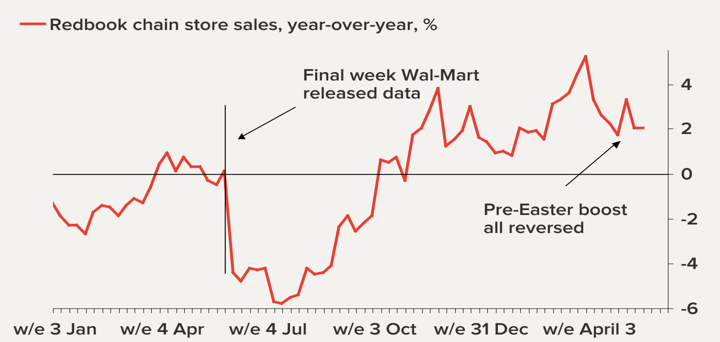
The problem with time-limited tax credits, in the housing market or elsewhere, is that they have the unfortunate habit of pulling forward activity until the expiration date, after which it collapses. *This volatility in activity is the price paid for higher average levels of sales across the year as a whole than would have occurred without the tax credit.*

Right now home sales are surely falling. In order to qualify for the homebuyer tax credit, contracts had to be signed by April 30, with closing by June 30. The pending home sales index due for release this morning is for April, so it will capture the final surge in activity before the credit expired. We look for a 5% increase, but this is largely a guess, and we are prepared to be surprised in either direction.

The index is based on contract signings, so we have to expect a hefty drop in May. What happens after that is unclear. Affordability is great and improving by the day as mortgage rates drop in the wake of the decline in Treasury yields. What we do not know, though, is whether the fear of capital loss and job loss has faded enough for people to be willing to take advantage of the cheapness of homes.

Today also brings the final Redbook chain store sales numbers for May. The month started quite well but sales then faded; a 2.5% year-over-year gain for the month as a whole is likely, little changed from April. *The bad news is that this would be consistent, we reckon, with a sharp drop in core retail sales between April and May, though the translation from Redbook to the official numbers is not always straightforward.* Note, by the way, that year-over-year Redbook sales will jump sharply next week thanks to basis effects. Wal-Mart stopped releasing weekly sales numbers in June last year, depressing the Redbook year-over-year rate by about four percentage points.

Redbook Softened As May Progressed



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This Week's Funding

Tue	Announcement—4-week bills (June 2)
	Auction—$27B 3-month, $27B 6-month bills
Wed	Auction—4-week bills
	Auction—$25B 52-week bills (settles June 3)
Thu	Announcement—3-month, 6-month bills (June 8)
	Announcement—3-year notes (June 8)
	Announcement—10-year notes (June 9)
	Announcement—30-year bonds (June 10)

This Week in Brief

Note: "SS" prefix denotes Snapshot for these data.

Monday, May 31

- **Memorial Day Holiday**

Tuesday, June 1

- **SS: ISM Manufacturing Survey (5)/10:00 EDT**
  The headline index dipped marginally, to **59.7** from 60.4. Almost all the decline was due to a sharp drop in the inventory index. Orders were unchanged, and employment rose.
- **SS: Construction (4)/10:00 EST**
  Spending jumped a massive **2.7%**, with gains across the board but especially in private housing, thanks to the tax credit.

Wednesday, June 2

- **MBA Mortgage Applications (5/28)/7:00 EDT**
  The purchase index should rebound from last week's 13-year low of **185.7**. Applications have plunged since the homebuyer tax credit expired, but falling mortgage rates should soon start to pull people back into the market.
- **Redbook Chain Store Sales (5/29)/9:00 EDT**
  Growth should be close to last week's **2.0%** year-over-year.
- **SS: Pending Home Sales (4)/10:00 EDT**
  Contracts had to be signed by April 30 to qualify for the homebuyer tax credit, so we expect a further **5%** increase in the index. **Consensus: 4.3%.**

Thursday, June 3

- **SS: ADP Employment (5)/8:15 EDT**
  We expect the ADP measure of private payrolls to rise by about **100K**, a bit better April's 32K gain. **Consensus: 56K.**
- **SS: Initial Jobless Claims (5/29)/8:30 EDT**
  Claims should be close to last week's disappointing **460K**; the underlying trend is now flat at best. **Consensus: 450K**.
- **Productivity and Unit Labor Costs (Q1r)/8:30 EDT**
  Productivity should be revised down to **3.3%** from 3.6%. Unit labor costs should be revised up to **-1.2%** from -1.6%. **Consensus: Productivity 3.4%, unit labor costs -1.3%.**
- **SS: ISM Non-Manufacturing Survey (4)/10:00 EDT**
  The headline index should nudge up to about **57** from 55.4, following recent core retail sales gains. **Consensus: 55.9.**
- **Factory Orders (3)/10:00 EDT**
  The 2.9% jump in durable orders implies a **2.0%** increase in factory orders. **Consensus: Orders 1.8%.**

Friday, June 4

- **SS: Employment (4)/8:30 EDT**
  We're guessing payrolls will jump by about **500K** as hiring for the Census accelerates, but just about anything could happen. Private payrolls should rise about 150K, and we expect April's 231K private number to be revised down. The unemployment rate should drop to **9.7%** from 9.9%, while hourly earnings should rise **0.1%**. **Consensus: Payrolls 540K, unemployment 9.8%, earnings 0.1%.**