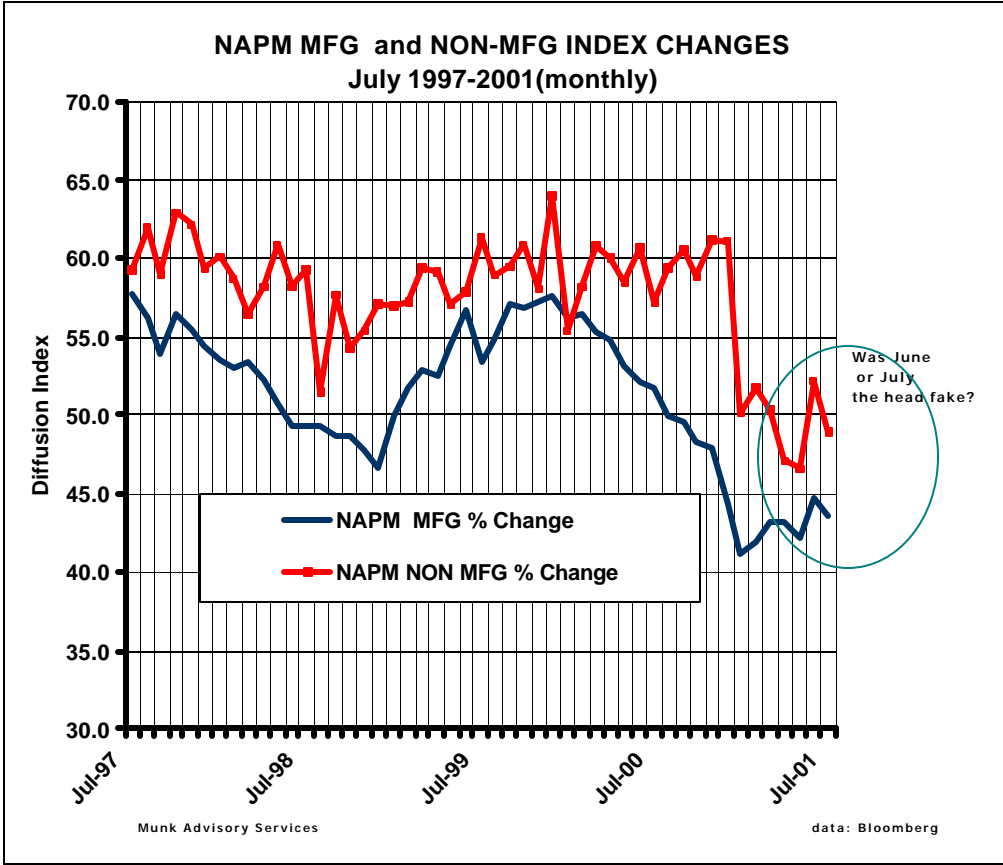


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Which Month's Data To Believe

Today's employment report showed no decline in measured unemployment but a continuing drop in manufacturing jobs. Service employment also grew only slightly. The absence of any change in the unemployment rate (4.5%) rested largely on the growth the government sector. Growth in government employment is likely to continue with the rise in government expenditures at least in the immediate future, but that is not what we look for to enable 'recovery.'



The market was "surprised," apparently, because the **absence** of rising unemployment is thought to weaken Fed resolve to cut the Funds rate further. The behavior of the NAPM non-manufacturing index was also a disappointment for those thinking that we are bottoming out. While the index remains below 50 (and thus indicates further contraction), **a rising index would have signaled that the rate of decline was slowing**. In failing to show a slowing of the contraction, the non-manufacturing index mirrored what the manufacturing data indicated earlier in the week.

July's behavior for both series raises a puzzle: which 'month' points out the true path? Is the rate of contraction rising or slowing? June showed a rise in both indices, a signal of deceleration in the rate of decline. To fall back from June's 'improvement' is clearly a negative signal for those believing that we are

coming to the end of the economy's decline.

One data point won't make or break the case for a further Fed cut in August, but **the NAPM non-manufacturing index points to the growth of continuing weakness**. Further, it seems to indicate another **bump** in the road to recovery. **Our take on the signal is that it will encourage the Fed not to give up its course of monetary ease too early**. An "investment bust" is an infrequent cyclic disturbance and we should give ourselves some latitude in what to expect from the Fed. They have to be looking through the glass darkly.

Since the "core" of this "growth recession" has originated in the excess capital investment created during the Long Boom--the importance of the manufacturing sector will dominate Fed thinking, even though manufacturing makes up less than 20% of GDP. Why? It is impossible to think that the economy can resume anything close to its potential growth rate (3-3 ½%) with a badly lagging manufacturing sector. July's reversal of June's apparent improvement will de-emphasize the weight given to one particular month and accentuate the importance of the trend. The trend is still down, but if you look mainly at the trend, you tend to discount this week's disappointment. It is simply very hard to tell if the slope is getting steeper or not. What you know for sure is the economy is not yet recovering.

A pessimist can read this data more ominously. July could be interpreted to mean that the June "uptick" was a ledge---and the economy has fallen down one more leg. That would also certainly keep the Fed in the game longer. They can just ignore the 'favorable' UE number. Manufacturing order data was clearly poor (Y-on Y percentage change was -6.4% for May, although one can make an admittedly weak case that the **month to month declines are getting smaller**. It is not the scribbling of some 'defunct economist' that haunts this cyclic disturbance. It is the troublesome second derivative on many of the data series!

We will stick to our "bumpy road" metaphor. It is just too hard to tell the slope of the road when you hit a bad pothole, and close this week's evaluation with a 'soft' observation about importance of the employment report from another perspective: **income maintenance**. Average hourly earnings in manufacturing were flat, but hourly earnings rose for all private employees as did weekly earnings. While the rise in wage rates affects profits negatively in a profits recession, it also helps to extend the consumer's staying power.

The tug of war will continue, another powerful incentive for the Fed to keep pulling its oar.