

Aftershocks

April 2. The consequences of the record-setting earthquake in Japan, coupled with the attendant tsunami and followed by severe problems with a nuclear power plant, are still unfolding. Beyond the immediate damage to property and loss of life, there are concerns about longer-term effects on Japan's economic growth. Manufacturing in areas not directly harmed by the earthquake has been affected by the damage to transportation infrastructure and the compromised electrical power generation. Japan's role in the global supply chain could be tested as well. For example, shortfalls of some critical parts for auto manufacturing may emerge, leading to temporary idling of auto plants outside of Japan.

Thus far, the markets have reacted without panic to this extraordinary calamity. As bad as the problems are, investors seem to believe that Japan will meet the challenge.

Housing

The earthquake that was the collapse of the U.S. housing market continues to generate its own aftershocks. A year ago the housing market seemed on the road to recovery, boosted by the temporary income tax credits for home buyers. Sales of new homes began to lag in the summer, perhaps because sales had been accelerated for the tax benefit, an aftershock of the end of the tax credit availability. Unfortunately, new home sales continue to lag.

In February the government estimated that just 19,000 new homes were sold, the lowest number since the figures began being compiled in 1963. That would work out to an annual seasonally adjusted building rate of 250,000 homes, also the lowest ever. Was the unusually harsh winter weather in February the culprit? Probably not, because the 12-month period ending in February also set a record low, at 349,000 units.

Sales of existing homes touched their lowest level in nine years in February, ending three months of gains. The median home price fell 5.2% from the year-earlier period. The \$156,100 average home sale price was the lowest since April 2002. Last October, economist Gary Shilling predicted that housing prices would drop an additional 20% before reaching bottom. In March, he publicly stood by that prediction.

Housing faces a tsunami of challenges. Excess inventory, more foreclosures and weak demand due to continuing high unemployment are all contributing to retard the recovery.

Inflation

Low core inflation has been a positive note so far this year. However, core inflation excludes food and fuel, whose prices are notoriously volatile. Recently, those components of the cost of living have gone up rather sharply. In March the President of the New York Fed, William Dudley, gave a speech in Queens, New York, on the economy's progress. When he was asked about inflation, Mr. Dudley responded that many prices are going down, and some items are getting better without increasing in price. "Today you can buy an iPad 2 that costs the same as an iPad 1 that is twice as powerful." To which someone in the crowd responded, "I can't eat an iPad."

Interest rates and inflation have been held in check by "Quantitative Easing 2," the Fed's program of buying U.S. Treasury debt. Market observers are divided as to what aftershocks to

expect when the program ends in June—if it does end on schedule. A significant drop in demand for Treasuries, coupled with the continued increasing supply, could push interest rates higher. That would be great for savers, but perhaps not so good for the fragile economic recovery.

Capital spending

To stimulate economic growth this year, the December tax legislation allows for 100% depreciation of certain investments in capital equipment this year. The break falls to 50% next year, before returning to the normal depreciation schedules. A better tax break should be a powerful incentive for deciding to invest sooner rather than later.

To date, the data are not demonstrating a rush to invest. Durable goods orders fell 0.9% in February, after posting a 3.6% gain the month earlier. Before the numbers were released, Bloomberg News reported the median forecast of 80 economists was for a 1.2% gain. Perhaps the difficult weather in February was again the culprit. Perhaps the fact that IRS guidance on the 100% depreciation rules wasn't released until March led to delayed investments. Alternatively, U.S. companies may not have a pressing need to replace outdated equipment, or the continuing economic uncertainty may be offsetting the temporary tax benefits.

Consumer sentiment in March fell to its lowest reading in a year. Higher gas and food prices got the blame, with consumers expecting inflation to reach 4.6% over the next year. Unfortunately, some portion of the stimulative effect from the December tax legislation is being dissipated in the higher prices for ordinary living expenses.