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ECONOMIC TALKING POINTS

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You Call This a Recovery?

In the last few weeks a growing number of investors have concluded that the prospects of a recovery in the second half are fading fast. They saw rising unemployment, falling consumer confidence and setbacks in the stock market as signs that an economic upturn is not in the cards until next year at the earliest. Whatever "green chutes" have appeared in recent months will not turn into trees, they believe, but instead shrivel up and fall apart because the business climate remains exceedingly hostile.

Are they right? Has the recovery been pushed back to 2010?

No! And we're not going to waffle on this.

From a technical standpoint, there is mounting evidence the 2008 – 2009 recession is essentially over. (We'll specify some of that evidence below.) After contracting three straight quarters, we expect to see the economy finally show a positive GDP in the third quarter, and there's still a chance we could squeeze out some growth in the just ended second quarter. As far as we are concerned, the debate should now shift from "how much longer will this recession last?" to "what comes next?" given the economic free fall has ended. In terms of our forecast, what comes next is a lackluster recovery, probably the weakest we have seen in many business cycles. Indeed, we can foresee an abundance of stories coming out with a central theme that asks: "You call this a recovery?"

The short answer to that question is yes! A feeble recovery is still a recovery -- even though it may not feel like one for most Americans. Our analysis suggests it won't be until the second half of 2010 before we achieve a more palpable upturn in economic activity, particularly in terms of employment and business sales.

Why such slow growth the next 12 months? Let's be realistic. No one can reasonably expect the economy to shrug off in just 18 months the most catastrophic financial, housing and employment collapse since the Great Depression. The damage done to the credit markets and the historic loss in household wealth make a spirited, v-shaped rebound an impossibility. History is replete with examples of recessions far less damaging yet they still labored hard to stage a comeback. During the 1990 – 1991 downturn, the recovery commenced in March 1991. Yet the jobless rate didn't peak until more than a year later! After the 2001 recession ended in November, unemployment didn't top out until 19 months later!! That's why we noted earlier this year that this could well become the mother of all jobless recoveries.

The second major constraint to growth are the many hurdles still faced by banks. No economy can thrive in the absence of a viable credit market and we're still far from waving the green flag that the financial crisis is over. One area of great concern is potential hit banks could still take from failing commercial real estate loans and credit card losses. That's the next wave of problems to monitor because it could lead to further substantial write-downs and generate new balance sheet troubles.

But even that is not the biggest hurdle financial institutions face. What's blocking the flow of credit is the continued shut down of the securitization market. Banks and other lenders need a workable market to securitize and sell off asset-backed securities tied to mortgages, credit cards and auto loans. Securitization allows credit to re-circulate. It provides institutions with fresh funds to make new loans. The problem, of course, is that the latest financial crises shed light on just how risky and opaque these investments can be. Those who bought asset backed securities suffered significant losses and now largely shun them. Not even government programs such as the TALF and the Public – Private Investment Partnership have made much headway to revitalize the market. With securitization dead in the water, banks issuing new loans may have to keep some on their books. That may be distasteful to lenders since they're trying hard to raise capital and shrink the asset side of their balance sheets. So until the securitization market comes back to life, the 2009 -2010 recovery will not be able to generate much steam.

In an attempt to discuss these and other issues in greater detail, we've put together a collection of some frequently asked questions we get from clients about the economy.

Q: Come on, is the recession really winding down? Isn't this just a trap for investors in the equity market?

A: Whenever the economy switches tracks from growth to recession, or the reverse, it is often accompanied by a mix of conflicting statistical data that can muddy up our understanding of the economy. In a perverse way this is good. After all, when an economy is sinking, virtually all indicators point southwards. When it is expanding, the economic data uniformly head higher. It is during periods of transition that we struggle with the simultaneous release of both positive and negative numbers. In moments like these we have to focus on those indicators that, in combination, have the greatest predictive validity in terms of where the economy is headed. Our conclusion from recent data is that the business cycle is turning away from recession and shifting towards growth, anemic as it may be. Let's go down the list.

- The number of jobs eliminated in the private sector has fallen from an average of 700,000 a month in the first quarter, to 440,000 a month in the second period. The worst of the job destruction is over.
- New applications for unemployment benefits are beginning to edge down.
- Consumer spending has picked up this year and that trend should continue now that the erosion in net household worth has run its course.
- New home construction, as well as monthly median home prices and sales on existing homes, are all moving higher.
- As business inventories continue to shrink, companies are starting to replenish their stocks. With more orders inexorably comes higher production and new hiring. Keep an eye on the industrial production and capacity utilization numbers this summer quarter. We suspect the June numbers (which showed production declined by the smallest in 8 months) could well be the cyclical low. An increase in output from this point on would be a strong sign that a recovery is in the works.
- The US trade deficit stands at its lowest level in a decade and that should contribute to growth.
- The private capital markets are showing early signs of life again. Large nonfinancial companies have secured new funds in the debt and equity markets. Moreover, the 19 largest US banks have raised more than $100 billion in capital from private investors and asset sales since March. Some have banks have even repaid their TARP money to the government.

Put it all together and we are calling for GDP to be on the positive side of the ledger this quarter, with growth averaging less than a 2% rate in the second half. Again, at such a sluggish pace most Americans will not be able to discern a recovery from recession, and that will pose new challenges for investors, business leaders, and policymakers. For a recovery to be palpable, we'll need to see several quarters of at least 3% growth, something not likely to take place until late next year at the earliest.

Q: You said one source of strength for the economy is consumer spending. But will consumers resume spending even as the unemployment rate keeps climbing?

A: We have to be realistic here. The days of excessive spending and borrowing by households are over. The party has ended. What we see is a resumption of expenditures, but with more discipline. Americans will limit spending to within their means rather than relying increasingly on debt or on savings as a way to finance their lifestyle.

Insofar as the relationship between consumer outlays and rising unemployment rates, here the answer may surprise you. There is no firm correlation between the two, particularly after a recession ends. Once a recovery has begun we typically both consumer spending and the jobless rate move higher. (See Chart 1.)

There are two reasons for this, one technical and the other cyclical. Technically, the unemployment rate often continues to move up long after a recession ends. That's because those who completely gave up looking for work during the recession out of frustration are no longer counted as part of the unemployed. However, once an economy starts to grow again, those who were earlier too discouraged to look for work turn more hopeful of the opportunities and tend to resume their search. Once they do, they are counted back as unemployed and that causes the jobless rate move higher.

There is also a cyclical factor to consider about consumer spending. The 90% of Americans who have jobs are also likely to cut back spending during an economic downturn because they worry about their own job security. Yet once a recession ends and the economy pivots towards recovery, there is a sense of relief that the worst is over and that alone can increase confidence and quickly spur more spending by those who still hold jobs.

Chart 1:

First 12 months of recovery after 1990 – 1991 recession

March 1991 – March 1992

Unemployment rate jumped from 6.8% to 7.4%
Consumer spending rose 2.9%

First 12 months of recovery after 2001 recession

November 2001 – November 2002

Unemployment rate climbed from 5.5% to 5.9%
Consumer spending increased 1.9%

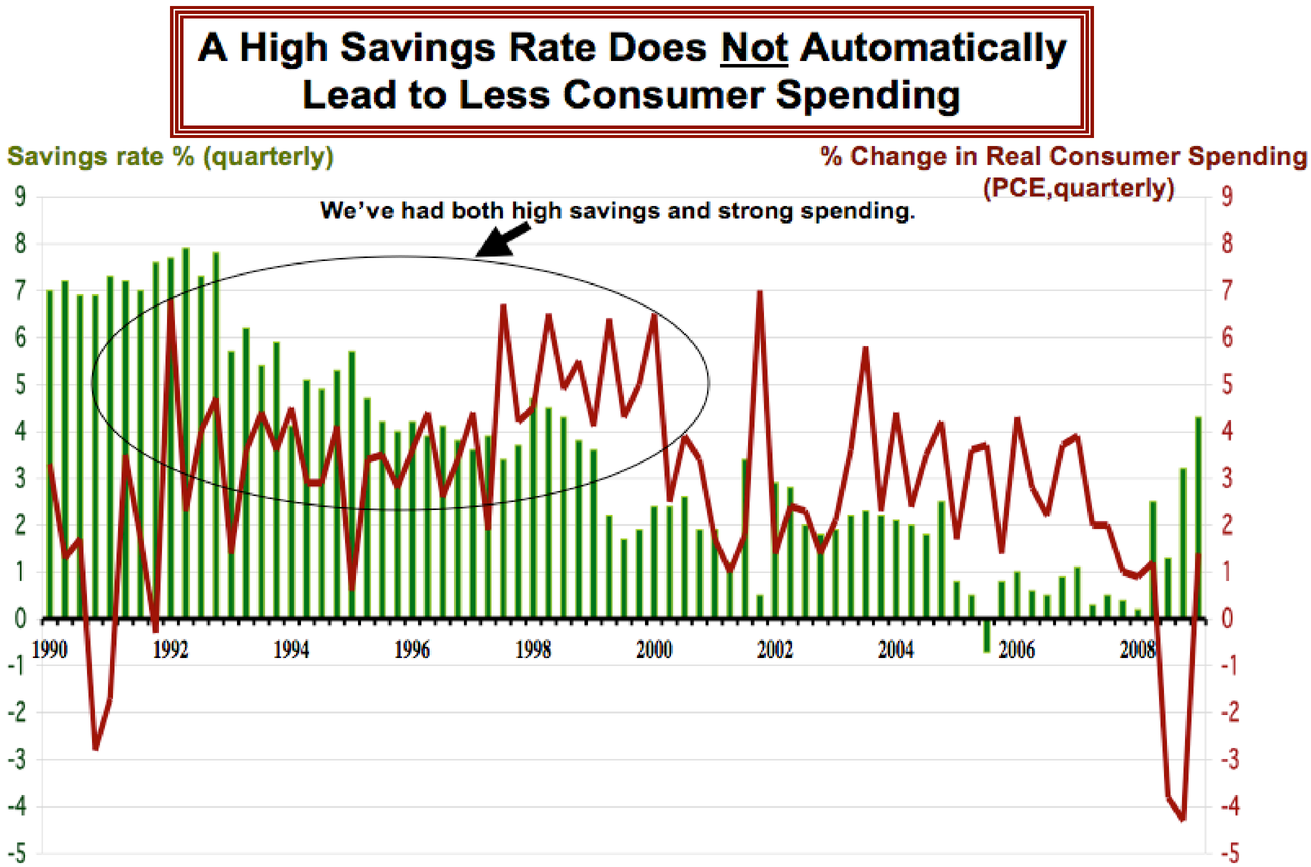
Q: Americans are also saving more of their income. Doesn't that mean they will spend less?

A: Not quite. Again, take a look at the chart below and you will see that Americans can increase spending even during periods of higher savings.

Imagine a worker making $100 a week after taxes who then decides to saves 5%. That means he saves $5 and spends $95 a week. Now let's say the employer rewards that worker with a modest 3% increase in pay. That employee now receives $103 a week and continues to save 5%. The result: He now sets aside $5.15 as savings--- but is as able to still spend $97.85, more than before the small raise.

There is one other important factor to consider. Suppose there is no increase in pay at all. So long as we have deflation with retail prices are falling, as is currently the case, income still rises in real terms. Remember, in deflationary environment, cash is king. You can buy more with each dollar earned because the general price level has fallen. That translates into real purchasing power. Case in point: While average hourly earnings over the past 12 months has slipped from 3.9% to 2.7%, real (inflation-adjusted) earnings has actually jumped by more than 4.5% because consumer prices have been falling. That allows households to purchase more even though the growth in nominal pay is slowing.

Chart 2.



Q: How is it that business inventories are declining when we're in the worst global recession in decades? Who's buying these goods?

A: Inventories typically decline during a recession. This is so because manufacturers shut down plants and reduce production. Yet spending never completely ceases even during a severe downturn. The economy, as awful as it was this past year, still generated $14 trillion worth of business. In other words, someone is still buying products. It could be certain U.S. companies, the government, foreign buyers and even US consumers possibly taking advantage of deep discounts. Just because we're in a severe recession doesn't mean the economy turns static. At some point, inventory levels become so lean businesses have little choice but to re-order from wholesalers and manufacturers. After all, you can't sell anything you don't have. So here's the good news. We are now at the stage where companies have begun to replenish their stockrooms. We see this in the ISM manufacturing survey and with the government's own report on durable goods orders. Both have jumped recently. Even the New York Federal Reserve has detected a change. New orders from its Empire State manufacturing survey climbed in June by the most since the start of the recession. This kind of inventory correction has traditionally helped fuel a recover. A sustained increase in orders eventually gets manufacturers to rev up dormant assembly lines and that can lead to more employment.

Q: So is another stimulus package coming, or not?

A: Another major round of stimulus is unlikely. If GDP growth turns positive the second half of the year, a scenario we foresee, then it's unlikely we'll have another large stimulus package. Bear in mind, only $53 billion of President Obama's $787 billion stimulus program has been spent so far. That's amounts to less than 7%. Most of the remaining package will be available next year. That round of stimulus, along with efforts by the private sector to increase spending will eventually accelerate growth past 3% by the end of 2010. Given all the concerns about trillion dollar budget deficits, we believe Congress will not pass a new stimulus under this scenario.

Q: With so much stimulus and money pumped into the US economy, won't inflation come roaring back?

A: There is no inflation threat out there, not next year or in three years from now. We're all aware of unprecedented liquidity the government has injected into the economy. But in the final analysis inflation pressures heat up once the demand for goods and services begins to strain the economy's ability to provide all those products. We are nowhere near this point are not likely to get there for at least another half a decade.

Here's why. US industrial firms have a record amount of their facilities sitting idle. Some 30% to 50% of the nation's factory equipment is now idle. And it's not just US producers that are shutting off the light at some of their factories. There's a massive amount of excess capacity with manufacturers all over the world. The point here is that output can increase with ease once a recovery takes hold.

Moreover, 14.7 million Americans are unemployed, the most ever recorded. With so many out of work, the growth in wages has been exceptionally weak. That alone will keep inflation well under control since labor costs make up two thirds of business expenses.

There are other reasons why inflation will remain subdued. Individuals and companies are still in the process of deleveraging and that by nature is deflationary. In addition, productivity, another anti-inflationary force, tends to improve at the beginning of a recovery. Concerned about oil prices? Don't be. When you combine a serious global recession with a glut in oil inventories, it's just folly to think the cost of crude would keep climbing. Ultimately it's fundamentals that drive oil prices, which is why we are now more likely to see it hit $50 before it returns to $70. Even if the US economy bounces back, other big consumers of oil, like Europe and Japan, are about six months to a year behind the economic curve.

We can sum it all up by saying that the output gap --- the difference between what the economy is capable of producing when its operating on all cylinders and what the economy is producing now --- is now so wide that we will not close that gap for several years even if growth exceeded 3.5% annually.

Q: Won't all these horrific budget deficits and the massive federal debt trigger inflation?

A: No, there is no definitive link between large deficits and inflation (unless, of course, those deficits take place when the US economy is operating at full speed, a highly improbably scenario the next five years).

Very large levels of government debt in Japan have, if anything, been accompanied by deflation --- not inflation. The Nordic countries have had both large increases in debt and a collapsing currency, yet inflation remained subdued for them. During World War II, the US took on lots of debt, often monetized by the Federal Reserve. But, again, it did not result in an increase of inflation.

Q: What about the US dollar? It seems nearly every country is talking about replacing it as a world reserve currency. Is the dollar about to plunge in value?

A: The US dollar will gradually weaken over the next three years. But an outright collapse is extremely unlikely. No do we see any other currency or basket of currencies replace the dollar as the premier world reserve currency for at least the next decade. Sure, China, Japan, Russia and other countries have expressed concern that the surge in US government spending and borrowing could damage the dollar and reduce the value of their holdings in US government securities. But these worries are also based on some questionable assumptions.

First, the big jump in the federal deficit is temporary as the government tries to offset the most severe economic contraction in 70 years. Second, US investments still look attractive. Chances are this economy will be among the first in the global community to emerge form recession, something that has not escaped the attention of investors. Despite all the critical rhetoric by foreign leaders over the dollar, a recent IMF report noted the dollar's share of currency reserves around the world actually **rose** in the first quarter to its highest since 2007! The share of dollars in global currency reserves jumped to 65% the first three months of this year from 64.1% in the final quarter of 2008. The euro's share slipped to 25.9% from 26.5%, and the yen's share fell to 2.9% from 3.2%.

More recently, foreign investors proved to be eager buyers of US government paper in the latest series of Treasury auctions.

Secondly, no major exporting region (hint: China, Japan and Europe) want to see a significant depreciation in the dollar because it would cause their own currencies to appreciate in value and that will harm exports.

Finally, the US current account deficit has been slashed as a result of falling oil prices, which means our need to rely on foreigners for financing has greatly diminished.

Having said that, we believe the dollar will weaken gradually over the long term. Once the global economy recovers, investors will look increasingly outside the US for higher returns, with Brazil, India, and China looking most attractive. That will divert capital flows away from the US and cause the dollar to depreciate in the FX markets. Nonetheless, the dollar will retain its status as the premier world reserve currency for the next decade. While the greenback may appear like an aging boxing champion after reigning supreme since World War II, there just aren't any other contenders out there than can take away its title any time soon.

Q: What economic risks do worry you?

A: We have a few. Here's the list.

1. Once the economy is on the road to recovery, we will carefully watch to see if the government has the know-how and the willingness to extricate itself form the private sector. How quickly and effectively the government disengages from the banking, insurance and the auto industries is critically important. Washington's unprecedented stake in the corporate sector represents a major distortion in the economy and capital markets. The sooner the government departs and allows market forces to resume, the more confident global investors, business leaders and consumers will be about the economic prospects. We expect the US will largely exit by 2011. If not, it will be problematic for the economy to gain any speed.

2. We want to see a credible plan to reduce the federal budget deficit over the medium and long term. Failure to do so could increase inflation expectations among investors. Our concern would then be that that Federal Reserve will find it necessary to tighten more aggressively. That could be dangerous for a fragile economy that's still shaking off the worst economic rises in 70 years.

3. Once the recovery takes hold, we'll monitor how Federal Reserve proceeds to absorb all the emergency liquidity it shoveled into the economy. Bernanke is scheduled to discuss the Fed's methodology before Congress next week. The key is to sop all those excess funds without causing any disruptions in the market. It won't be easy. The consequences of failure would be horrendous. Confidence in the Federal Reserve would plummet and that might fire up inflation expectations. Watch those bond yields as a gauge of how well the Fed is perceived to be doing on this front.

4. We also expect geopolitical tensions to reach fever pitch levels the next 18 months, as North Korea steps up its belligerent actions and Iran edges closer to the point of no return in developing nuclear weapons. Should these threats erupt into a full-fledged crisis, it could be damaging blow to a fledgling global economic recovery.