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ECONOMIC TALKING POINTS

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June 30, 2009

The Debate Has Shifted: Prepare For a Stronger Recovery

We have traveled extensively the last three months, both in and out of the country, visiting clients and speaking at conferences. One of the gratifications from these trips was how often people came up to acknowledge the accuracy of our earlier forecasts. Not only did we pick up signals back in late 2008 that the recession was winding down, it also became clear the residential real estate sector was in the process of bottoming out as well.

To my surprise a few even recalled a piece I wrote for *TIME* a decade ago alerting government officials of a cataclysmic financial crises after seeing banks and investment firms recklessly take on excessive derivative risk without fully understanding the dangers these securities pose in the event of a downturn in the business cycle.

What really surprised our clients and provoked the most questions, however, was our assessment of what comes next for the economy. Not only do we see a recovery commence in the second half of 2009, the probability has risen that growth in 2010 will turn out to be stronger than what most analysts currently foresee.

Let's Begin With Our Earlier Forecasts.

By virtually all accounts, the debate has now shifted from "how long and how destructive will this recession be?" --- to – "now that the recession is losing its grip on the economy, what kind of recovery can we expect?" Back in October of last year, we first came away convinced that the most severe economic contraction of the last 65 years will give way to a recovery in less than a year. That transition ---- from recession to a trough to a recovery --- has now begun.

Here is how we phrased it in our original reports.

(“*While it may take two or three years for banks to fully rehabilitate themselves --- during which they will recapitalize, reliquify, and restructure their risk management practices, the economy should rebound sooner. Credit will begin to flow again by spring of 2009, with the economy showing moderate positive growth in the second half of the year. We believe the next big surprise will be how quickly the economy will recover from its near death experience*.”)
Source: **Economic Talking Points**, October 15, 2008)

(“It is still my view the economy will emerge from recession in the second half of the 2009, largely as a result of the $700 billion financial rescue package, massive Fed monetary stimulus, additional expected fiscal stimulus from Congress, and based also on some recent hints the housing sector may be close to bottoming out.”)
Source: **Economic Talking Points,** November 3, 2008

(“We’re still deep inside the belly of the recession beast even as Washington is furiously working to get us out. Though the evidence is still scant, we believe the Obama economic program combined with ongoing restructuring in the financial sector will set the stage for the economy to return to positive growth by next fall.”)
Source: **Economic Talking Points**, January 16, 2009

Part of the optimism for the second half and for 2010 stemmed from our conclusion early this year that a bottom was forming in the housing sector.

(“Despite the uncompromisingly awful news out this morning on January housing starts, we have begun to detect enough evidence to suggest this sector is approaching a bottom. …..Given the decline in housing inventory, record home affordability, greater traffic into home builder showrooms, and the introduction of a major plan to reduce foreclosures by the White House, we believe the seeds are in place for housing to stabilize in the second half of the year.”)
Source: **Economic Talking Points** (February 18, 2009)

Since those statements were made, we have seen existing home sales increase the last two months, the first back-to-back monthly gain since September 2005. Indeed, the median price of existing homes in May is the highest of the year, according to the National Association of Realtors. More home seekers are now moving ahead with purchases. The Mortgage Bankers Association’s index of applications to purchase homes has risen in six of the past eight weeks.

Even homebuilders are starting to sense a change in the market. New home construction and permits also rose last month to the surprise of many analysts. The pace of new home sales is up 4% from January and the inventory of unsold new houses is at multi-year lows.

Previous Warning Of A Pending Banking Crises Went Unheeded

Finally, the warning to investors, bankers and regulators that a catastrophic financial collapse was in the making came in a piece I had written entitled "The Banks' Nuclear Secrets" (*TIME*, May 25, 1998) . The article was cited in 1998 by Brooksley Born, then head of the Commodity Futures Trading Commission, during testimony before the House Banking Committee, when she argued --- unsuccessfully --- on the need to regulate derivatives such as credit-default swaps.

OK, I admit there's some chest-beating going on with these citations. But there is a genuine message here as well. Following the release of major economic and financial indicators, all too often analysts focus excessively on the headline data and fail to drill down deeper into those reports where the truly valuable clues can be found on where the economy, inflation, and interest rates are headed. There's a lot more going on in the economy than what the headline numbers say.

The moral? Get your hands dirty and dig deeper into the high-frequency economic reports for a more accurate picture on the health of the economy and its likely path.

So What's Ahead for the Economy?

All this leads us to the obvious question. What's next?

If the US is transitioning out of recession, will the economy merely bounce monotonously along the bottom the next 6 to 12 months? Or, could we see a faster, stronger rebound in activity? Just what kind of recovery can we expect?

Our latest outlook has turned more optimistic, with GDP growth accelerating close to a 3% rate in the final quarter and then slightly exceeding that pace in 2010. What are the principal drivers behind this growth? Aside from the government's massive stimulus programs, we see the private sector benefiting from two key developments: Higher consumer spending and increased inventory investment by business --- both of which could result in more hiring in the final quarter of this year and throughout 2010.

Greater Consumer Spending

True, U.S. households have been hurt, even traumatized, by the $12 trillion loss in their net worth this recession and this has certainly cut into their spending. This wealth destruction was caused by the plunge in home values and the steep fall in stock prices. But the deterioration in net worth has now run its course. First of all, we have seen an impressive rebound in the stock market lately, with the S&P 500 index up 16% in the second quarter and more than 35% since its March 9th low. In addition, home values on a month to month basis have also begun to stabilize. Whether you look at the monthly S&P/Case Shiller trend (down just 0.6% in April from the prior month, the best performance since June 2008) or the latest May data by the National Association of Realtors (which uses a larger national sample and showed the median price for existing homes rose in three of the last four months), the residential real estate market is starting to settle. The upturn in equity prices and a firmer housing market should lead to an increase in net worth in the second half of the year. That will further bolster consumer confidence. Keep in mind that both monthly confidence surveys (the University of Michigan and the Conference Board) have been climbing this year. We're not at all bothered by the June slippage in the Conference Board's numbers. The June level followed three significant months of increases. While it dropped back to 49.3 from 54.3 the previous month, it's still double the low reached in January.

Contributing to the overall pick up in confidence this year has been a jump in real (inflation adjusted) pay for the 90% of Americans who are still on the job. With inflation non-existent, real average hourly earnings has been surging 4% or more each month this year. Real average weekly pay over the past 12 months has remained positive throughout 2009. This has been further corroborated by increases in real disposable personal income (actual take home pay home).

Why focus so heavily on real pay increases? Because this allows Americans to BOTH save ---AND spend more at the same time! How? An increase in real pay means households are seeing their purchasing power improve with each dollar they earn. In other words, the savings / spending relationship is not a zero sum game when wages and salaries are rising faster than inflation. You can actually spend and save more simultaneously so long as your purchasing power increases.

Case in point: The savings rate by Americans surged to a 15-year high of 6.9% in May. Yet we also saw an increase in consumer expenditures that month.

(1) The latest retail sales report by the Commerce Department showed consumers spending jumped a better than expected 0.5% in May. Take out autos and it still jumped by 0.5%.

(2) The broadest measure of consumer spending is the personal consumption expenditure report (AKA Personal Income & Outlays). Again, we saw household spending increase by 0.3% last month.

(3) Early indications are that this trend is continuing. Chain-store sales for the week ended June 27 rose 0.6% from the year-earlier period, according to the International Council of Shopping Centers. On a week-over-week basis, sales jumped 1.6%, the biggest gain since Jan. 31.

We're upbeat on future consumer spending for another reason too. Americans have postponed shopping this recession, causing pent –up demand to swell. One should not underestimate the power of pent-up demand, especially when the economy pivots from recession to recovery. There are a lot of products in the pipeline that consumers need to replace and haven't, from appliances to autos. For example, motor vehicle sales in recent months have been running at a 9.5 million-unit rate. But historically replacement alone accounts for 12 million units! So auto sales has been running substantially below replacement for some time.

Our expectation is that with the pace of job losses slowing, the decline in net worth coming to an end, and real earnings staying positive, the stage has been set for an upturn in consumer spending in the months ahead. Of course, we're not talking about households returning to their reckless spending and borrowing habits of the last 10 years. That party is over. But nor are Americans expected to hibernate through 2010. Consumers are going to be aligning their spending closer to within their means. Our key point is that we should see moderate, but sustained increases in expenditures in the second half and through 2010.

Shrinking Inventories Have Already Led To Higher Orders

Inventory levels throughout the business community--- i.e., manufacturers, wholesalers, and retailers --- have been falling for eight straight months, the longest stretch in 6 years. At some point, the amounts of goods carried in stockrooms and back lots shrink to where companies have to consider replenishing their inventory.

Has that moment arrived? Some analysts say no, arguing the inventory sales ratio is still to high. Why order more products, they say, when there are still few customers willing to buy? We disagree with this assessment. It's certainly true the inventory sales ratio for business still stands at a relatively high 1.43 months. It has hovered between 1.25 and 1.35 months most of this decade. But the problem we have with the I/S ratio is that it reflects a snapshot of just the current sales rate ---- and completely ignores the fact the economy has reached an inflection point in the business cycle when sales promises to accelerate in coming months.

In other words, the level of inventories is too low based on *expected sales* as the economy enters the recovery phase. Indeed, it is precisely because the outlook has improved that we are seeing businesses begin to place new orders to refill inventories and purchase new capital goods. The May ISM index for "new orders" jumped to 51.1, the highest since prior to the recession with nine of the 18 manufacturing industries reporting growth in new orders from their clients. A jump in new orders leads to higher production and, if sustained, to rising employment in the months ahead. Tomorrow we'll get the June ISM data. We're looking for another increase in new orders.

Nor is it just the ISM survey that has recently reported higher orders by businesses. Many market analysts were surprised last week by the vigorous jump in durable goods orders, which was up 1.8% in May, following an identical rise in April. Both months posted their best performance since December 2007, when the recession began. Business leaders are thus growing concerned that they may not be adequately stocked to satisfy the anticipated pick up in demand the latter half of 2009.

Bottom line: The recession is over with the conclusion of the second quarter. While there is still uncertainty about the kind of recovery we'll have, the odds have improved the economy will bounce back with more vigor the next 18 months, thanks to the Obama stimulus program, higher consumer spending and greater business expenditures.