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ECONOMIC TALKING POINTS

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End of 2008 – 2009 Recession Is In Sight. But What's Next?

The recession is winding down. We have seen in the last few weeks enough meaningful indicators that show the economic contraction has slowed, notwithstanding the disappointing news on February's personal income and spending. The odds have increased markedly that we are approaching an inflection point in the economic cycle and that the worst of the Great Recession of 2008 – 2009 is behind us. We're now probably just months away from bottoming out.

More problematic is what happens next. What kind of recovery can we expect given all the monetary and fiscal stimulus injected into the economy? Our analysis, I'm afraid, shows that we will have to endure the mother of all jobless recoveries caused by a growth recession that will last through most of 2010. By growth recession we mean an economy that's growing so tepidly that companies limit hiring to a pace far below what is needed to lower the unemployment rate. So while we may emerge from recession from a statistical standpoint later this year, I suspect most Americans will be hard-pressed to tell the difference between a recession and recovery the next 12 months. Our expectation is that growth will average an anemic 1.5% in the second half and about 2% next year.

Personal Income and Spending

Household spending increased a modest 0.2% in February, after a strong 1% jump in January. While some analysts may express concern over the latest slowdown in consumer expenditures, we're encouraged by the fact that this marked the second month in a row that spending increased, following 7 straight months of declines.

Others may point with alarm to last month's decline in real disposable personal income (take home pay adjusted for inflation) and wonder whether consumer spending can be sustained in coming months. But we believe the more important figure is what real disposable income did --- not over a single month ---but over the past year, and here the news is fairly good. Over the past 12 months, real DPI jumped 2.2% in February, after a 2.7% jump in January. These are the best annual numbers we have seen since last spring.

But let's be clear here. We are not calling for a sharp rebound in consumer spending in the months ahead. Household balance sheets are far from healthy, the employment market still looks dismal, and Americans have seen $11.2 trillion of their wealth go up in smoke last year. There is still little for consumers to celebrate, which is why the latest reading on confidence held close to three-decade lows. The Reuters/University of Michigan survey showed consumer sentiment stood at to 57.3 this month, barely above its 28- year bottom of 55.3 reached last November. (It averaged 85.6 in 2007, the year the financial crises erupted, and 112 over the last 30 years.)

The point to make here is that there are some crosscurrents at work that should, at the very least, help stabilize consumer spending in the months ahead. Real (inflation-adjusted) earnings for the vast number of Americans still working have risen in each of the last four months. Signs of sales and discounts at retailers are ubiquitous. All of this represents a significant increase in purchasing power for households. Moreover, the S&P 500 is on track to show its biggest monthly gain in 35 years. If shares prices continue to recover, that may well bolster future confidence and encourage some spending – but no blowout.

Though February's personal spending numbers was a bit on the soft side, we have seen a spate of economic indicators in recent weeks that were unambiguously positive. Virtually of the reports below took most forecasters by surprise.

• Sales of existing homes, which makes up more than 85% of the housing market, rose 5.1% last month. The median home price actually rose in February to $165,400, the first increase in 8 months. Purchases of single-family homes were up 4.4% and prices too saw its first monthly pick-up in 8 months. Even sales and prices of condos and co-ops rose. Inventory levels have eased as well. The months supply of all existing homes has now dropped to single digits (9.7 months) from a high of 11.3 in April 2008.

• Sales of new homes, which has a bigger impact on GDP than existing homes, rose 4.7% last month, the first increase in 7 months. Of equal interest is that the supply of completed homes sitting idle on lots has now plunged to 157,000, the slimmest inventory since August 2006.

- That factor, plus the numerous programs introduced by the Obama Administration to support the housing sector, may have led homebuilders to start up new construction. New starts leaped 22% in February and permits for future construction was up 1.1% --- the first rise for both since last June. Home constructions makes up 5% of GDP, but if you also factor in all the spending that goes into furnishing a new home, the proportion swells to nearly 25% of total output.

- Mortgage applications to refinance or purchase a home surged by 32% in the latest week as mortgage rates dropped to below 5%, record lows.

- February orders for durable goods, a gauge that portends future production and hiring, jumped 3.4%, the first gain in 7 months and the biggest increase in a year. Perhaps the most intriguing piece of news this report is that the stockpiles of durable goods at factories have now dwindled to a level that may soon call for more production. The inventory of durable goods fell 0.9% last month, after dropping by 1.1% in January. This is the largest two-month decline in stockpiles in 6 years!

- Retail sales and the final GDP numbers for IVQ 2008 were also better than expectations.

Where do we go form here?

While we do expect a recovery to commence in the second half, the economy will face some significant headwinds the next 18 months. First, it will take several years for the financial institutions to fully flush out their toxic assets and clean up balance sheets. The extra time needed to recapitalize the banking system and restore it to health will keep the cost of loans and capital higher than the pre-crises era for some time. In other words, we suspect the problem will not so much be the supply of credit, but the higher rates cautious lenders (and investors) will demand for their funds.

Second, we also expect to see a fundamental shift in the behavior of households, with more Americans deciding to live within their means and rely less on credit and on the liquidation of savings as a way to finance their life style in the future. Consumers have been unnerved and frightened by the loss in value of their homes and their investments (particularly retirement savings). Cutting down on spending and replenishing savings is their penance after a decade of excess borrowing and spending.

Third, the US cannot expect much help from foreign buyers of American goods and services, not with the global economy undergoing its first synchronized recession since WW II. The collapse in world trade this year will be the most severe since the 1930s. Little wonder US exports have so fallen in each of the last 6 months, a trend that will likely continue for the rest of the year.

Bottom line: Given the dynamics underway in the economy, we are in the final stage of recession, one that will probably bottom out sometime in the next two quarters. A recovery is foreseen in the second half of the year, but growth will be so sluggish that most Americans will not be able to make the distinction. Given past history, joblessness will continue to increase well past the end of the recession. Indeed, if the 1990 and 2001 recessions are any guide, we could be staring at a jobless recovery that could last through 2011, if not longer.

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