

# THE ECONOMIC OUTLOOK GROUP



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## ECONOMIC TALKING POINTS

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### **“Luck is the Residue of Design”**

That quote by a former baseball executive (Branch Rickey) captures well the improved outlook for the economy and, consequently, the turn in political fortunes for President Obama.

Think back to just a year ago. The U.S. economy was in a frightening free fall. Production was plummeting and companies were laying off more than 700,000 workers each month. At the same time, we were arguably confronting the worst financial crises in U.S. history. Enter the new Obama Administration: They quickly crafted a program that would pump more than \$1 trillion into the economy. The Federal Reserve also threw out its biggest lifeline ever by knocking interest rates down to record levels and introduced numerous programs that would inject unprecedented amounts of cash into a credit-starved nation. Yet for months afterwards the economy remained dormant, seemingly impervious to all the stimulus.

It was not until last summer when the recession hit bottom in our opinion. By the end of the year the economy expanded at the fastest pace in more than six years.

Leading the recovery this time turned out to be business and exporters. The rush to replenish nearly depleted inventories among retailers, wholesalers and manufacturers helped revive the economy. Firms also spent to acquire new capital goods, such as machinery, equipment, and software.

Now it appears consumers have returned as well. Personal spending rose in February for the fifth consecutive month, according to yesterday's Commerce Department report. Indeed, real spending (i.e., after adjusting for higher prices) turned out to be the highest since December 2007, the month the recession began.

What is behind all the latest round of shopping? First, Americans are more upbeat about the economic outlook. The Conference Board surprised many analysts when it reported that Consumer Confidence rose this month by more than what analysts initially expected. The optimism index climbed to 52.5 in March, versus 46.4 the prior month. (The consumer confidence index averaged 45 in 2009.)

Perhaps a more concrete sign that consumers are growing confident about their own personal finances is that they are setting aside less of their income for savings. The personal savings rate in February dropped to 3.1%, the lowest in 15 months.

A second factor that has emboldened American households is the ongoing recovery in their wealth. The S&P500 index, for instance, is up 50% over the past year, putting some smiles on the faces of individual investors. Even real estate values have stabilized. The S&P/Case-Shiller home-price index for 20 cities unexpectedly climbed 0.3% in January from December. Homes in more than half of the 20 cities surveyed registered higher prices.

But there is one critical part of the economy that has not moved much. The recovery has so failed to generate net new jobs, and without a rise in employment and household income, a lasting recovery is not possible.

That, too, may be about to change. We're expecting the labor market to show new signs of life. We'll get fresh evidence of that on Friday with the release on March employment numbers, and we're forecasting a net gain of 50,000 to 150,000 in payrolls. True, some of those jobs will include government hiring for the census, but we should also see impressive hiring in the private sector. We view the March gain in jobs as the beginning of the next phase of the economic cycle, where private sector activity will begin to increase on its own and rely less on government spending.

What it all comes down to is that this is starting to look like a good old-fashioned recovery. We're now nine months into an economic rebound. The banking system has been stabilized. Corporate profits have jumped by the most in 25 years in the last quarter, and business and consumers are ramping up spending. Though home sales are still lagging, it too should pick up once the job market turns up.

All that good news comes with one spoiler: Be prepared to see both inflation and market rates pick sooner than expected. We're not concerned about an explosive breakout in higher prices anytime soon. The danger we see is that policymakers and investors may get caught off guard by how quickly inflation pressures re-emerge. After all, many have downplayed inflation concerns, citing the ample slack in labor and industrial resources in the economy. Just look at past FOMC statements and you see that even the Federal Reserve keeps pointing to the "substantial resource slack" as a reason why "inflation is likely to be subdued for some time."

We agree there is lots of slack in the economy. But that's not the issue. It's not the quantity of that unused capacity, but the "quality" of it. For example, more than 40% of the unemployed have been out of work longer than six months. Skill sets typically atrophy when one is jobless for so long and this group may not easily find suitable employment even in a recovering economy. Similarly, a lot of that idle industrial capacity has been aging. Remember, corporate spending to replace, modernize or repair existing equipment collapsed in 2008 and 2009. Thus, while the current level of capacity utilization is a low 72.7, some of that industrial capacity has become antiquated and less productive. For that reason we have begun to warn clients that a stronger economic recovery could heat up inflation pressures sooner than current expectations and drive interest rates up more quickly.

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