

# THE ECONOMIC OUTLOOK GROUP



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## ECONOMIC TALKING POINTS

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### **Growing Middle East Unrest Heightens Risks to the U.S. Recovery**

Let's get right to the point. We have raised the probability of a growth recession and slightly elevated the risks of an actual downturn before the year is out.

The chance of a growth recession, where the economy expands at an annual pace below 2.5%, has increased from 30% to 50%. One major consequence of that would be a setback in the job market with the unemployment rate rebounding towards, and possibly surpassing, 10%. (The economy needs to expand at least 3% to make progress on lowering joblessness.)

The likelihood of an actual recession is still quite low, though we have lifted that chance as well, from 15% to 20%. What this means, of course, is that our previous expectation for the economy to expand at a moderate pace of 3.5% to 4% pace this year has been downgraded from a 55% probability to 30%.

Behind these changes is the growing turbulence in the Middle East and North Africa, and the near inscrutable outlook how this will play out in terms of regional stability and future oil prices.

What has been unleashed in these oil-rich regions is without historical precedent. Of particular concern are the protests beginning to brew in Saudi Arabia, Kuwait, and the United Arab Emirates ---nations that essentially possess all of the world's excess capacity. The unrest foaming in these countries are getting louder and more organized. Protestors are demanding reforms of governments that have a traditional phobia for change. Yet all sides are digging in. It is the ultimate nightmare scenario for oil consuming nations. With oil prices continuing to march higher, the looming question is whether fuel prices will escalate to a level that bulldozes a recovery whose foundations remain fragile?

For now---there is little chance of that happening. However, the steady drumbeat of positive economic news we saw the last few months may be coming to an end.

## **Layoff Announcements**

- Out this morning was a report on announced layoffs as tallied by the Challenger, Gray & Christmas outplacement firm. First, some background: We saw a steady decline in job cuts throughout 2010. In fact, total announced layoffs last year turned out to be the fewest in 13 years! But the February report suggests employers are ramping up job cuts again. Layoffs jumped to 50,702 last month, the most in nearly a year. One out of every three jobs eliminated occurred in the government sector, as financially strapped federal, state and local municipalities slash payrolls to reign in deficit spending.

But the private sector is also handing out pink slips in greater numbers, with retailers, factories, aerospace and financial firms trimming payrolls the most.

While the report also noted that "announced hiring " rose to 72,581, we should stress that some 85% of that increase was with one firm, Home Depot, and that those jobs in any event would be temporary.

## **ADP Employment Report**

- ADP's employment release for February had a more positive twist to labor market activity. They reported that companies hired an additional 217,000 people last month, which surpassed expectations. What's interesting is that 94% of these hires took place at small and medium size firms. (ADP defines medium size firms as those between 50 and 499 employees, and smaller firms logically payrolls less than 50.)

But what is disconcerting is that small and midsize firms also happen to be the most vulnerable to higher commodity costs. Unlike larger corporations, which possess significant cash reserves and have a diversified product line, smaller firms have accumulated far less savings, make fewer products, and often find it difficult to access credit when needed. Thus any significant increase in energy costs can hurt their margins more quickly. If, on top of that, the economy hits a speed bump as a result of higher oil and gasoline prices and sales begins to trail off, we could see jobs creation shut down fairly quickly with small and medium size companies.

### **Personal Spending**

- Have we seen any slowdown in sales yet? Well, earlier this week, the government said consumer spending inched up only 0.2% in January, far less than analysts predicted for the month. This slowdown in expenditures came despite a large 1% increase in income. There is fresh evidence that the rise in food and fuel costs have forced Americans to scale back spending on non-essentials, like sporting goods, hobbies, clothing, furniture sales and dining out.

Moreover, workers still have little power to negotiate an increase in pay since the job market is still sluggish. That means household budgets will get squeezed in the months ahead if energy and food costs remain elevated. Perhaps in anticipation of tougher financial times ahead, Americans chose for the first time in six months to set aside a larger portion of their income as savings in January.

But is this the result of chaos in the Middle East and rising gasoline prices? Or could it simply because more than 60% of the country was inundated with snow in January?

We will need another month or two to sort the data out and see whether consumers are retrenching in the face of higher fuel costs.

### **ISM**

- What about yesterday's quite upbeat report from Institute for Supply Management? The national purchasing managers group released some good news on the manufacturing front for February. The factory activity index jumped to 61.4, last month, its highest level since 2004. In addition, new orders to U.S. factories, which foreshadow production in the coming months, jumped to 68, the highest in seven years. And here's one other eye opener: The ISM employment measure rocketed to 64.5, its strongest since January 1973!

These numbers from ISM look encouraging and suggest that US manufacturers are still accelerating output in response to higher domestic and foreign demand. But our job is to look around the corner and assess the implications of higher fuel costs on future consumer and business spending.

If, as we now expect, oil and gasoline prices will remain elevated due to the unrest in the Middle East, it is only a matter of time before manufacturers are forced to pass higher commodity costs on to customers. After all, *the ISM price index has now been rising for 20 straight months, with the pace of inflation now accelerating.* The price index has just climbed to 82, the most in more than two years. Of the 14 industries queried, 13 reported paying more for material last month.

The overriding question here is whether the acceleration in production and new orders point to strength in the global economy? Or, does it all reflect growing concern among wholesalers, retailers and exporters that they better rush to place their orders **now** before factories lift prices? Our concern is that it may be the latter.

Over the next week and a half, we'll get fresh news on jobs, retail sales, consumer confidence, business inventories, weekly mortgage applications, and the mood of small businesses. They should shed more light on how the geopolitical eruptions have affected consumer and business psychology --- and ultimately the recovery.

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