

## ECONOMIC OUTLOOK

August 7, 2009

### CAUTION: FASTER GROWTH AHEAD

The steepness of the Inventory liquidation in the first half of 2009, together with the recent boost in car sales, from the “cash for clunkers” program, (\$1 billion of which was exhausted in a week and another \$2 billion which was earmarked by Congress before their summer recess) strongly suggest a larger rebuilding of depleted inventory, in the second half. This should also lift near-term Industrial Production.

Moreover, with residential construction showing signs of bottoming out, as permits, housing starts and pending home sales have all become more positive, the housing sector will provide some lift to real GDP. There is a good chance that we will see stronger than expected, 3%, rather than 1%, GDP growth in the second half of 2009.

Nevertheless, the 3% GDP bounce will look like a dribble, by historical standards. When compared to past recoveries from steep recessions, the 6.3% drop in GDP in Q4 08 and Q1 09, would typically be followed by strong, 7% annualized rates of growth, in the first two quarters of recovery, according to Barclay’s.

### AN UPSIDE GROWTH SURPRISE?

Barclay’s argues that we could be in store for an upside surprise. They point out that the general view is that near doubled digit unemployment rates, and negligible growth in personal incomes, are “viewed as an impassable obstacle to recovery. In 1982, unemployment rose to 10.8%, while real income growth was stagnating at minus 0.6%, and yet GDP soared at a pace of 7.7%, over the ensuing six quarters.”

While consensus believes that “companies will be much slower to hire than they were to fire,” Barclay’s argues that “the massive post-Lehman rise in the US unemployment rate was a mistake, on the part of panicky managements. Employment and output were both reduced, far more than necessary, as businesses assumed a worst case scenario.”

Another part of the bearish case is built on the need for households and businesses to deleverage. However, Barclay’s argues that since 1950, US private sector borrowing ex-mortgages has declined relative to GDP, in the first year of recovery. Much of the bearish case is built on the destruction of household wealth, due to declining home and stock prices. But stock prices have now recovered 50%, from their early March lows, and home prices have begun to stabilize, over the past few months.

We’ve also seen a significant improvement in housing affordability. The ratio of median house price to family income has dropped dramatically, from nearly 4, to about 2 1/2, putting the ratio of home affordability back to late 1960’s and early 1970’s levels. This suggests that home prices may have reached a bottom, in all but the most overbuilt areas of the country.

All of these factors suggest a change in the economy's direction, an end to the decline, and the development of a new growth trend. What's more, there is even a possibility that growth could be even stronger than consensus expectations. The real question is whether or not growth will last, or will it succumb to renewed weakness, as fiscal and monetary stimulus is removed? Are we headed for a "W"?

### A HOST OF QUESTIONS

Frankly, the answer to that is dependent on a number of variables. First, will households be confident enough about their future to start spending, or will news of persistently high unemployment rates and limited income growth, make them err on the side of caution pushing them in a direction to pay down debt and build up savings?

Certainly, July retail sales were disappointing. In part, retailers themselves are to blame, as they kept their inventories down, and had more limited availability of marked down merchandise to put on sale, in an effort to preserve margins. Some blame the unexpected surge in auto sales, responding to the successful "cash for clunkers" program, which diverted purchases from retailers. What's more, as car buyers take on new car financing obligations, it will take a chunk of money out of other discretionary spending.

Second, while we've seen significant improvement in affordability of housing, will the Fed act prematurely in exiting its "Quantitative Easing" program, raising the cost of home financing, as mortgage rates move higher, undermining the tenuous housing recovery?

Since June, we've seen the bond market back up, any time it was faced with short term supply pressure. Indeed, while 10-year Treasury rates were down to 3 ¼%, as recently as July 13<sup>th</sup>, it hit 3 7/8% today, on a stronger than expected employment report, and in anticipation of next week's auctions of 3, 10 and 30 year Treasury securities. Mortgage rates have followed the 10 year Treasury yield higher, crossing over 5 ½%.

Third, while businesses are likely to rebuild inventories and increase industrial production, to meet consumer demand, will they also loosen their budget purse strings, to increase fixed investments and capital spending? Will they stop the layoffs and begin hiring new workers?

Finally, will there be another installment of fiscal stimulus next year, or will Congress take comfort in the economic recovery? The argument against new fiscal stimulus stems from concerns over a weaker dollar, and rising national debt to GDP ratios. The risk is that without a second dose of stimulus to help the long-term unemployed, and state and local governments facing growing budget deficits of their own, we could see a downshift, in economic activity, in the second half of 2010.

## THE ECONOMIC SKEPTICS BEAR CASE

Rebuilding household savings, to an 8% to 10% rate, that prevailed, prior to the equity bubble of the late '90s, and the housing bubble, earlier this decade, will rob GDP of as much as half of its growth potential. A 4% increase in the savings rate, bringing it up to 8 ½%, would imply a nearly 3% shortfall in the consumption component of GDP growth, (since consumption represents 70% of GDP). Indeed, the June savings rate came in at 4.6%, following a downward revised 6.2% May number (vs. a preliminary 6.9%). While the May statistic was artificially inflated by the receipt of rebate checks, the absence of rebate checks led to a 1.3% drop in June personal income, and an even bigger drop in the savings rate.

Furthermore, state and local governments will continue to be under significant pressure to reduce spending to erase looming budget deficits, resulting from reduced sales tax receipts and income tax revenues. While this year they could live off of “rainy day funds” that they had squirreled away in good times, and other one off measures, like sales of government assets, they won't have those cushions to rely on, in the next fiscal year. This comes at the worst time possible, especially for households that are dependent upon unemployment benefits, health care, and other government services and subsidies.

With significant slack in both labor markets and industrial capacity, it is hard to make a case for business investment and capital spending rebounding any time soon. Nor is it likely that inflation will be a problem over the near term horizon.

While the July unemployment rate dipped down 0.1% to 9.4%, and the rate of job loss slowed to 247,000, last month, the unemployment rate is still expected to drift higher, reaching a peak of 10 ½%, sometime in 2010. Until the jobless rate peaks, it is unlikely that the Fed will raise short-term rates. Nevertheless, a step-back from the Fed's QE policy would accelerate the recent uptrend in mortgage yields, undermining a key driver of economic recovery. That's because higher mortgage rates mean higher monthly payments, and higher levels of income to qualify for a mortgage loan, at elevated rate levels. This, in turn, means fewer people would qualify for mortgages, requiring elevated monthly payments, which would only prolong the overhang of unsold homes.

Bottom line, the good news is that recession has ended and recovery is underway. Early indications are that near term growth will be greater than originally projected, largely on the heels of an inventory rebound, ongoing fiscal stimulus, benefits from net exports, and the elimination of the drag from residential construction. The overriding question still remaining is how robust will growth be, in the second half of 2009, and how long will it last?