

After recession, US recovery will be mediocre but beneficial

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- US government officials and the vast majority of private forecasters agree that the business recession will end within the next six to nine months. Where views differ sharply is on what happens next.
- The White House and Congressional Budget Office both foresee a sharp “V-shaped” recovery. The Fed weighed in Wednesday with its latest summary of economic projections: less optimistic than three months ago, with a wide 1.5%-4.0% range for real GDP growth in 2010. But the central tendency was close to the Obama administration’s forecast. A number of private forecasters concur.
- We and a sizable minority of other private-sector economists see a more restrained business rebound next year: a so-called “U-shaped” recovery, rather than a “V.” Moreover, our main risk scenario is for what might be called a “W-path”, one in which a spurt of growth, maybe even as early as the middle of this year, as the Obama fiscal stimulus takes effect, fizzles in the first half of 2010, before picking up again thereafter.
- Each of these scenarios carries very different implications for the financial markets, magnifying the prospects for an increase in price volatility in stocks, bonds, and currencies as market participants try to grapple with the financial consequences of this unique business cycle.

Behind the optimism of White House economists and their followers

Washington is clearly in the optimistic camp. The White House budget is based on an assumption of 3.2% growth in real GDP for calendar year 2010. The non-partisan Congressional Budget Office predicts 2.9% growth. The Federal Reserve’s latest published forecasts for 2010 show a wide dispersion among Fed officials and we will find out their latest projections after the next Federal Open Market Committee meeting ends next Wednesday, April 29.

Washington’s relative optimism is based on three factors, as articulated with great cheerfulness by Christine Romer, head of the Council of Economic Advisers, CEA, in a recent speech to the Council on Foreign Relations in New York. Essentially, she and her White House colleagues assume history will repeat. Deep recessions have always been followed by strong upswings, she insisted. The Obama administration takes for granted that the combination of aggressive monetary policy and powerful fiscal stimulus will generate progressively larger increases in business activity over the second half of this year and well into 2011. And the White House and Treasury assume the financial markets will get back to normal soon, aided by the battery of liquidity and capital support programs that are being implemented by the Treasury and the Federal Reserve. Indeed, the main downside risk to the CEA growth forecast, said Romer, is if the improvement in financial market conditions were to stop and instability on the scale of last fall broke out again.

The case for a “U-shaped” recovery

Fundamentally, we doubt that the economy will bounce back strongly from this painful business downturn. Economic history will not repeat, because this recession is unique. It has been caused by massive wealth destruction, not simply the normal forces of the business cycle. It is the culmination of many years of excesses in the credit markets that literally brought the financial sector to the brink of collapse. US households indulged on cheap and easily available credit to spend much more on cars and houses than they could afford. They were betting that prices would keep rising, especially home prices, and that would bail them out. As evidenced by an uninterrupted rise in mortgage defaults and foreclosures, they have learned a painful lesson that will not be quickly forgotten.

To the contrary, US households are confronted with a number of cruel realities that will continue to influence their spending and savings decisions in the coming year. Their jobs are at risk because of severe dislocations in US industry. Firms in a variety of industries are threatened by insolvency, not just in home-

building or motor vehicles. Wages and salaries are under tight control everywhere, as businesses struggle to lower costs. Proof is in the slowdown of the Employment Cost Index as well as in average hourly earnings. New hiring is severely restricted even in industries that are still reasonably healthy. Moreover, state and local tax revenues are down so sharply that school boards are unable pay teachers already on their payrolls, normally the most stable occupation in the economy.

But worst of all is what has happened to household wealth. It has plummeted because of falling home prices and the sharpest drop in equity prices since the 1930s. Back then, however, only a slim fraction of Americans owned stocks, essentially the wealthy. Nowadays, things are completely different. The majority of middle-class Americans depends on self-directed pensions, most importantly the familiar 401k accounts, to provide for their retirement, over and above the limited benefits received from Social Security. Those 401k accounts are now down 30% or more from their peaks, despite the recent stock market rally.

Consequently, the US consumer is in no position to become a dynamic force for economic recovery. If anything, millions will seek to increase savings to replace part of this lost wealth. They will not rush out to buy new homes, because they rightly fear further erosion in housing values. They will be content to keep their cars a little longer, rather than buy new ones. Even if some consumers are inclined to increase their spending, they will face continued credit restraint imposed by hobbled banks that have established far more restrictive lending standards. This so-called “negative wealth effect” will influence business decisions, too. Firms will be more selective in approving capital expenditures and will retain tough control over costs. They will also face difficulty getting credit, particularly for commercial real estate development. Finally, the global nature of the current recession is unprecedented. US exports have already been adversely affected, and foreign demand will remain suppressed for some time.

Putting these factors together we project an economic trajectory that depicts moderate, rather than robust, growth in personal consumption, continued weakness in business investment, and flat residential construction. Only increased public sector outlays will reliably contribute positively to GDP growth through the end of 2010.

Risk scenario: the “Running W”

A U-shaped recovery such as we favor as a base-line forecast is essentially a stable, sustained upturn in business activity, only at a more restrained tempo than the V-shaped rebound that more optimistic forecasters assume. We have also begun to look closely at various alternative risk scenarios that do not produce a stable, sustainable recovery. They are grounded on a key assumption: that weaknesses in the sectoral composition of domestic output will remain significant and will continue to provide headwinds that the next business expansion will have to overcome for some time -- perhaps throughout the entire term of the Obama administration. These headwinds are not likely to hinder economic growth on a steady, predictable path. More likely they will run hot and cold. Sometimes, they will merely dampen the effects of various sources of strength, such as the end of inventory destocking or the revival of business spending on equipment and software. But at other times they will clash forcibly with positive factors. That could mean a period of a quarter or two during which time the recovery stalls nearly completely offsetting, despite the continuing lift to economic activity provided by the phase-in of various spending components of the Obama fiscal stimulus and the Fed's ongoing policy of aggressive monetary accommodation.

The pattern of real GDP associated with this scenario can be depicted as “W-shaped”— a “Running W” if you will. [For devotees of American history, a “Running W” was the most famous brand of the sprawling King Ranch of Texas. The brand was registered in 1859 by founder Richard King and his then-partner Captain James Walworth. The ranch, by far the largest in the United States, still brands its cattle with a “Running W.”] What we think is most plausible is a bigger than now expected pick-up in activity in the second half of 2009, following a weaker than expected second quarter. Thus the yearly average change in real GDP is unchanged from the base-line forecast, approximately -2.5%, but the Q4-Q4 growth rate is a more appealing -0.5%, instead of -0.7%.

The surge is associated with three principal factors: a quick end to inventory destocking, a big boost from government spending, and a tax-cut induced jump in personal consumption expenditures. However, while these factors generate a respectable 3.3% per annum rebound in real GDP in the second half of 2009, the rebound is not sustained. That is because businesses do not immediately follow up with a rise in capital expenditures—it takes some time for businesses to move from restraint over plant and equipment spending to more generous capital spending budgets. They also are inclined to increase inventories until they get more evidence that final demand growth is long-lasting. In this still cautious atmosphere, moreover, they do not move quickly to rehire workers that had been laid off during the recession. Thus, the unemployment rate continues to move higher, personal income growth is stunted, and as the effects of tax-cuts wear off, consumption spending stops recovering by the beginning of 2010. What's more, export growth is hampered by continued sluggish economies in Europe and elsewhere. By the middle of 2010, business capital expenditures to begin to perk up – after all, monetary policy is still accommodative—and exports being to do better. So for the year 2010 as a whole, under the Running W scenario the average increase in real GDP comes in at 1.2% per annum, just a touch below the base-line forecast. But the Q4/Q4 rate of 1.0% is well below that of the slow and steady base-line forecast of 1.8%.

Three competing scenarios: How will the financial markets react?

Under any of the three scenarios, volatility in the financial markets will not quickly disappear, as market participants weigh the implications especially for future corporate profits and inflation. Here is a very preliminary sketch of how participants in US equity, fixed-income, and currency markets are likely to react to the economic data as they emerge under the three scenarios we have laid out:

The V-shaped recovery. It would seem to be best by far for near-term corporate earnings but would not necessarily be best for the stock market. That is because the quicker the economy recovers, the more worries investors will have about the inflation outlook. They will start to press for the Federal Reserve to begin moving away from a near-zero interest rate policy and unwind massive liquidity support. These concerns will be most insistent in the fixed-income market, where the government yield curve will steepen as investors anticipate deterioration in bond prices. Higher bond yields will offer increased competition to stock market investors, blunting some of the earnings-induced price advance. As for the dollar, a clear strengthening of the US economy will be unequivocally beneficial for the dollar until international investors start to fear what could happen to their fixed-income holdings. In addition, voices will be heard complaining that the initial rise in the dollar will dampen the ability of US exports to benefit from a rise in global demand. Some of those voices may be come from inside the Obama administration, itself.

U-shaped recovery. Slow improvement of the economy will not lead to a powerful rally in the stock market, but it will increasingly be a source of support, as investors become more comfortable with the notion that a mediocre recovery, even if a little disappointing in magnitude, is most likely to be sustainable. Inflation fears are likely to be subdued. That will allow the Fed to maintain an accommodative monetary policy, but will not compel further budget-busting fiscal policy measures by the White House. Under these conditions, fixed-income markets will trade in a relatively narrow range, stock markets will irregularly improve, and the dollar will tend to fluctuate mildly lower against other major currencies. Bank profits will be sufficient to provide internally-generated funds to strengthen capital positions, and that will let most banks repay their TARP exposures by the end of 2010. That will help rebuild confidence in the financial system.

Running-W recovery. This will be troublesome for the financial markets. Assuming the pattern begins with a relatively strong pick-up in activity during the second half of 2009, many market participants will be surprised by the initial strength of the rebound, The stock market will initially rally, but many investors will jump to the conclusion that inflation, not deflation, is the main policy concern and will be impatient for the Fed to start a process of gradual monetary restriction. Thus, the bond market will set back, and the dollar will rise. The market consensus will be badly shaken, however, when the data begin to show in early 2010 that the growth spurt was largely technical and not easily sustained. Stocks will slump, bond prices will rebound, and the dollar will tumble. When the next set of better

economic numbers comes out around the middle of the year, market participants will be more apprehensive and less willing to see the upturn as sustainable. That will likely include most businesses. They will be even more cautious in resuming hiring, thereby limiting personal income growth and setting the stage for another “W-shaped” path in 2011.

Conclusion: be careful what you wish for, slow & steady can be better

Some readers may be inclined to view our base-line forecast as unnecessarily cautious. After all, they might argue, the Obama administration is committed, as CEA head Romer emphasized in her answers to questions, to “do whatever it takes” to stimulate a strong, durable expansion. Why not admit that commitment assures a positive outcome for both the economy and the financial markets?

That is not how we judge the probabilities. Even achieving the middling recovery we are forecasting is a challenge, given the loss of wealth, employment, and credit creation potential associated with the financial crisis and the deep recession still under way in the US. It is a long shot that the administration can engineer a powerful recovery in the absence of the twin factors that have generated past recoveries – namely, a major surge in consumer demand for houses and cars. Neither is likely this time. Nor is a sudden boost in demand from abroad for US exports. Instead, too much of the positive outlook for renewed growth is associated with the potential success of government spending in spilling over onto the economy at large or with the essentially transitory technical benefit of ending inventory destocking.

But a mediocre recovery does not at all mean a mediocre outlook for the financial markets. To the contrary, it is the safest way to lay the groundwork for a non-inflationary business expansion, including a non-disruptive end to a near zero federal funds rate and to the patchwork of measures that fall into the category of Quantitative Easing. In that sense our forecast should be judged “as reasonably optimistic,” not overly cautious.

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