What’s Wrong (And Right) With This Recovery

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I. What Kind of Recovery?

- Relatively weak GDP rebound
- A jobless recovery
- A lopsided upturn
- Only partly transformative
- Inorganic and not yet sustainable
- The recovery policy gave us

II. More Headwinds than Tailwinds
Relatively Weak GDP Rebound

A deeper than normal drop is being followed by a weaker than normal rebound.

This is to be expected from a balance-sheet-led recession as opposed to a business cycle recession and recovery.

GDP has grown at an annualized rate of 2.2%, 5.6%, and 3.2% in Q3 2009, Q4 2009, and Q1 2010, respectively.
A Jobless Recovery

Jobless recoveries have become the norm of recent economic rebounds.

After the 2001 and 1990 recessions officially ended, job losses continued for many months.

This jobless recovery appears to be the worst yet. Even with the encouraging news that the economy added 290,000 jobs in April, the U-6 (the broadest measure of unemployment) increased to 17.1%, and we still confront a jobs deficit of 12.8 million.
A Jobless Recovery:
A Pattern of Missing Jobs Continues

The performance of America’s most technologically advanced industries was particularly disappointing over the past decade.

According to economist Michael Mandel, America’s leading-edge industries were projected to create 2.8 million new jobs between 1998 and 2008. Instead they actually lost 68,000 jobs.

The recovery is perpetuating this worrying trend, with only health care and education showing net job gains over the course of the recession and recovery.

![High-Tech Job Losses and Gains 1998-2008](chart.png)

Source: Bureau of Labor Statistics
A Lopsided Recovery: Equity Rebound, Housing Slump

While equity markets have recovered much of their losses, housing prices have not.

The crash of the over-inflated housing market has disproportionately affected middle-income homeowners, who have much of their wealth invested in non-financial assets, such as homes.

While the outlook in the equity market is uncertain, many economists expect housing prices to decline at least another 10%.
A Lopsided Recovery: Surging Profits, Stagnant Wages

Corporate profits have rebounded but job growth remains anemic and wage gains are stagnant.

During the fourth quarter of 2009, corporate profits were 30.6% higher than in the fourth quarter of 2008.

Nominal wage growth, however, has continued to decline, growing only 1.6% from April 2009 to April 2010.

Average Hourly Earnings
Year-Over-Year Percent Change

Source: Bureau of Labor Statistics
A Lopsided Recovery: The Return of Plutonomy?

The stock market recovery benefits high-end consumers.

Stagnant wages and housing prices hurt moderate- and low-income consumers.

The economy therefore has been driven by high-end consumption, what former Citibank strategist Ajay Kapur called the plutonomy.
Partly Transformative (Positive): Rapid Productivity Growth

**Strong productivity growth increases the economy's growth potential.**

But, strong productivity growth also explains weak job creation because businesses have been able to increase production while relying on fewer workers.

Nonfarm business sector labor productivity increased at a 3.6% annual rate during the first quarter of 2010. From the first quarter of 2009 to the first quarter of 2010 overall labor productivity increased 6.3%, the largest gain since 1962.
Partly Transformative (Positive): CapEx and Industrial Production

CapEx spending and industrial production show signs of strength.

Capital spending on equipment and software expanded at a 13.4% annual rate in Q1 2010, on top of a 19% pick up in Q4 2009.

Industrial production has increased 5.2% year-over-year, the fastest pace since mid-1997.
Partly Transformative (Negative): Too Dependent on Consumer Spending

Consumer spending as a percentage of GDP has actually increased to an all-time high of 71%.

In the first quarter of 2010, consumer spending accounted for 2.6% of the 3.2% increase in GDP, the largest contribution to growth since Q4 2006.

Consumer spending has been boosted by tax cuts, consumer rebates, and government transfer payments.
Partly Transformative (Negative): Too Dependent on Financial Profits

Financial sector profits are soaring, once again.

Financial sector profits make up 35.7% of all domestic corporate profits, down slightly from the peak in Q4 2001 of 44.6%.

Financial sector profits are driven by trading revenue. In the first quarter of 2010, Goldman Sachs, Morgan Stanley and Bank of America earned 72%, 45%, and 16% of their net revenue from trading.
Partly Transformative (Negative): Personal Savings Falling, Again

After an encouraging increase in 2009, personal savings are again on the decline.

The personal savings rate decreased to 2.7% in March 2010, enabling consumers to purchase more.

Declining savings means a slower pace of household deleveraging and a longer adjustment period.
Partly Transformative (Negative): Importing Our Way to Prosperity

A healthy economic recovery would benefit from rising net exports.

But the trade deficit is increasing again as the dollar rises and as economic growth in America’s largest trade partners slows.

Net exports subtracted 0.6% from GDP growth in the first quarter of 2010.
Inorganic and Not Yet Sustainable: One-Off Inventory Gains

Rebuilding inventories has contributed to over half of growth during the past three quarters.

But growth from rebuilding inventories are one-off gains if final demand does not materialize.

Real final sales have averaged only a 1.7% increase over the past three quarters. In a typical recovery the rebound is closer to 3.5%, with far less government support.

Source: Bureau of Economic Analysis
Inorganic and Not Yet Sustainable: Consumer Spending is on Life Support

The increase in consumer spending has been supported not by rising wages, but primarily by government transfer payments.

Transfer payments now make up nearly a fifth (18.3%) of personal income.

Excluding transfer payments, personal income increased just 0.3% since the third quarter of 2009.
Policy Has Worked: The Recovery Reflects Washington’s Policy Priorities

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<tr>
<th>Gigantic monetary reflation and Wall Street bailout</th>
<th>Recovery of financial assets and profits</th>
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<td>Tax cuts, “cash for clunkers,” and unemployment insurance</td>
<td>(Temporary) support of consumer spending</td>
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<td>Modest infrastructure and public works spending</td>
<td>Weak job creation and stagnant wages</td>
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II. More Headwinds Than Tailwinds

- The debt overhang
- The phasing out of fiscal and monetary stimulus
- State and local government fiscal crises
- Continued housing woes
- The euro crisis, the rising dollar, and a new Asian export push
- Renewed world deflationary pressures
- Uncertain tax and regulatory environment
The Debt Overhang

The deleveraging in the private sector has just begun. Since consumer credit peaked in 2008, American households have cut just $310 billion of credit.

High debt levels will hold back future consumer spending and new credit expansion.

Even as debt in the household and financial sector begins to shrink, public debt is on the rise.

Credit Market Debt Outstanding
As a Percent of GDP

Source: Federal Reserve
Fed Wind-Down

To fight the great recession, the Federal Reserve slashed interest rates and more than doubled its balance sheet to over $2.3 trillion dollars.

The Fed has recently ended buying mortgage-backed securities (MBS) and other parts of its quantitative easing program.

The Fed has begun to prepare the market for future rate increases.
Government Support Will Fade

About half of the funds allocated under the Recovery Act have been paid out.

Federal government stimulus is expected to peak in the summer of 2010, after which fading stimulus will act as a drag on growth.

Concerns over rising public debt will make new government-led recovery efforts more difficult.

### Recovery Act Spending

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<th>Category</th>
<th>USD Billions</th>
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<tr>
<td>Tax Benefits</td>
<td>$288</td>
</tr>
<tr>
<td>Contracts, Grants, Loans</td>
<td>$175</td>
</tr>
<tr>
<td>Entitlements</td>
<td>$224</td>
</tr>
<tr>
<td>Funds Not Paid Out</td>
<td>$395 billion</td>
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<tr>
<td>Funds Paid Out</td>
<td>$392 billion</td>
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Source: Recovery.gov
State and Local Government Fiscal Crises

State and local governments face fiscal shortfalls and are beginning to act as a drag on GDP growth and job creation.

During the first quarter of 2010, state and local governments subtracted 0.5% from GDP.

In April, states cut a net 5,000 employees from payrolls, and more cuts are on their way.

*Estimated Source: Center for Budget and Policy Priorities
Continued Housing Woes

The Case-Shiller 20-city index slid 0.1% from January to February, a sign that the housing market may be starting to head south again.

The actual health of the housing market has been distorted by the homebuyer tax credit, the Federal Reserve purchase of mortgage-backed securities (MBS), and other government support.

Housing experts predict renewed downward pressure as the shadow inventory of unsold homes continues to grow and as banks are finally forced to put houses back onto the market. When accurately calculated, there are over 19 million empty residential housing units—a 20-month supply.
The Euro Crisis, the Rising Dollar, and a New Asian Export Push

The EU accounts for 21% of U.S. goods exports and 20% of China’s exports. A European slowdown will reduce demand for the two primary engines of world economic growth.

The rising dollar will hurt the competitiveness of the U.S. producers, short-circuiting a manufacturing revival.

Japan and China are putting renewed emphasis on exports, especially as China tries to rein in credit to avoid a larger property bubble.

Dollar/Euro Exchange Rate

Source: Federal Reserve, Bloomberg
Renewed World Deflationary Pressures

Because of global overcapacity and a large western debt overhang, world deflationary pressures are resurfacing, increasing the risk of debt deflation and future financial crises.

With European growth impaired and China and Japan resorting to exports, it will be impossible for the United States to export its way to a sustainable recovery.

The United States may once again have to absorb the excess capacity of other major economies or face a prolonged world recession.

The world is awash with excess capacity — in the U.S., there are simply too many vacant houses, empty apartment and office buildings, idle manufacturing plants and unemployed people. Credit is contracting. Money velocity and the money multiplier are anemic. This is a highly deflationary brew.

David Rosenberg
Chief Economist and Strategist
Gluskin-Sheff
Uncertainty Over Taxes and Regulation

Uncertainty over taxes and government regulation is deterring business investment and job creation.

According to the April 2010 Empire State Manufacturing Survey, employee benefit costs, taxes, and government regulation were generally seen as the biggest problems—both in absolute terms and compared with a year ago.

Outsourcing of jobs and investment becomes a more attractive option for companies during periods of uncertainty.

Policy uncertainty is a negative for the economy and markets. Solving [America’s long-term policy challenges] is imperative. But while the debates around major initiatives to address them are an important part of the democratic process, the uncertainty that accompanies major policy change is weighing on business and consumer decisions to hire, expand, buy homes and spend.

Richard Berner
Chief U.S. Economist, Morgan Stanley