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Sinai's Economic and Market Perspectives

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# What's Wrong With the Economy—"What You See is What We Got"*

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## What's Wrong With the Economy?

Answer—A lot!

Feeble real GDP growth of 1.3% reported for the second quarter and downward revisions to history *underscore a long-standing Decision Economics Inc. (DE) theme*—Recovery and then Expansion will be the weakest, most anemic, subpar, and longest with these characteristics of any economic upturn post-W.W.II. Indeed, now even the upturn is in question with odds 1-in-4 of some sort of "Double-Dip" (Table 1) and 35% total downside risk to an anemic Baseline.

*The U.S. is in for a tough time for a long time.*

## DE Baseline and Scenario Risks—For a Long Time Well Below-Consensus; Now More Downside Risk

The Consensus-disappointing 1.3% growth in real GDP for the second quarter (DE, 1.4%; Consensus, 1.8%-1.9%) was due to essentially unchanged consumption, in real terms up only 0.1%. Along with a downward revision in real GDP growth for 2011:1 to 0.4% from 1.9% *and* the subsequent June result on Consumption (-0.2% nominal; -0.2% inflation-adjusted)-- the recent data: 1) give a recession-like cast to the first half; 2) raise questions about what is going on; 3) ask what will be the path going forward; 4) move front-and-center whether some sort of a "Double-Dip" downturn is in process.

Washington worked through its latest policy issues, tortuously so, raising the debt ceiling and starting on a road of fiscal consolidation—no debt default, although now the realization of the prior DE forecast of a downgrade.

DE forecasts a pickup in the economy over the third and fourth quarters, 2% to 3% real growth, very little changed from its previous expectation. However, real economic growth for the full year will be less than 2%, fourth quarter-to-fourth quarter, in part due to the big downward revision of real GDP in 2011:1. *The Federal Reserve will be disappointed.*

*Based on a Decision Economics, Inc. GDP Report Teleconference, Friday, July 29, 2011.

*The Fed's latest published projection (June) of 2.7% to 2.9% growth for 2011 cannot stand up.*

For 2012, DE forecasts real GDP to grow in a range of 2-1/2% to 3%, no change from forecasts in-place since February and essentially going way back to early 2009. In 2013, as federal government spending restraint hits the economy, growth should slow to a range near 2-1/2%, or even less, depending, though, on policy changes that could occur between now and then.

Anemic U.S. economic growth coupled with continuing high unemployment amounts to a weak and unsatisfactory recovery and expansion.

The DE Baseline, even before the Recovery began in 2009:2, was depicted alphabetically as an uptilted "L," not a "V," "W" nor "U," at 70% odds earlier this year, reduced to 65% last month, and now 60%.

The likelihood of a full-fledged "Double-Dip" Recession like the one experienced in 1981-82 is still 5%, but a change in odds to a more negative prospect cannot be ruled out. A more likely Alternative Scenario Risk, with odds currently 20%, is that the economy might grow very slowly, say in a 1% to 2% range, a kind of "Double-Dip," but in *growth,* not *levels* of real GDP. Odds on a "Double-Dip" Growth Recession were 15% a month ago and 10% previously.

**Table 1**
**DE Baseline and Alternative Risk Scenarios and Probabilities**
**(July 29, 2011)**

| | **Current** | **Previous** |
|---|---|---|
| Baseline—"Muddle-Through" or Uptilted "L" | 60% | 70% |
| "Double-Dip"—Another Full-Fledged Recession Some Time in 2011-12 | 5% | 5% |
| "Double-Dip" Growth Recession with Low Inflation—"Japan-Like" | 20% | 10% |
| U.S. Sovereign Debt Crisis | 10% | 10% |
| "Delayed Takeoff"—Lags in Spending Hold Economy Back But Then a "Takeoff" on Positive Effects from Previous Massive Monetary and Fiscal Stimulus | 5% | 5% |

**Transitional Slowdown? Soft Patch? Or, "What You See Is What We Got?"**

The *Consensus* had been that first half economic weakness was a transitional slowdown, a soft patch, something that would be temporary. Consensus and Federal Reserve projections had suggested a big rebound in the second half, to a 3-1/2% or 4% pace.

It has been tempting to view the slowdown as temporary, an interim period of softness as in so many other business cycle upturns, particularly given the probable temporary spike up in crude oil, energy, and gasoline prices that depresses growth and raises inflation.

*DE has not, and does not, see(n) it that way.* The DE picture of this Recovery/Expansion continues to be an alphabet letter caricature uptilted "L" with the

uptilt at the bottom, not a "V" as so many had thought early on, nor a "W" or a "U," but *an unusual, aberrant episode depicted with an alphabet letter that itself is unusual.*

Instead, *"What You See Is What We Got"* is the DE outlook, as it has been—*chronically slow growth,* on average; *anemic; subpar; half-speed; a frustratingly soft expansion of the economy, not a good nor satisfactory one, sclerotic and stubbornly weak.*

*Why*?

*The central reason is the consumer and consumption.* Consumers simply are not spending anywhere near the pace typically seen in economic upturns. The fundamentals surrounding the consumer indicate continuing weakness, nowhere near what used to be the case; between 1955 and 2005, some 50 years, approximately 3-1/2% trend growth per annum for real consumption. *Since consumption is so large a part of the economy, about 70-1/2% of real GDP, how consumption goes so will go the economy.*

In the second quarter, the GDP report showed real consumption up at a miniscule 0.1% annual rate; in the first quarter only 2.1%. Since 2009:2, the beginning of the Recovery, real consumption has grown by 1.7% per annum. Over previous economic upturns post-W.W.II, two years into Recovery, the average per annum increase in real consumption has been 4.3%. *As long as this pattern of consumption continues, the U.S. economy can not deliver the kind of overall result seen before.*

*There are other problems, other reasons*, of course, for the poor economic performance.

In the second quarter, *state and local government sector spending* was down 3.4%, at an annual rate. There is a huge adjustment going on in this sector—cutbacks because of balanced budget requirements. State and local government spending currently is 11% of real GDP. The state and local government sector probably has now seen the worst. Prospects are more positive on state and local government sector municipal bonds as a result, assuming there is not a turn of the economy into a full-fledged recession. Or, some credit rating downgrades. But, prospects for a lift up in spending from this sector are nil.

*Fiscal consolidation* is now the motion of Washington, though not yet clear on how much, the timeline, and how to be done. But, in a big picture sense, *fiscal consolidation of federal government outlays has begun and will be contractionary*.

The agreement between Congress and the President, or "Deal" just fashioned, finessed the debt ceiling issue, but did not prevent a downgrade of U.S. sovereign debt by S&P. The reasons are that the United States has not really resolved its huge fiscal and debt problems, continuing uncertainty around this issue, and the political goings-on to get fiscal consolidation of some sort done. *Whatever is the ultimate outcome, however, fiscal consolidation of some degree will slow down economic growth in the outyears.*

*U.S. exports*, although in the second quarter still quite good, seem to be slowing. Exports are now a record-high 13-1/2% of real GDP and one of the few relatively strong sectors in the U.S. economy. But the global economy is slowing and, in turn, U.S. export growth.

**U.S. "Lost Decade?"**

Table 1 above shows the assessed likelihood of 20% that the United States, like Japan, has been, and will be, in a "Lost Decade," with low, but positive, growth of the real economy for many years. Put differently, the odds that the economy generates an upside

surprise in which consumers start spending a lot more and business starts hiring a lot more is only 5%. *The U.S. private sector continues to languish, the problem Japan had and the U.S. had in the 1930s.*

On the historic data and data revisions of the past few years, and prospects, *it does appear that the U.S. already is a little more than halfway through its version of a "Lost Decade."*

**Puzzle—Why Such Weak Growth After So Much Policy Stimulus?**

Remarkable is so weak U.S. economic performance in the aftermath of unprecedented economic policy stimulus.

For monetary policy, zero interest rates, huge injections of bank reserves to stimulate credit, and two rounds of increases in the Federal Reserve's balance sheet, QE1 and QE2, essentially "printing money," represents the most aggressive and sustained monetary policy ease in history. For fiscal policy, about $1.3 trillion of stimulus over 2008, 2009 and 2010 has been legislated and implemented, mostly government outlay-centric, and tax reductions that were "temporary." Despite this, there appears to be little to show in terms of the economy, jobs, and unemployment. Instead, there is a legacy of huge federal budget deficits and U.S. sovereign debt relative to GDP. *Thus far, the private sector just hasn't responded as it has typically.*

*Why this disconnect?* The full answer is not really known at this point.

But, *weak consumption spending is central.* Since 2009:2, real consumption has risen just 1.7% per annum, far below the average 4% plus seen over the first two years of previous upturns.

The *ineffectiveness of policy* is another. On monetary policy, a classic Great Depression 1930s-like "liquidity trap" is in-place. The response to low interest rates and the printing of money has been minimal. *Federal government outlay multipliers are far below the average fiscal multipliers of history.*

What are the *consumer fundamentals* that have contributed to this?

*One is weak jobs growth*, which itself has been partly due to weak growth in the economy. Weak jobs and a high unemployment rate put downward pressure on wages and compensation, which after adjustment for inflation produces low growth in real disposable income. In the data, over the first and second quarters *real disposable income was up only 0.7%.* Real disposable income is quantitatively the biggest determinant of consumer spending.

*The process of restoring household financial health is another factor*, absolutely necessary because of past excesses in spending, credit, and debt. Here, there is positive movement but it is slow. *The DE Household Financial Conditions Index,* a measure for the state of the aggregate household financial position, was 183.6 in the first quarter (low levels are "good," high "bad"), improved from the peak high level of 303.5 in 2009:3 but a long way from "equilibrium," which would be an Index level somewhere around 125 to 100.

*Household wealth, in real terms, has been rising but weakly so*—not anywhere near recapturing what was lost up to and during the economic downturn and financial crisis of 2007-09. *Consumer sentiment is recession-like. Funds, either from cashout mortgage financing or realized capital gains, are not readily available. The banking system is not supplying much credit to households*, many of whom unfortunately are underwater on a big source of household wealth—residential real estate.

*This long list of negative fundamentals around the consumer suggests that consumer spending will continue to rise, but nowhere near so strongly as in the past.* Therefore, the U.S. economy can grow, but only slowly.

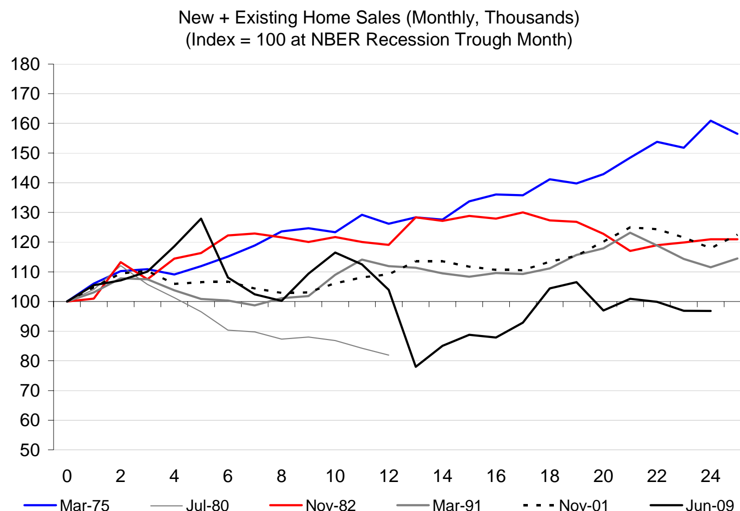
*There is a tricky feedback loop operating that is negative for the economy.* Business, for various reasons, is reluctant to hire. It is in the interest of shareholder value-maximizing companies to keep costs down. Labor costs are the biggest cost for business, especially when benefits are included. So, in a soft demand environment, business is substituting capital for labor. A soft U.S. sales environment leaves businesses looking for ways to save on expenses and one way is to substitute capital for labor to help productivity, profits, and to maximize shareholder value, i.e., the share price.

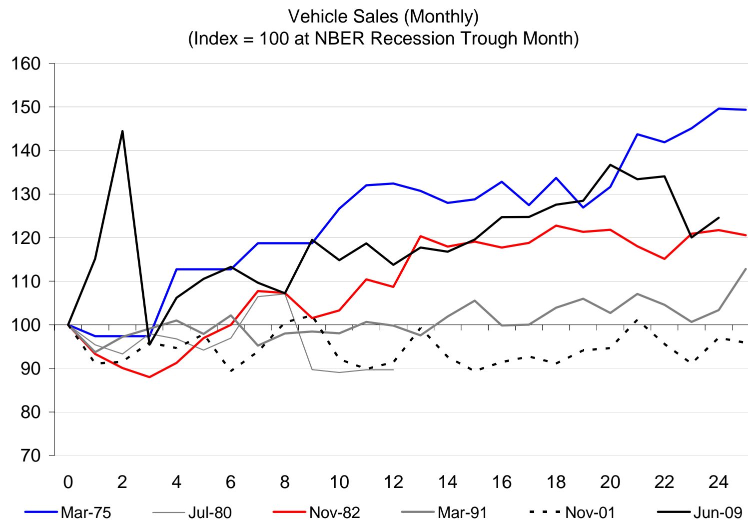
Substitution of capital for labor reduces the demand for labor. There is less jobs creation, then less income generated that could support consumption, less consumption, less sales within the U.S., less hiring, more substitution of capital for labor, etc.. In engineering terms this is a *positive feedback loop,* but in economic terms it has a *negative effect*.

Where the weak consumer fundamentals have mostly shown up compared with previous business upturns is in big-ticket item spending, especially Motor Vehicles and Housing. Normally a big surge in big-ticket item buying occurs in the early stages of an upturn because of pent-up demands, low interest rates, and easily available credit.

As Chart 1 shows, this has not happened. *New and Existing Home Sales are essentially flat to the level of June 2009, the first month of the Recovery*. Home sales can be seen to be the weakest of all previous business cycle upturns going back to 1975. Motor vehicle sales bounced up after the onset of the recovery in June 2009 but have stayed pretty flat since mid-2010. Both of these results stand in stark contrast to the economic upturns depicted in Chart 1 and those that came before.

**Chart 1**
**Big-Ticket Item Purchases by Consumers Very Weak Compared with History**






Numerous categories of consumer expenditures are tied to sales of new and existing homes and thus also have been much weaker. On limited growth in real disposable income, a compromised household financial situation, diminished wealth, less retirement funds and a lack of jobs, it is no wonder that consumers have hunkered down spending on big-ticket items and allocated resources to more value-based expenditures and activities such as travel, leisure and hospitality, and discount retailers.

**Slower GDP Growth—Way of the World?**

Since the bottom of the downturn in June 2009, the U.S economy has grown at an annual rate of just 0.7%. That compares with historical trend growth of 3.2% per year since 1955.

This points to nothing less than a Seismic Shift having occurred—*a long-time DE investment and investable theme (over five years now)—that consumers will spend far less for far longer and save far more for far longer than ever before*. Driven by weak consumer spending and higher savings out of limited income, slow economic growth is likely to continue far longer than previously seen in modern U.S. economic upturns.

To summarize and repeat, numerous fundamentals surrounding the consumer support a forecast of slow real economic growth well into the future. *This has been, and is, a reality of recent history and the prospect going forward—What You See is What We Got!*

- Jobs and growth in real disposable income drive consumer spending. Without stronger jobs creation and tighter labor markets, growth in real disposable income will not be high enough to support a sustainably strong pace of growth in spending and U.S. output.
- Households are continuing to save to restore equilibrium in household finances. While this goes on, consumers will be saving far more for far longer than ever before and this will contribute to a lower growth path for consumer spending than before.
- Many home mortgages are "under water," meaning the size of the mortgage exceeds the value of the home. This creates a raft of personal financial issues; also limits consumer spending.

- Household wealth is rising but weakly so. Investors have not yet recovered anywhere near the losses suffered during the 2008-09 financial market collapse.
- Consumer confidence, as measured by the University of Michigan-Reuters Survey and the Conference Board, has been at recession-like levels for many months—negative for spending.
- Struggling financial and banking sectors are not aggressively lending.

*Finally, the financial system, U.S. and global, is not functioning as it typically has given the adjustments occurring in the private sector and the transmission mechanism for monetary policy to household spending and economic growth is not operating as it usually has.*

*Weak consumer spending is contributing to a self-defeating feedback loop.*

With weak private sector demand, businesses do not hire much in the U.S.. Because of high labor costs, all-in including benefits, labor is replaced with tax-advantaged capital, which further reduces the growth in employment. Weak growth in jobs limits growth in income. This limits consumer spending, limits growth in the economy, which limits the growth in jobs, etc..

*There is no reason to think that anything will soon break this self-reinforcing feedback loop.*

Other factors are also causing chronic, slow real economic growth:

- state and local government spending has declined 2.5% in the past year, though DE believes the sector is turning, assuming a full-fledged recession does not occur.
- it is unclear how Washington will resolve the fiscal wrangling. The latest deal offered only a temporary respite to the problem. Whatever happens, there may be more debt downgrades which will force more fiscal contraction. As now being approached, the U.S. budget deficit and debt problems seem intractable, and prevent further stimulative fiscal policy measures from being taken.
- on the monetary side, the Federal Reserve has to be supportive, maintaining interest rates at an exceptionally low rate for essentially as far as the eye can see and, in doing this, attempt to keep long-term interest rates as low as possible. But, not until inflation can be seen to peak and point down can there be any QE3.
- the U.S. export sector has been healthy, due to a declining dollar and strong non-U.S. economic growth, particularly in Developing Countries. But export data reflect some slowing in a global economy that itself is now at more risk.
- the world economy and its interactions with the U.S. and vice-versa is one of the blindside surprises that is operating to weaken economies everywhere—a new phenomenon.
- the "flames" of a sovereign debt crisis are licking at U.S. shores—the process can be seen to be in-train.

**Earnings and Economy Disconnect**

As of August 8, with 419 companies in the S&P500 having reported, DE increased its S&P Operating EPS estimate for 2011:2 to $24.75, up from the pre-earnings season far-above Consensus $24.35.

This may appear surprising, given the poor U.S. macroeconomic backdrop. But, the pattern of earnings growth relative to GDP is familiar, having been seen in all U.S.

economic upturns since 1990-91. S&P500 Operating Earnings growth has been a large multiple to nominal GDP growth in each of these post-recession instances, reflecting the ability of U.S. companies to generate earnings under almost all circumstances.

*One reason for the disconnect between the S&P500 Index strong performance and poor economic growth is that companies are not hiring much.* Instead, labor is being replaced by capital, raising productivity and profits. And, particularly this time, *companies are not paying out increased profits and cash flow to workers, given the huge slack that exists in the labor market.*

*Another reason is the increased diversity of sales, revenues, and earnings for U.S. companies to outside the United States*. Non-U.S. sales and earnings now constitute about 45% to 50% of S&P500 company earnings. Companies have moved production, sales, and business to those parts of the global economy where prospects are better. Shareholder value-maximizing companies are supposed to do that. *In addition, a long-run decline, on average, for the U.S. dollar* has enhanced earnings as companies have diversified away from the U.S..

*Again, this disconnect is not unfamiliar.* In the post-1991 recession, earnings grew smartly for years while GDP grew at a modest rate. This also showed up subsequent to the 2001 recession. *It is important to remember that earnings and interest rates—not GDP—drive the equity market; hence a big disconnect between "Wall Street" and "Main Street."*

That disconnect is likely to continue along with many others, "new" features of a modern, globalized business cycle with finance highly integrated into the real economy, interactive worldwide, making them more normal paradigms of macroeconomic policy actions difficult in their effectiveness.

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