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Economic Outlook

Mean Shoots

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mean (adj): inferior in rank or quality
Oxford English Dictionary

"Green shoots" is the new catchphrase used by Federal Reserve chairman Ben Bernanke and others to refer to signs in financial markets and the U.S. and global economies that a recovery is in the offing. The appearance of green shoots, or at least the appearance of the term, has coincided with an increase in risk appetite in financial markets. There are reasons to believe that "green shoots" are really "mean shoots," or signs of recovery that are "inferior in rank or quality" and therefore not supportive of the sharp rise in equity values that has been driven by the strongly enhanced risk appetite among investors.

Why Greater Risk Appetite?

Three events have helped to support a global increase in preference for risk assets, especially stocks, since mid-March. A slowing rate of contraction of some measures of economic activity in the United States has fueled hopes for a second-half recovery despite the extraordinary collapse of growth in Germany and Japan during the first quarter at annualized rates of decline around 15 percent. The second source of support for the rising risk appetite has come from the transition of the financial crisis from an acute to a chronic phase. This occurred after the stress tests engineered by the Federal Reserve and the Treasury provided markets, hungry for reassurance, with some hope that the largest banks could stabilize their reserve positions with only modest capital increases totaling $75 billion. Finally, signs of renewed growth in Asia (particularly in China), tied to massive credit and spending stimulus, have boosted hopes that an increase in Chinese domestic demand may ease global imbalances. Taken together, these three indications of slowing economic and financial deterioration have contributed to a rise in U.S. equity markets and a narrowing of risk spreads.

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Slower Contraction—for Now

A slowing rate of contraction in the U.S. economy was largely tied to survey data on consumer confidence and purchasing managers' surveys of manufacturing activity. The consumer confidence data are linked closely to the rise of the stock market, while the manufacturing data are closely tied to the improvement in Asian activity, which is, in turn, linked to the sharp stimulus applied by the Chinese government. (See the May 2009 *Economic Outlook*, "Can China Keep Growing?")

U.S. consumption growth was positive during the first quarter, cushioning the sharp 6.1 percent annualized GDP contraction tied largely to a collapse of investment. More specifically, the collapse

of nonresidential fixed investment subtracted over 4.5 percentage points from growth, more than six times the normal investment drag during postwar recessions. The fortunate, offsetting moderate rise in consumption was supported by stronger growth of disposable income resulting from increased transfer payments and lower taxes. Personal income fell at a 1.5 percent annual rate during the first quarter, dragged down by a large contraction of wages and salaries at a 4.5 percent annual rate. Nevertheless, the boost from lower taxes and increased transfer payments resulted in a 4.2 percent annualized increase in real disposable income during the first quarter that, in turn, supported consumption growth sufficient to add 1.5 percentage points to the first-quarter growth rate, which would have been –7.6 percent (annualized) without the boost from consumption.

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The "green shoots" scenario of U.S. growth resuming in the second half of this year depends heavily on sustained positive consumption growth. There are numerous reasons to doubt whether that condition will come to pass. A sharp moderation of the contribution to real disposable income growth from lower taxes and increased transfer payments is set to occur in June. That said, even with the substantial support from lower taxes and transfer payments in April, nominal retail sales have been extraordinarily weak. During the forty years from 1967 to 2007, there were only four individual quarters during which current dollar retail receipts fell at more than a 5 percent annualized rate. Each of these episodes was isolated—five to ten years apart. Through the first quarter of 2009, there have been three *consecutive* quarters when retail receipts fell at more than a 5 percent annual rate, and the April retail sales data suggest that we are on track for a fourth consecutive quarter of extraordinarily weak retail spending. This makes year-on-year changes in retail spending by far the worst on record.

At the same time, retailers have not been able to reduce inventories as rapidly as sales are falling. The March inventory-sales ratio for retailers remained 15 percent above the January 2000–June 2008 norm. Looking ahead, desired inventory-sales ratios are a function of expected demand trends. Given the weak outlook for demand growth tied to weak income growth, desired inventory levels are probably even lower. Anecdotal evidence from China's Guangdong province, the principal manufacturing location of back-to-school supplies for U.S. retailers, reports no pickup in demand from that source. That observation is fully consistent with the notion that U.S. retailers are skeptical of demand growth going forward and therefore are not eager to boost inventory levels and that they are, in fact, probably eager to run inventories down further.

A sustained rise in U.S. consumption and a restoration of U.S. consumer confidence will require an improvement in the dismal picture now surrounding employment and wage growth. During April, headline employment fell by 539,000. However, adjusting for the usual large negative revisions to previous months' data and large temporary increases in government payrolls tied to hiring of census workers, private payrolls fell by 680,000. Nominal wages and salaries dropped at about a 4 percent annual rate over the six months ending in April. The only way to sustain consumption in view of such a sharp contraction in incomes is through substantial transfer payments and tax cuts provided by the government and a substantial reduction in the saving rate. The impact of transfers and tax reductions will be sharply reduced in June (as mentioned above) while households suffering from substantial wealth losses—collectively, $15 trillion—tied to impaired equity portfolios and housing values will very likely strive to continue boosting their saving rate rather than reducing it. So to repeat, a substantial slowdown in the deterioration of labor markets is a necessary condition to support rising consumption growth.

While markets are focused on "green shoots," notwithstanding mounting evidence that they are not sustainable, one "mean shoot" that is sprouting is an intensifying global disinflation/deflation trend. The Consumer Price Index (CPI)—at –0.74 percent year-over-year—reached a fifty-year low in April. Were it not for a large increase in tobacco prices tied to higher excise taxes, the negative CPI inflation reading would have been closer to 1 percent. Core inflation is at 1.8 percent on a year-over-year basis, and most forecasts predict that it will turn negative sometime next year. The year-over-year CPI inflation rate is also falling in Europe, down to 0.6 percent based on the latest available readings, while Japan has slipped back into deflation with consumer prices falling at a 0.3 percent rate. For the first time in decades, the year-over-year CPI for the United States

(the right index for global comparisons since most other countries do not look at core inflation) is the lowest in the world and heading downward. This is particularly ominous given the relatively high levels of indebtedness of U.S. consumers. Falling prices increase the real burden of debt and hinder efforts by the central bank to stimulate the economy with conventional interest rate cuts. Rather, the United States has already pushed its policy-setting rate—the federal funds rate—virtually to zero and is now being forced to employ a form of quantitative easing tied to purchases of mortgage assets and Treasury securities to try to arrest accelerating deflation.

With spring, the arrival of the “green shoots” scenario, coupled with a rising preference for risk assets, has, for the time being, constrained the Federal Reserve’s efforts to offer assurances that deflation will not be allowed to accelerate. The “green shoots” scenario, which includes a second-half recovery, also raises market expectations of higher inflation, which, in turn, boost interest rates even on low-risk assets such as ten-year Treasuries. By May, the rally in risk assets had proceeded to a point at which rising Treasury yields and the rebound in stock prices moved the stock market’s dividend yield back below the yield on ten-year Treasuries. With talk of green shoots raising expectations of recovery, markets appear to be anticipating higher inflation, while the data signal lower inflation. The higher yields on low-risk Treasury notes reduce the attractiveness of stocks with lower dividend yields, especially if green shoots turn into mean shoots in the months ahead.

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Part of the rising tension between more deflation and investors’ current preference for risk assets over government securities may be resolved by a persistent drop in the underlying support for corporate earnings going forward. During the first quarter of 2009, year-over-year nominal GDP growth, a measure of the total dollar value of U.S. output, turned negative for the first time since 1957. Without a substantial recovery in growth during the second half of the year, year-over-year nominal GDP growth will remain negative, at least for the next several quarters. In that environment, a realistic estimate for earnings of the S&P 500 companies (based on conventional methods employed by equity analysts) would be about $40 a share, which, at a normal fifteen to seventeen index-earnings multiple, would produce an S&P 500 Index range of 600 to 680, as opposed to the mid-May figure of about 900. In a context of falling stock prices and continued accelerating deflation trends, the Federal Reserve will need to turn back to an emphasis on fighting deflation at a time when deflationary momentum is likely to be building.

Banks out of Crisis?

The second leg of the “green shoots” scenario has been the proactive stance of the Obama administration toward the financial sector. This has included initiation and completion of stress tests to determine the viability of U.S. banks as operational (lending) entities. This step, coupled with the Fed’s commitment to quantitative easing, has helped to move what was an acute financial crisis with elements of panic to a contained chronic phase in which banks broadly have stabilized but have not yet begun to operate as lenders to U.S. households and corporations. If the hoped-for second-half return to positive growth of the U.S. economy is achieved, the “adverse feedback loop” running from the real economy back to the financial sector should be broken. Since September 2008, when the collapse of Lehman Brothers dramatically ushered in the acute phase of the financial crisis, causing in turn a virtual collapse of economic activity during the fourth quarter and into the first quarter of this year, the adverse feedback loop running from the financial economy to the real economy was operating with a vengeance.

If the financial sector crisis is restrained, the major question that remains is this: will the damage to the real economy begin to heal quickly enough to avoid another round of an adverse feedback loop that runs from the real economy and back to the financial sector? In this context, it is important to remember that earnings reports of financial firms and the assumptions of the stress tests themselves are highly conditional on the prospects for the economy, including, in particular, the prospects for easing of the housing crisis, which has yet to show signs of stabilization. Rather, most forecasters expect another 10–15 percent fall in home prices over the coming year. Meanwhile, foreclosures are accelerating.

The “successful” outcome of the stress test, a part of the “green shoots” scenario, leaves unanswered some

questions about the continuing viability of U.S. banks. The results of the test were—as noted—conditional on underlying assumptions about the future path of the economy and the value of the assets on bank balance sheets. The stress tests were originally undertaken in the context of a challenging environment regarding bank losses on assets. The International Monetary Fund's latest "Financial Stability Report," published in April, estimates that U.S. banks will have cumulative losses of about $1.6 trillion over the period between 2007 and 2010 on their loans and securities. Write-offs through the first-quarter earnings season have been about $600 billion, leaving about a trillion of total losses still unrecognized. The immediate pressure on banks to provision for such losses was substantially reduced by a ruling from the Financial Accounting Standards Board (FASB) that allowed the banks to continue to value assets at about ninety cents on the dollar even though comparable assets were trading in the market at somewhere between thirty and fifty cents on the dollar. In effect, the banks were allowed to assume that the assets would be held to maturity and sold at the current assumed price of ninety cents on the dollar. Needless to say, the path of the economy between now and the maturity date of many of these assets will either justify or place additional stress on the forbearance offered by the FASB.

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The banks were given ample leeway under the stress tests to scale estimated losses back to manageable levels. The nineteen banks under consideration had cumulative losses estimated at about $600 billion. The banks were allowed to credit two years of their own estimates of expected future net income against the losses. That brought the $600 billion loss figure down to about $300 billion. Further accounting adjustments—credits for capital raised in 2009 and higher-than-expected income during the first quarter—reduced the capital requirement for the nineteen banks to a manageable $75 billion, well within the limits suggested by available funds of over $100 billion from the Troubled Assets Relief Program (TARP).

It is hard to imagine that government-conducted stress tests would have revealed bank capital needs in excess of available resources in TARP funds, and, indeed, this was not the case. However, without the second-half recovery and a diminution of current deflationary trends, the estimate of an extra trillion dollars needed to recapitalize U.S. banks to a point at which they can become active lenders will become a burdensome obstacle to a sustainable global economic recovery. Indeed, the Obama administration recognized as much when it inserted a provision to provide an additional $750 billion of funding for bank recapitalization in its 2010 budget. It is to be hoped that such funding will not be needed since, so far, members of Congress have indicated no willingness to provide additional funds for U.S. banks. Were the second-half recovery not to materialize, a far more likely response from Congress would be an additional stimulus package that would include further payroll-tax reductions or more of Congress's favorite pork-barrel projects along the lines of the model established with the current stimulus package.

Hope from China?

The third leg of the "green shoots" scenario is perhaps the most substantial, although it carries with it the least direct support for a recovery in the United States. China's substantial commitment to boost spending on capital equipment and infrastructure in 2009, along with Japan's announcement of a further fiscal stimulus package worth about 3 percent of GDP, should help to stabilize Asian economies and perhaps to mitigate, at least, the rapid plunge at a 15 percent annual rate in Japan's first-quarter figure for GDP growth. Both stimulus packages look to be applied rapidly and will be focused on boosting domestic demand.

China has augmented its large stimulus package with a flood of credit to the private sector that is helping to boost spending and the stock market. China's efforts to stimulate demand through public works projects and capital investment in its traded-goods sector, while supportive in the near term, promise an increased supply of traded goods emanating from China that will only increase the deflationary pressure already evident in the global traded-goods sector. The possible deflationary impact of China's stimulus efforts is perhaps most ominous for the United States. Intensified deflationary pressures are already facing the American traded-goods industry, as underscored by the bankruptcies of Chrysler and General Motors, coupled with the emergence of substantial excess capacity both in the United States and Europe.

U.S. capacity utilization dropped to 69.1 percent in April—the lowest reading in the fifty-year history of the series. Demand growth will need to recover substantially

to reverse the deflationary fall in capacity utilization. Many are counting on the desire to raise inventories given the sharp inventory sell-off during the first quarter to increase production going forward. However, as of March, the latest month for which data are available, the ratio of business inventories to sales stood at 1.44, substantially above the average of about 1.28 over the last four years. Inventories of unsold automobiles were still highly elevated in March at 2.45 times sales, not an encouraging development given the relapse of auto sales to a 9.3 million unit annualized level during April, down from a figure of 9.9 million units in March.

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U.S. Consumption Growth Needed

The three-legged, "green shoots" economic outlook for the United States depends most heavily on one thing: a resumption of spending growth by U.S. consumers, whose spending accounts for 70 percent of U.S. economic activity and whose additional spending can provide substantial help to the global traded-goods industry, which is currently in sharp decline. As noted above, while transfers and tax cuts helped to support U.S. consumption through May, a sharp reduction of that support starting in June raises doubts about the sustainability of the modest consumption recovery already underway. Second-quarter growth will probably decline at a 2.5 percent annual rate, slower than the 6 percent annual rate decline in the first quarter, but without the substantial support from government programs, the second-quarter growth rate would be as weak as the first-quarter rate.

The most fundamental change needed to sustain consumption growth is for the monthly drop in employment to slow to a pace below five hundred thousand per month while the rapid rise in the unemployment rate slows as well. The outlook for either is not particularly bright. The interruption of production at Chrysler and General Motors, notwithstanding some boost from Ford, further threatens consumer incomes, employment, and confidence.

A key element of the "green shoots" scenario has been the stabilization of the American financial system, which can buy time for economic stabilization to take hold. Stabilization, however, will need to be made operational by moving the banks to a point at which they can supply credit to American households and businesses. That will require truncating the adverse feedback loop flowing from the (damaged) real economy to the (weakened) financial sector. But the risk is that we have seen the best for consumption growth in the first quarter of this year thanks to the substantial boost to disposable income from larger transfer payments and reduced taxes.

There are fundamental contradictions embedded in the "green shoots" scenario. We need faster U.S. consumption growth to make it work, and faster consumption growth requires, in turn, more credit for U.S. households and businesses. Yet, credit-financed spending in excess of income is exactly what created the housing and finance bubble, the bursting of which precipitated the financial-economic crisis from which we are trying to recover.

For now, the federal government is using credit-financed spending in excess of income—much larger budget deficits—to try to restore banks' lending ability and household spending ability. Modest success—in terms of –3 percent growth at midyear instead of –6 percent growth—has inspired the talk of "green shoots." If the government borrow-and-spend growth boost atrophies before the economy achieves autonomous sustained growth, we shall have to decide whether to go for another borrowing round or just face the music in the form of a protracted period of lower growth. I am betting on another round.

What is your call, Mr. President?