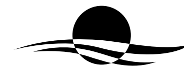
Growth STRATEGIES

Trend Analysis That Builds Business Decisions



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IN THIS ISSUE: WHERE NEXT FOR THE ECONOMY

1 – THIS IS A RECOVERY?
2 – THE RECOVERY THAT NO ONE WANTS TO BELIEVE IN
3 – IN THE AFTERMATH OF THE GREAT RECESSION
4 – WHAT ECONOMISTS AT KIEL TOLD US
5 – WHAT CONSUMERS ARE TELLING US

1 – THIS IS A RECOVERY?

Yes, we are in a nascent recovery, but as the recession was atypical, so too will be the recovery. As we are reminded by John Mauldin (past CEO of the American Bureau of Economic Research), we had a deleveraging recession – and we are still deleveraging – a process that takes years to unwind. Debt crises always end badly, but as the saying goes, if something "simply cannot go on," then it simply won't. And we simply cannot borrow our way out of a debt crisis; something has to change.

But didn't the economy grow at 5.6% in the last quarter of 2009? Yes, due to inventory accounting and the effects of the stimulus, but the underlying economy is still weak. What about employment/unemployment? Well, businesses may have stopped laying people off, but there are not a lot of job openings. Even rosy scenarios still have unemployment above 8% in four years (and that assumes a total of 1.5 million new jobs can be created this year and two million every year thereafter, with no recession!).

Remember, we need about 125,000 new jobs a month just to keep up with the growth in our population, writes Mauldin. What kept the unemployment rate from rising significantly was a deduction of 238,000 people who have given up looking for jobs (and thus are no longer considered unemployed). The U-6 unemployment rate, which includes those involuntarily underemployed, rose to 16.0%.

As I wrote here six months ago ("We Shopped Till We Dropped"), we are looking at years of higher taxes, slower growth, higher interest rates, slower productivity growth and higher unemployment. And that's a "good case" scenario. Mauldin does not rule out a worst case scenario: not just a double-dip recession but a depression.

2 – THE RECOVERY THAT NO ONE WANTS TO BELIEVE IN

Robert Johnson, associate director of economic analysis at Morningstar, does not agree. He sees strong economic growth (4% or higher) in both the short and long term. In fact he says that pessimists and skeptics have always been proven wrong, and they will be again. On what does he base this optimism?

Consumer spending is now approaching its pre-recession high despite high unemployment levels. While still down from record highs, consumer net worth (all assets minus debts) is now $6 trillion above its lows as net worth moved from $48 trillion to $54 trillion at the end of 2009 and is still increasing. That $6 trillion increase compares to the annual GDP level of $14 trillion. That is nothing to sneeze at.

The negative wealth effect that we have faced for more than a couple of years is now beginning

to work in reverse. Even without further asset growth, consumer spending still has room to advance as employment and incomes could begin to expand in the very near future. So far, employment has been a drag on consumer spending as it often is at the very beginning of a recovery.

Production and Manufacturing are Showing Signs of Life. Low inventories are already costing some businesses sales that they would have otherwise been able to make. The current inventory/sales ratio recorded by the Federal Reserve was 1.25, the lowest level since the Fed began formally measuring the ratio in 1990. On a year-over-year basis, the sales part of the calculation was up while inventories moved down.

Business Investment is Just Beginning to Make Its Move. Although the consumer makes up about 70% of the economy, improvements in business investments will eventually kick in, too. Although the investment portion of GDP is about one fifth the size of the consumer sector, the swings are far wilder. Thus far the business-investment part of the equation has provided little of the economic growth during this recovery. That is beginning to change.

Productivity Growth Should Drive Exports. A well-educated workforce, labor flexibility, and a large manufacturing equipment and software industry all have helped make the US economy a productivity machine as of late. When one also includes the fact that US wages have been more restrained than in most other economies and that the dollar has been weak, some US goods are surprisingly competitive in world markets.

Modest Recovery So Far Is Good News, Not Bad News. The rather slow economic recovery has some silver linings. We have crawled this far out of our economic hole without any improvement in employment or investment spending or very much help from the housing sector. Those are things that will come in months and years ahead, sustaining economic growth for longer than anyone thinks possible today.

Johnson's biggest fear now is the relationship between consumer incomes and inflation. Non-inflation-adjusted hourly wages haven't shown much growth for some time, but inflation has been very tame. In fact, during some months of the recession, average hourly wages were flat while we actually experienced deflation, basically giving employees the raises that their employers refused to grant them. That phenomenon helped move consumer spending along, especially in early 2009.

Now in 2010, real hourly wage growth still looks anemic, but inflation, especially in energy prices, is beginning to pinch a little. In the months ahead, there will be a contest between the removal of salary freezes, merit raises, bonus reinstatements, and so on, and increasing inflation on the other side. That bears watching.

[Editor's note: economist Larry Kudlow is also bullish. He writes: "Commodity charts are showing a V-shaped rebound. So are the latest ISM reports. Retail chain sales may actually be up 10% in March, according to the latest reports. Household employment is growing, up 1.1 million jobs in the first quarter, according to the March report out last Friday. Even non-farm corporate payrolls rose for March. They're up about 220,000, including prior upward revisions.

We know that money remains very loose, with a negative real interest rate and a bloated Fed balance sheet. We also know there's a global boom going on among the emerging countries. This is not forever. We are facing higher taxes and probably higher interest rates next year. But for now, we've got several quarters of booming economic growth."]

Growth STRATEGIES

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- Market and industry analysis
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Trend Analysis That Builds Business Decisions

3 – IN THE AFTERMATH OF THE GREAT RECESSION

Americans are moving less than at any time since World War II. With a grim job market, the young also seem more cautious. So the Great Recession's nastiest scar could be an era of economic frustration, characterized by slower growth and contentious competition for scarce resources. So writes economist Robert Samuelson.

What would that look like? Stunned by huge wealth losses in stocks and real estate, Americans save more and spend less. Businesses suffer from weak demand. Hiring remains sluggish. Worse, the slowdown coincides with an aging population, which could compound the effect. (In 2020, the projected number of Americans 55 and older will reach almost 100 million, 29% of the total population. That's up from 59 million, or 21%, in 2000.) An aging society could become a stand-pat society, protective of the status quo and resistant to change.

Against this glum prospect, writes Samuelson, the standard rebuttal evokes history. The US economy is amazingly resilient, the argument goes. It has been a consistent job creator: 21 million in the 1970s, 18 million in the 1980s, 17 million in the 1990s, 12 million in the past decade through 2007.

A "can-do" culture – combining intense ambition with a flexibility to adapt and an instinct for innovation – ensures that the economy will ultimately rebound strongly. The harsh recession may have actually improved the long-term outlook by purging high-cost firms and forcing efficiencies. Productivity (output per hour worked) has risen 4% in the past year. Profits are already up 21% from their low; surviving firms will soon expand.

WHICH VISION WILL PREVAIL?

The answer may hinge on two things: trade and entrepreneurship. Most economists see stronger exports as a substitute for weaker consumer spending. Unfortunately, that depends heavily on economic growth and trade policies abroad. By contrast, entrepreneurship is a sleeper issue that depends on what Americans do.

If you doubt its importance, consider this: All net job creation from 1980 to 2005 came from firms that were five years old or less. It's not small firms but young firms that count.

If Americans don't continue to create firms the economy may languish. But beginning a business is a risky, exhausting, chaotic process. Every year, there are roughly 500,000 to 600,000 company "births" and almost as many "deaths." Half of new firms don't make it to year five.

There's a warning here, concludes Samuelson: Complex regulations or high taxes may discourage start-ups and job creation. As for broader questions, the answers may remain murky for years. Has the mix of economic trauma and aging made us prudent – or merely fearful? Has economic resilience survived – or given way to a stand-pat society?

4 – WHAT ECONOMISTS AT KIEL TOLD US

The bi-annual meeting of economists at the Kiel Institute of World Economics took place last month in Germany. Our colleague Jorn Thulstrup was again in attendance.

Dr. Joachim Scheide opened the conference with the presentation, "High Uncertainty: Are We Returning to Normal?" The answer is no; despite the turnaround of almost all indicators, there has been no considerable increase of capacity utilization in any industrialized country. Business expectations have risen, but the level of production or orders is still well below the level of 2008. ***And it's the level that's important, not the change.***

Dr. Scheide ruled out a strong "V-shaped" recovery, pointing out strong recoveries only follow recessions ***that do not also involve a financial crisis.*** The consequences of a "go-slow" recovery include 1) The risk of inflation may appear earlier; and 2) Budget deficits are structural and will not be ameliorated. He credited central banks' monetary policies with preventing a Great Depression, but expressed concern with "exit strategies" (expiration of quantitative easing), as we don't have much experience with them!

Dr. Scheide focused on what he termed ***the highest level of debt to GDP in peacetime.*** He said countries will have to shift to substantial primary surpluses soon and even if that policy is successful ***it will take between 10 to 20 years to return to the debt-to-GDP ratios of 2007.*** As for interest rates, ***the question is not if they go up but when.***

Dr. Robert Chandross of Seton Hall University predicted a rather mediocre outlook for the US economy over the upcoming years. He said the modest growth seen in the US during the second half of 2009 was mainly due to fiscal stimulus programs and the deceleration of inventory cuts. ***He characterized the prospects for significant employment growth in the near term as low and predicted that fiscal drag will start to hold growth in 2011.***

House prices have stopped falling but foreclosures are still running at a high rate. Any signs of optimism in Dr. Chandross' speech were few and far between: A large output gap argues against inflation problems for some time, and the Federal Reserve is in no hurry to start raising short-term rates.

5 – WHAT CONSUMERS ARE TELLING US

The monthly **Consumer Demand Index** – our proprietary national survey of US households' purchasing decisions – moved slightly up in March, but remains in negative territory. The CDI now stands at -1, up from -3 in January and February. The 3-month moving average however went down into negative territory for the first time since November 09, and now stands at -2.5. Both the current and 3-month indexes are dramatically higher than in March 2009, but the significant upswing we have seen since June 09 has lost momentum.

For perspective we again turn to Jorn Thulstrup, CEO of the US CDI. He writes,

"I am as you know a winter bather. Last week I noticed that the water temperature had increased by 1000% from the previous week, from 0.2 degrees Celsius to 2.0 degrees. ***But it's still damned cold.*** So to echo Dr. Scheide, yes, consumers' purchasing decisions are higher than in March last year, but look at the level!"

The Consumer Demand Index is a monthly survey of American households' buying decisions for the next 90 days. Unlike other measures of consumer "confidence" or "sentiment," the CDI measures what percentages of US households WILL BE making purchases in the next 3 months across a wide range of durable and non-durable goods, including cars, white goods, PCs, TVs, home furnishings, kitchenware, clothes/footwear, and food/groceries. We also measure, uniquely, what percentage of households WILL NOT be making purchases in ANY of the product categories surveyed.

For more information and to subscribe, go to www.consumerdemand.com.