The Economic Outlook: Spring 2002

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Where we're going, short-term: More of the same…only different

Anyone looking for clear and definite signs that we are out of the clouds and in for a smooth ride, is bound to be disappointed. Over the next quarter, we can expect a mixture of economic reports, both good and bad. Overall, positive indicators will outweigh negative results, but even so, not every upward trend will be a strong one. While the elements of recovery are in place and preliminary first-quarter GDP results are surprisingly robust, the recovery is not likely to be borne along by the sustained vigor of the mid-Nineties economic expansion.

Despite real estate activity pointing in the opposite direction late last year—that is, record sales of new and existing homes—the economy showed signs of slowing as early as the spring of 2001. A number of factors contributed to the slowdown even before the tragedies of September 11. Word from the National Bureau of Economic Research—the official arbiter of boom-bust cycles—is that the US economy slipped into recession in March of 2001.

Most domestic economic forecasts now indicate that the economy has bottomed out, already; but that does not mean the unemployment rate is finished rising nor that a strong or rapid rebound in general economic conditions is just over the horizon. The timing and strength of the recovery remain open to debate, accounting for much of the variation in economic forecasts for 2002. The general consensus is that while some indicators will turn positive well in advance—as has already occurred—it will not "feel" like a recovery until the second half of the year. Some of the most pessimistic economic forecasts, especially those from abroad, even doubt that recovery will be solid by then.

Concern about consumers

This economic slowdown was led by the business sector, where reduced output and inventories translated into a sharp increase in unemployment over the second half of 2001. In contrast, consumer activity remained strong, the result of lower interest rates, promotional financing for autos[1], cuts in energy prices[2] and tax breaks. As a result of that combination, household disposable income did not take the early hit that was anticipated from rising unemployment. Furthermore, consumers have shown a propensity to save less and to borrow more during the past year, thereby contributing even more to the national spending spree. Since consumer and household activity are such a big part of the economy, accounting for more than two-thirds of GDP, the future psyche and spending habits of that sector are of great concern. So far, consumer confidence has shown remarkable resilience.

At some time in the future, high debt-to-income ratios, as well as a slowdown in housing activity, will create a braking effect on consumer spending. With the business sector poised for a moderate, rather than all-out recovery, the consumer sector and consumer confidence bear watching. The concern is that a fall in confidence or

[1] The largest monthly increase in consumer credit on record, occurred during November 2001, at the height of the zero-interest car loan frenzy.

[2] The spot price of crude oil fell from nearly $30 per barrel at the beginning of 2001, to below $20 per barrel by year-end. Consumers benefited further as a result of higher than average winter temperatures, which further reduced energy demand. As of March, 2002, spot oil prices were just under $25 per barrel.

retrenchment of consumers (such as a rise in credit card rates might precipitate) could not only hinder the pace of recovery, but also cause the dreaded "double dip" recession.

Intermediate Outlook: Weak to moderate business gains for the year

Looking beyond the consumer, businesses have responded as expected to weak profits, uncertainty over future conditions and Fed easing. Last year, manufacturers led the way in response to slower sales, as the first to cut output in order to reduce inventory oversupply. Subsequently, they proceeded to reduce staff and close plants, to reduce operating expenses, as demand for exports and intermediate goods continued to slow. The decline in manufacturing output during 2001 was half again as large as the manufacturing sector's contraction during the 1990-91 recession.

Later, temporary staffing agencies, business service providers and transportation companies exhibited the first signs of sluggishness on the service side of the economy. Commercial real estate, banking, telecoms, utilities—and finally travel and tourism (dramatically, post-September 11)—all followed into declining territory, at different times during the second half of 2001. After September 11, the question of whether Fed easing alone would have been sufficient to avert a full-blown economic contraction became a moot issue.

At the same time, the high-tech sector experienced nothing less than a meltdown last year. That was partly as a result of "irrationally exuberant" valuations for early-stage dot-com startups (with high debt-loads and no profits) and overreaching telecoms (which overpaid at auction for rights to the digital spectrum, especially in Europe), but also perhaps, through "guilt by association." Despite the dot-com bust, the dramatic retrenchment that continues to occur in the venture capital industry represents an overreaction. There is much evidence to suggest that the United States' economy did experience a "Technology Revolution" of sorts during the past decade —that is, an increase in productivity, as a result of business investment in computers and related equipment (i.e., everything from automated cash registers and small business accounting software to state-of-the-art manufacturing equipment).

Continued productivity gains, lower interest rates and inventory adjustments are at the root of this economic recovery. What is missing—i.e., strong exports—and what is unclear—i.e., sustained consumer participation—are the elements that would otherwise kick-start the rebound. Enhanced productivity means that once inventory overstocks are depleted, companies can increase output in the near-term without an immediate increase in hiring—indeed, while unemployment continues to rise. With concern looming about the consumer sector and with much of the rest of the developed world also muddling along near the bottom of the business cycle—and with a strong trade-weighted dollar further tempering demand for US exports—business expansion plans over the next year will be conservative.

A corollary to the outlook for modest expansion is that the level of business investment will remain lower than during the Nineties. Companies continue absorbing the productive capacity put in place during that period, along with the corresponding increase in corporate debt. Beyond the short-term, as the recovery continues, companies will increase output without increasing investment—first by restoring furloughed capacity and later through a gradual resumption of hiring. As a consequence, investment levels will remain modest. That phenomenon, in combination with weak corporate profits, implies a slow recovery for equity markets.

Weak demand was a factor well in advance of the Fed's last rate cut, to 1.75 percent, last December 11, the eleventh drop of the year. The weaker stimulative influence of late-cycle (as opposed to early) interest rate cuts is as important in interpreting the Federal Reserve's recent monetary policy decisions, as is the fear of inflation—which is low and is expected to remain low, given the excess in productive capacity and synchronized weakness in employment and output around the developed world. Unless inflation accelerates dramatically—very unlikely at this time, even with a rise in energy prices and unrest in the Middle East—expect the Fed to maintain a neutral stance rather than either tightening or easing. The Fed is in a position where looser monetary policy is unwarranted, given signs of an economic rebound, while tighter policy could crimp the expansion.

Longer-term: Risks from debt, the strong dollar and trade imbalance

At present, all systems appear "go," for a modest recovery in the US, as economic activity resumes a slow pace of growth after corporate balance sheet adjustments resulting from debt refinancing and inventory adjustment. The seeds of recovery were planted through monetary policy in combination with fiscal stimulus. Consumers are unlikely to spoil the recovery, but they may not contribute much, either, during the next six to nine months, while levels of unemployment and household debt remain high. The rebound will vary by sector—right now, it appears that defense-related industries will see the strongest gains, while tourism and travel continue to experience aftershocks from September 11, and high-tech remains hungover from the Go-Go Nineties.

Without households and consumers to drive the economy forward—an important component of domestic demand—many companies traditionally turn to international trading partners to take up the slack. However, most of the developed world is also at the bottom of the business cycle—an unusual coincidence. US exports are further restrained by the relative strength of the dollar against the currencies of major trading partners.

A number of factors contribute to the current strength of the trade-weighted dollar, including the United States' current account imbalance, with imports running far ahead of exports, and global insecurity in the wake of September 11, whereby the dollar is regarded as a safe haven for foreign investors.

Eventually, however, the ability to run current account deficits, like other borrowing, will cease. An exchange-rate adjustment in which the dollar falls against foreign currencies at the same time as some of those economies recover, would not necessarily be a bad thing. The likely corresponding increase in exports and decrease in imports would shore up the recovery abroad while providing additional—much-needed—outlets for US goods and services, especially manufactured goods. That would be a far better outcome than continued growth of the current account deficit, which could lead foreigners to dump US assets at some time in the future.

Risks: Federal spending, security and interest rates

For the time being, Washington and the nation continue to concentrate on the war on terrorism. The focus of the President's budget is homeland security and national defense. Congressional Democrats have little mettle for argument with a popular President during a time of perceived national crisis, so at least in the near-term, the fiscal picture appears clear—that is, no new taxes and additional spending on defense and security, with fiscal restraint almost everywhere else. Early forecasts see the deficit rising for at least the next two years. If economic recovery is delayed, fiscal deficits could be larger than anticipated.

Increased Federal borrowing by the Treasury to finance the national debt could have a serious adverse impact on long-term interest rates. Already, rates have hiccupped but remain lower than year-end forecasts anticipated, primarily because economic weakness and uncertainty have favored lower rather than higher expectations of growth. As investors become more sanguine about the recovery, rates should begin a steady, if gradual, climb. Budget deficits could hasten the rise.

Conclusion

For the near-term, expect the economy to continue to expand with sporadic interruptions. The pace of expansion will be moderate when compared with past strength. Consumers cannot run on credit, forever; and the corporate sector has plenty of capacity for servicing anticipated demand without either immediate new hiring or investment. Domestic activity will be assisted by no more than modest export growth while the dollar remains strong and the rest of the world is also recovering.