ADVISOR PERSPECTIVES

ECRI: Recovery and Jobs Growth are Underway

By Robert Huebscher
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We spoke with Achuthan on December 16.

In your book, you make the point that every recession and every recovery is unique. What was unique about this recession? Specifically, do you believe the degree of deleveraging contributed to the uniqueness, insofar as it created a self-reinforcing relationship between foreclosures and unemployment?

Certainly the home-price downturn was at the epicenter of this recession and crisis. But it's really the way that the excess is manifest in each cycle that makes things different. In the last recession, in 2001, we had a lot of excesses, for example in information technology, that were unsustainable. In the run-up to 2007, we had a belief that home prices would never go down and the idea that exotic derivatives were a very efficient way to manage risk. Both of those assumptions came crashing down in this cycle.

As you point out, there is a lot of deleveraging in the private sector that happens in every recession, and in this one there was quite a bit that had to occur because housing tends to be the biggest debt-fueled investment that households take. There's a lot that got leveraged up and therefore a very long way to go. That doesn't end when the recession ends; it can continue into the recovery.

While there are common aspects to every recession, the locations of excesses or the stories behind each recession change from time to time. Pre-World War II, we have had a number of cycles in which a lot of deleveraging had to occur and in

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which there were financial crises. When you get these big credit-induced turning points, they are not smooth or mellow. They tend to be a little bigger.

Have the excesses been sufficiently worked off to say that we are in a recovery? What will be unique about this recovery?

We can say that we are in a recovery. However, some of the excesses are still being worked off and may limit what would otherwise be a stronger recovery. In April of 2009, our forecast was that the recession would end in the summer. Today, that forecast looks to be accurate. GDP for the second half of 2009 will run around 3%, although the numbers are still settling. It also looks like we will have headline jobs growth likely to start in the next few months.

On these two counts – GDP as one big measure of economic growth and jobs starting to be added instead of being lost each month – this recovery is starting out stronger than the last two. That may sound – and it does sound – like a very bold statement. But it really isn't, because the last two recoveries were pretty anemic.

If you went back to 1983, that recovery was a lot stronger than what we are seeing now.

Absolutely. The 1983 recovery was quite a bit stronger than what we have seen so far. We had six or so quarters of strong GDP growth and the jobs growth was a bit quicker than it is now.

The other thing to remember when we are talking about recovery – what does it mean and what does it feel like – is that having a recession end and a recovery begin certainly does not mean that we are recovered. It is very plain that we have lost seven million jobs, and if we add 100,000 or 200,000 jobs a month it will take a long time – years – to gain those jobs back

Where will those jobs come from? What industries do you see adding jobs at this point in the business cycle?

We have leading indicators that look at overall levels of employment. Looking out a couple of quarters, we will have jobs growth. It may be a little stronger than expected. It may be somewhat surprising on that count.

There are some drags that are fundamental to the current job market. One is that it is very difficult to get strong growth in manufacturing employment because of a structural shift that has been eroding those jobs permanently. Some go overseas and some are lost to productivity increases. So much so that, ten years ago, we had 18 million people in manufacturing and today we have just under 12 million people. Those jobs are never coming back. That trend of a decrease in manufacturing

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employment isn't cured by the recession ending. We might get a little bounce here and there, but it's not something we can build on. Even though the jobs market is going to improve overall, it has to come from outside of the manufacturing sector – from non-manufacturing employment.

There are two places within non-manufacturing employment that, after a bounce, will remain weak. They are related to the bubbles that burst. One is in construction – where it is hard for me to imagine a new bubble forming right away. Therefore, construction employment, which is a relatively small part of overall employment, won't be the engine behind jobs growth. The other is in finance, where you might get a bounce-back from the job cuts, but it won't be a job engine because of all the issues associated with the credit bubble. The jobs growth will come in the areas that are non-manufacturing and not construction or finance.

If that's not where jobs growth will come from, where will it come from?

The non-cyclical areas like healthcare, defense and education are not terribly discretionary, so they will continue to grow. The less discretionary you are, the less susceptible you are to the business cycle. Business services, consulting, retail and some consumer-related jobs will come back. We've seen already in the November numbers that the non-manufacturing sector added some 30,000 jobs, and 91% of us work in that sector. A decent chunk of those additions were in business and temporary services. That is where we are looking to get some jobs growth back, because employers in the non-manufacturing sectors, reacting to the severity of this Great Recession, probably overdid it a little bit in terms of their firings, and now they're trying to adjust.

But there is still have some catch-up to do in terms of the work week.

We saw the work week come off some record low readings. In the last report it moved 2/10 of an hour. That sounds like a little, but it is actually a pretty big move. It seems to be normalizing, albeit at a low level. We'll have to see where it goes from here. In a cyclical sense, in the next few quarters, the news may be better than expected.

My concern on employment goes beyond that. It's the long term where you have quite bad news. With unemployment at 10%, our economy, even when everything is going right, on average can reduce unemployment by about half a percentage point per year. This is something that is true going back over many decades, not just recently. If you do the math, and you want to get back to 5% to 7% unemployment – it was lower than that before this recession started – you would need roughly a 10-year expansion to get the unemployment rate down to what we desire it to be and to what it was just a couple of years ago. That ten-year expansion is likely to be very elusive. I don't see that as being a high-probability event in the coming decade or

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so. Rather, you will see more frequent recessions in the coming decade than in the last two or three.

So is the great moderation in business cycles over and will recessions will be more frequent?

If we are right on this, then the unemployment rate, after having a cyclical decline down to 8% or 9%, may be hit with another recession knocking it back up. So it kind of stays at these high levels instead of coming down to where we want it.

The logic behind this is pretty clear. The so-called great moderation of business cycles since the mid-1980s, with cycles that have been less dramatic, is over. Not only is this because of the Great Recession, but especially because of how hard it is going to be to withdraw the stimulus smoothly. If you withdraw a little too early, the risk of another recession goes way up. If you withdraw a little too late, the risk of a really surging inflation cycle goes way up.

The moderation of the business cycle that we've enjoyed for most of our lifetimes, over he last 25 years, is unlikely return even if we have great policy moves in the coming years.

Separate and apart from what I just described, the pace of growth of the US economy during each expansion has been falling for decades. In you combine lower trend growth expansion with higher cyclical volatility, it dictates more frequent recessions. Japan, with a 1% GDP trend growth rate for the last 20 years, has seen four recessions, about one every five years. On the other hand, China, with roughly a 10% GDP trend growth rate, has seen zero recessions in the last 20 years.

That really illustrates the points I am making. Regardless of all the hand waving, those are the hard facts. Our trend growth rate is getting lower and our cycles are getting shorter and more volatile. We only have to look to the second largest economy in the world, which is Japan, to see that that adds up to more frequent recessions.

What is your forecast for consumer spending? Isn't your forecast for a cyclical recovery dependant on growth in consumer spending?

This is a recovery. It's not going to falter in the first or second quarter and very likely will make it to the second half of next year. You are going to see broad consumer consumption numbers continue to grow. Part of that will be accompanied by jobs growth. This is already happening.

Underlying that, though, is literally a tale of two worlds.

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If you have a job and didn't lose it during this recession, then you are looking around and you have pent-up demand. Prices are lower across the board, noticeably so. That combination means you are going to consume a bit.

If you don't have a job, you're not going to do that.

A recent poll made a related point. If you are earning over $100,000, then your plans are to spend over 50% more than last year. That's stunning. Equally stunning was that if you are making less than $30,000, then you are going to cut your spending by a third.

In a related backdrop, the wealthiest consumers, say those in the top decile of earnings and net worth – and this is not something new – account for almost half of all spending. The lower 90% account for the other half. You will see weird things happing in consumer spending.

If you go to Wal-Mart, and they are offering a deal, consumers will buy at the right price. Discount stores, if they are executing a good business plan, will make the cash registers ring. At the other extreme, some luxury brands are actually working. Tiffany's is actually doing well.

In the middle there is a big gulf.

I'm not describing something that is terribly healthy, but, when you add it up, you are going to see consumer spending grow. When we look at what a business cycle is, at its very base, the classic definition is that you have employment and GDP growth either peaking or troughing to mark the start or end of a recession. The supplemental information used to break a tie is sales and income. Those are your big coincident indicators of cycles. You can't have a recovery if only GDP is going up.

Does the NBER place enough emphasis on employment in its dating of business cycles?

Geoffrey Moore, who was ECRI's founder, *was* the dating committee of the NBER until 1979. He used to joke that he had lunch with himself to date the business cycles. In 1979, they made a true committee and Geoffrey was the senior person on that committee until he passed away in 2000.

ECRI continues to monitor the dating of business cycles, and we agree with the dates the NBER has picked through the December 2007 peak. We verified it, and it is an accurate date based on a classic definition, which includes GDP growth and jobs supplemented by sales and income, with equal weighting of growth and jobs.

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There is a real risk going forward that there will be a shift in the dating committee of the NBER to one that places less weight on employment. It's not something that is necessarily related to current events. People obviously have different backgrounds in terms of their knowledge. When I look at the committee, it is shifting more toward a model-based approach that puts heavier weight on production than employment.

I don't know that it will happen. We will keep a close eye on it. We are very alert to this issue.

Doesn't that risk becoming detached from reality? The average person couldn't care less if GDP, income, and sales are growing if they don't have a job.

I couldn't agree more. The classic definition of a recession was established in the 1920s by Geoffrey Moore's mentor, Wesley Mitchell. That definition has withstood the test of time, through a lot of structural change, including wars and financial crises. That definition has been very good.

If you notice, the December 2007 peak in the business cycle coincided with the end of jobs growth. That classic definition is very sensitive to what people, not businesses, experience. If there is a drift from that emphasis, we will see it.

How great is the risk of inflation? How will this risk be affected by the stimulus policy decisions that you mentioned earlier?

Let's deal first with the objective data. We have a future inflation gauge (FIG), which has as its only purpose to turn ahead of a cyclical turn in the inflation cycle. The FIG has risen to a one-year high, and – to put this in context – this was after falling to a 50-year low.

We're not trying to tell a story and find data to fit it. This is what the index is telling us: deflation is off the table for the time being. Underlying inflationary pressures have begun to simmer. We do not yet see a surge in inflation. When you look at measures like the CPI, where there was actually negative growth, it has turned up and is threatening to go a little bit positive. That is consistent with earlier moves in the FIG.

For the moment, you could say that we are in a temporary sweet spot. But the problem is the cycle keeps moving. It becomes very important where the FIG goes from here. Does it start to ramp up and gain and accelerate to the upside? If so, then you have your answer as to what is the bigger risk. Our forecast is cyclical – for the next couple of quarters. I cannot tell you two years from now whether inflation or deflation is the bigger risk.

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This is the dilemma the Fed faces. If, either by their actions or for some other reason, we have a new recession in relatively short order – let's say in 2011, for which we have no forecast – then deflation could emerge. That kind of bunching, with more frequent recessions, starts to allow deflation to gain traction.

On the other hand, if the Fed says it is not worried about inflation at all and will leave interest rates low for an extended per of time, or even if it does that without saying so, then you increase the risk that the FIG will surge up.

I find it difficult to figure out what the Fed is going to do, and I think even the Fed doesn't know what it will do. Therefore, it's okay admitting that we don't know what will happen in 2011 or 2012, which lets us follow our cyclical indicators.

In terms of clear and present dangers, these leading indicators can tell you if the time is now. So far, the very literal near-term reading is that we have a recovery. It is not going to falter in the next few quarters, deflation is off the table, and we don't have surging inflation in terms of consumer prices.

For the time being, that's not a bad position to be in.

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