

Liz Ann Sonders on the US Economic Recovery

By Robert Huebscher

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Liz Ann Sonders is Senior Vice President and Chief Investment Strategist at Charles Schwab & Co., Inc. She has a range of investment strategy responsibilities reaching from market and economic analysis to investor education. She chairs Schwab's Investment Strategy Council, which provides strategic asset allocation guidance and tactical sector recommendations for the firm's investor base.

We spoke with Sonders on March 31, 2010.

You've said that "we're in the midst of a somewhat classic V-shaped recovery with more to come." Can you elaborate on that view? Specifically, what will be the key drivers of growth in the US economy?

I have had the view that we would come out this in a relatively V-shaped fashion since last spring. I am not just reacting to what is obviously better news now. I anticipated that recovery would take place when I wrote in May of 2009 that the recession was ending. I believe we will find out that it officially ended sometime around then – maybe in June.

There is still a tremendous amount of skepticism about this recovery, even though just about any way you measure the economy – whether it is broadly or looking at the individual components – they all look very V-shaped. What the skeptics will note is that the compression was so deep, that we are now seeing just a statistical recovery. In other words, the percentages look sharp because of how significant the compression was.

I'm not arguing the "statistical" recovery. We've had deep recessions in the past. The initial phases of those recoveries are just that- they are big percentage increases because of what I think about as "coiled spring." You compress anything dramatically- industrial production, inventories, jobs, or GDP overall and the jump from those troughs looks quite remarkable.

The more valid argument is where we go from here. Is this the left half of a "W"? Or is the worst case scenario a square-root symbol, where we get the V-shaped part and then it flattens out?



To me, that is the more likely worst-case scenario, not a double dip recession, as long as we don't have major policy missteps, like we did in the 1930s, i.e. protectionism. Barring those, a lot of the engines to move this recovery into the expansion mode could happen in the first quarter – i.e., we get to that prior peak point from which point you can officially consider it an expansion, not just a recovery.

The drivers will be different this time than what has driven the economy over the last several cycles. It is not going to have a heavy bias to consumer spending and that will surprise the skeptics who believe without a heavy push from consumers the economy can't grow sustainably. The primary drivers will be business capital spending and an export-driven recovery – as it has been to date.

What about housing? Can the economy recover even if home values are still in a precarious state? Inventories of single-family homes are still rising and there is a potential for further declines in home values. How do you see that playing out in the recovery?

Inventories for the latest month of two have been up-ticking, but we are well down from the high of where we were.

We are in recovery mode in housing. Based on the Case Shiller numbers, for six or seven months in row there have been increases in prices (albeit marginal ones). We are finding the bottom. Typically real estate cycles tend to be more regional in nature. This one started as a regional downturn, and then obviously it became national. Everything got crushed. The recovery started with all regions participating as prices and sales began to recover off the bottom. Now at this stage you are going to see a more diverse set of numbers. In those regions where the price compression was greatest, and the drop was most severe, you are seeing some of the biggest sales increases and price improvements, at least in percentage terms.

You are going to see some pockets of better strength than others. It will be driven by those regions with the right mix of businesses and industries to be at the forefront of this recovery.

Gone are the days when we could make a universal comment about real estate, as we could when everything was imploding. We are finding the bottom in some areas, but it's more than that. We are in recovery mode.



Inventories still have to come down more than they have. We are at about the flat-line for prices, relative to the double-digit declines that we saw at the worst phase in the crisis.

You don't tend to get 180-degree turns in housing. But the improvement is sufficient enough to no longer be a drag on the economy. I don't know that it's going to be a big addition to the economy, though.

That said, look at a breakdown of GDP, and compare first quarter of 2009 to fourth quarter of 2009. The reason I compare those two quarters is that Q1 of 2009 was the worst quarter of the recession and Q4 of 2009 has been, so far, the best quarter for the recovery. You are comparing trough to (so far) peak. There was a huge negative contribution to GDP from residential investment in Q1. There as a decent positive contribution in Q4 of 2009. You are already seeing some beneficial impact. We know that with stability in house prices it is no longer detracting from household net worth, after having been a huge hit to net worth.

We can get a meaningful economic recovery even if housing continues to find its bottom, as opposed to turning into a true robust housing recovery.

There is a key release of unemployment data coming this week, which will be known by the time we publish this. I believe you've said that you expect approximately 200,000 jobs to be created. [Ed. Note: On April 2, the BLS announced that non-farm payrolls increased by 162,000.]

I don't publish forecast job forecasts. If I mentioned a number, it was the consensus.

The consensus is around 200,000 but the range around that is huge. There are estimates as high as 400,000 with most economists believing the risk to the consensus being to the upside not the downside.

The whisper numbers are going higher, which is not necessarily a good thing, because then the bar gets set higher and higher.

We had the ADP numbers out today, which were weaker than what people were hoping for. Sometimes it tends to be a fairly good indicator of what the BLS jobs report will be; other times it totally misses. I don't generally put a lot of weight on that number as a guidepost for what this Friday's numbers are going to be.



Bigger picture, do you expect this to be a jobless or a “jobful” recovery?

Somewhere in between. If you look at the decline in initial unemployment claims, which is the key leading indicator for jobs growth, and if you take the four-week average, which is the common way it is measured, claims are down about 200,000 from the peak. If you compare that pace and that decline to the last two recoveries, which were the so-called “jobless recoveries,” after the 1991 and 2001 recessions; and you also compare it to the recovery prior to that, which was the 1983 recovery that came after the back-to-back recessions in the early 1980s, the current path is tracking much closer to the 1983 experience. There we saw a very strong jobs recovery.

That gives some hope that this is something better than those jobless recoveries. If you draw a regression line that compares past recessions to past payroll losses and you look at the peak-to-through decline in GDP for all of the past recessions alongside the peak-to-trough drop in payrolls during those same periods, there is obviously a very tight fit on the regression line. The bigger the drop in the economy, the bigger the drop in payrolls. No big shock there.

If you take what we know to be the drop in the economy during this recession, which was a 3.8% decline in GDP, and put that dot right on the regression line, it suggests that we should have seen payrolls drop by 4.3%. Instead they dropped by 6.1%. That is a 36% greater loss of jobs than what was justified by the drop in the economy.

We have a catch-up phase to look forward to, hopefully. It was much more severe this time because during the period when monthly job losses were the greatest (700,000 or more) – in the fourth quarter of 2008 and the first quarter of 2009 – business sentiment at the time was expecting true Armageddon. Businesses anticipated Great Depression II. We know in hindsight we didn’t get that. That’s not to suggest this wasn’t an awful recession. It just wasn’t quite as severe as what the worst case scenario was viewed to be at that time. We have a catch-up phase coming, even if we’re not off to the races.

The sense that this is another jobless recovery may be a little bit too pessimistic.



With major sectors of the economy like housing, finance and automobiles permanently crippled relative to what they were three or four years ago, what sectors of the economy are going to contribute to job growth?

It's funny that you mention that, because some financial and most manufacturing industries, including autos, are actually rehiring. It's another example of coiled springs and flies against conventional wisdom that the most troubled industries have no hope to be participants in the recovery.

As is the case in almost every recovery, there will be a set of industries that represent some of the brightest lights in the next phase of the economy. Those industries won't necessarily be the ones that led in the past. To me, it is not all that difficult to figure out where some of those areas are going to be: maybe biotechnology or energy technology. You can easily find some sectors and industries where there is employment growth potential. With those aforementioned hard-hit industries, because the layoffs were so severe, with any kind of pickup in demand you get the coiled spring of needing to replace inventories which feeds into production, which feeds into jobs.

You've said that inflation in the US will not occur as long as "velocity of money, wage pressures and unit labor costs remains depressed, and excess capacity remains elevated." Over the longer term – say three, five or even ten years from now – do you view inflation as a much more serious threat, particularly because of rising budget deficits?

It depends on the aforementioned conditions. Inflation is not an automatic threat by virtue of budget deficits. You've listed the things that would have to fall into place to suggest the risk of inflation was increasing. I don't have this "dig my heels in the sand" view on inflation in either direction. Right now the conditions are not in place for any kind of meaningful core inflation to erupt. That doesn't mean, "That is my view as far as the eye can see, and damn the statistics I'm going to stick with it."

I just know the various things I will look at to get a sense of when inflation will be a threat.

A debt crisis that arguably we have been in for some time isn't guaranteed to be inflationary, even though unfortunately we haven't gotten ourselves out of that crisis because all we've done is shifted the debt from the private sector to the public sector. For evidence, we have no further to look than to Japan, which has been in a deflationary spiral, even in the face of what appears to be insurmountable debt and a brutal economy.



That is just one example. If you look at the Reinhart and Rogoff work on past financial and debt crises, they found that those are inherently deflationary, not inflationary.

There is this misguided view that one equals another: rising debt means we are guaranteed to get inflation. We may, but I am not dogmatic in thinking that it is automatically going to come. I know that a combination of the money multiplier, wage pressures, unit labor costs, excess capacity, TIPS spreads – all those things that you mentioned – are the things we are looking at to judge inflationary pressures to come.

You have to understand the way the math works and understand that there are different deflator rates for each of the components of GDP. Clearly residential investment has had a huge negative deflator, whereas in commodity prices there has been a lot of inflation. It's a question of what ultimately filters into core inflation. We know that 38% of core CPI is something called "owner's equivalent rent" and there continues to be downward pressure on that.

A lot more analysis needs to be done to develop a concrete view on inflation. Too many people are making very simplistic assumptions of why it is necessarily coming.

I'd like to talk about your interest rate forecast. You've also said there are clues that the Fed may begin raising interest rates. Do you foresee problems in a supply/demand imbalance with projected issuance US Treasury bonds that could also force rates higher? Can you foresee a scenario, potentially over the near term, with sharply rising real interest rates?

There is certainly a huge risk that we could run into trouble financing our deficit. That is one reason, but not the only reason, that we're starting to see upward pressure on the long end of the yield curve.

There are other reasons, and some of those may not necessarily be bad reasons, why you will see some upward pressure on yields, not the least of which is if we get some downward traction in the unemployment rate and there is more adherence to the view that this is indeed a self-sustaining recovery. That's a good reason why yields would go higher – not because of some massive inflation scare or need to ramp rates by bond vigilantes because of the budget deficit. It's going to be a combination of forces, some good and some bad, that will keep pushing rates upward.



There is a natural resistance when you get to about a 400 basis-point spread between the Fed Funds Rate and the 10-year yield. Just about any time that has happened in the last 10 years, you've gotten a little bit of a reprieve and a rally in the bond market. Yields have come down a little bit. I don't ever attempt to give advice to someone who trades the bond market. This is not to suggest that my view should be reacted to with a trade. There will be a bit of a trading range for yields. The bond market reacts to extremes of sentiment just like the stock market.

Often times that 400 basis point spread doesn't resolve itself by the long end coming down. Sometimes it resolves itself by the short end going up.

I don't think the Fed is imminently going to raise rates, but I wouldn't be surprised to see the key "extended period" language change at the April meeting. Does that suggest the next meeting will result in a rate hike? Who knows?

I also think it's silly that so many people have this view that the Fed already knows what it is going to do and when, and that it's just a question of when they are going to start hinting to us. They are in the same boat as all market watchers. They are judging the data as it comes in.

They will be really pushing it, come the end of April, assuming we don't have a collapse in a variety of economic numbers, to continue to press that extended period language. The dissents are increasing.

Frankly, I think it would be a good thing if we were actually in an environment that suggested short rates had to start to go up. I shudder to think of an environment that justifies zero Fed Funds Rate through this year and into next. There are folks out there who think the Fed shouldn't raise rates until 2012. Zero percent is an emergency level of rates. I think an environment where the Fed is justified in normalizing rates is a good thing. It may not protect the market from having a little indigestion, but that's normal as you approach a rate hike cycle.

You've criticized Paul Krugman's proposal for a 25% tariff on Chinese goods. Isn't China's currency manipulation just another form of trade protectionism? How should the US respond?

I don't want to get into recommending policy. My comment there was based on what we know the damage was from Smoot-Hawley back in the 1930s. I'm generally against overt protectionism. The thought is that



China has every reason due to its own budding inflation problem to consider currency revaluation. I'd rather see that be the impetus.

I would be remiss if I didn't ask about your assessment of the health care bill.

We don't comment on that. We stay out of the political second-guessing.

Clearly there are companies that are taking some write-downs. That is going to be the next big issue. Companies that have announced accounting hits are going to be brought in to testify. We are starting to see some of the implications. But we don't take a hard political stand on this.

Aside from the politics, do you believe it will be stimulative or inhibitive of economic growth, particularly over the long term?

We'll see. The early read from companies is that it's hurting companies as they have to take immediate write-downs for future healthcare liabilities

What worries you the most about your forecast? What are the key risks that could, for example, bring about much slower growth or higher inflation?

I don't consider what I do forecasting. I don't forecast GDP or employment, and I don't put year-end targets on the S&P 500. We are not market timers. It's more about a general view that I have on the market and the economy, as opposed to an explicit forecast. We are staunch believers that specific prediction is not an appropriate thing to do. It doesn't help individual investors, in particular. I would shudder to think that there is anyone swinging their money around in the short term based on my or anyone else's forecast.

After being pessimistic about both the economy and stock market since mid-2007, I became decidedly more optimistic about both in the spring of 2009. Entering 2010 however, I felt it would be a choppier year than it was since March of 2009. I don't think that we have that kind of trajectory in front of us.

In terms of my economic view, debt is at the top of my list of concerns. We are about to cross a very important threshold where public debt becomes greater than 90% of GDP. That will happen this year. Reinhart and Rogoff have shown very clearly that, over the last several hundred years, that is an important threshold for the ability of economy to grow. As debt is growing as a percentage of GDP, up until the 90% threshold, it



doesn't tend to have a big impact on GDP. But because of the "crowding out effect" and the potential for rates to rise in order to stimulate demand by the debt's financiers, 90% tends to be the tipping point, not only for developed economies but for emerging economies too. As we cross that point this year, you can't help but have that as a niggling concern.

Is it inevitable that the government will have no choice but to inflate its way out its debt problem?

Not necessarily. What I hope is inevitable is that the government realizes that the only long-term way to solve a deficit problem as large as we have is to establish the conditions to grow the economy as fast as possible without runaway inflation. That's really the only way to solve a real deficit problem.

You've got three pillars of deficit reduction: tax increases, spending control, and economic growth. The tax increase part we are getting, whether you like it or not. That pillar is in the bag. The various rates and the expiration of the Bush tax cuts are still to be decided, but rising tax rates are coming, no question about it.

At the national level, the focus seems to be controlling the rate of growth of spending. What's interesting is that you are starting to see more actual spending cuts at the state and local level, because in some cases their budget deficits are at more dangerous levels than at the national level. Politicians and policy makers are starting to realize it's not just the rate of spending that should be cut, you actually have to cut spending outright from the prior year. New Jersey is one of the newest examples of a state, with a new governor, that has announced very deep spending cuts.

If you look at the various surveys and polls, even when the deficit or debt as a percentage of GDP was elevated, it doesn't tend to be a huge issue for the public – for voters. It is a much bigger issue now. There is more attention on this, and it is higher up on the priority spectrum for the public. Politicians on both sides of the aisle are going to realize that.

Although debt was not as elevated in the early 1990s as it is now, it was uncomfortably high and had been growing rapidly. We were also coming out of a financial crisis – the S&L crisis. You couldn't have gotten anybody to believe then that there would be a budget surplus at the end of the decade. But a very strong economy did just that.



It can (and needs to) be a combination of boosting tax revenues, reining in spending and establishing the conditions for above-average economic growth that brings down deficits to a more manageable level.

Do you favor allowing the Bush tax cuts to expire at the end of next year?

I was an advisor to the Bush Administration on the tax cuts at that time. I'm not a fan of double-taxation of income, period. I'd be happier to see those extended rather than to allow them expire, unless we see some significant upside momentum to the economy.

We are still in recovery, but I would not deny at this stage it is fairly shaky. Piling up another set of tax increases on top of that will have some unintended consequences.

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