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Economics Group

Special Commentary

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Benchmarking Recovery: Rhyming not Repeating

"History does not repeat itself, but it does rhyme."

Mark Twain

Recovery signals are in the air, corroborating our statistical model estimates, yet also intimating that the character of this recovery already is different than prior recoveries. Consumer spending is up, reflecting income growth, however such growth does not primarily reflect earned income but rather federal transfer payments. Meanwhile, as many dear readers suspect, production and employment advances lag, as they have done in recent cycles. The current recovery reflects more a "statistical" recovery than a recovery for the "man on the street". Finally, the shape of the recovery, a topic for almost every senior corporate strategy session, remains the product of the confluence of expectations on the future of key price variables for credit (interest rates), commodities (goods), the dollar (exchange rate) and labor (wages) for both private and public decision-makers.

Three questions will be addressed in this essay. First, what are the signals for the recovery? Unfortunately our profession and the media are infested with perennial bulls and bears who fail to acknowledge that the economy follows cycles and that providing insights to the economic turns and not popular entertainment, should be the product of our efforts. Second, what benchmarks do we have to measure the progress and character of the recovery? The picture on recoveries is never black or white but the many colors of the multiple sectors in myriad phases of improvement. Finally, what factors will drive the shape of the recovery? Mindless speculation on the shape of the recovery fails to provide any depth of thought or guidance to decision-makers on how we may track the unfolding pattern of the recovery.

Signals for Recovery: Models and Surveys

Recovery is the signal from our statistical model.[1] Over the past two years, we applied this model to first identify the rising risk of recession and now the significantly lower probability of a recession going forward. The probability of recession two quarters from now has downshifted sharply over the previous quarter (Figure 1) with the latest recession probability at below one percent as to be in agreement with probabilities associated with prior economic recoveries. We reviewed a very broad set of variables in our model and the results imply economic recovery is likely in six months. Faithful readers also recognize that we had expected recovery in the second half of 2009 in our Annual Economic Outlook published in December 2008. Supporting evidence for economic improvement began to show up in our model in recent months in the regional Chicago Manufacturing Survey. While the official recovery call will come much later from the National Bureau of Economic Research, our outlook is that the recovery on a quarterly basis will begin in the third quarter of this year.

We should also note from Figure 1 that recession probabilities move quickly and thereby reinforce the point that rapid change can characterize any economic cycle as well as the expectations of

[1] **John E. Silvia, Sam Bullard and Huiwen Lai, "Forecasting U.S. Recessions with Probit Stepwise Regression Models,"** ***Business Economics*****, January 2008.**

decision-makers for that cycle. Hence, it is not surprising to see large rallies in stock prices just before or at the start of the economic recovery as investors quickly discount the likelihood of future economic improvement. Moreover, the data connote that while it may be fashionable for some so-called pundits to be always bearish or bullish, the reality is that the economy is characterized by cycles and our clients are best served by economic advice that recognizes that cycle.

Figure 1

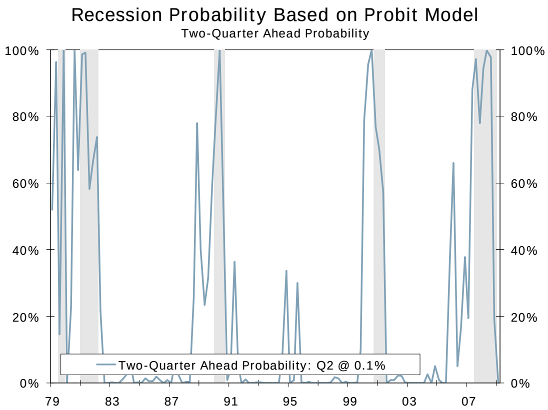
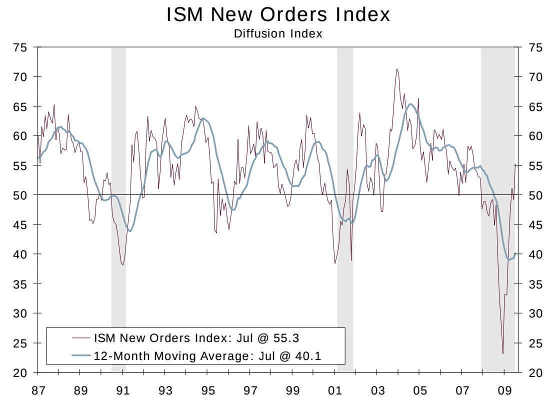


Figure 2



Source: Institute for Supply Management and Wells Fargo Securities, LLC

ISM New Orders—Signal for Growth

As a leading economic indicator, new orders (Figure 2), which preface subsequent production and employment advances, have been a very reliable indicator of recovery over time. According to the July 2009 release for the Institute for Supply Management (ISM), new orders rose to 55.3, which is a solid gain and above the breakeven level of 50. Moreover, there were additions in a number of sectors, such as electrical equipment, chemicals, computers, primary metals and paper.

Historically, an ISM manufacturing index above 48.8 percent, over time, is generally consistent with an increase in the Census Bureau's series on manufacturing orders (in constant 2000 dollars).[2]

Four Benchmarks to Measure the Progress and Character of the Recovery

Employment, both as an economic and, especially, political benchmark, serves as a lightening rod for the progress and character of the economic recovery. In Figure 3, we show the progress of employment compared to the path of employment in the prior seven recoveries (we assume for purposes of illustration that April marked the bottom of the recession). In this case, the current path of employment dramatically lags the path of the average gain in employment of the prior seven economic cycles.

[2] **Institute for Supply Management, *July 2009 Manufacturing ISM Report on Business*, August 3, 2009.**

Figure 3

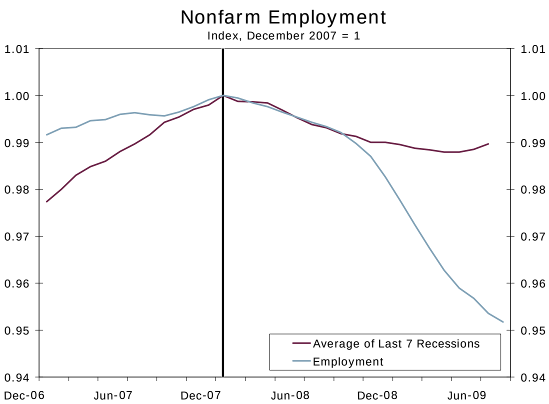
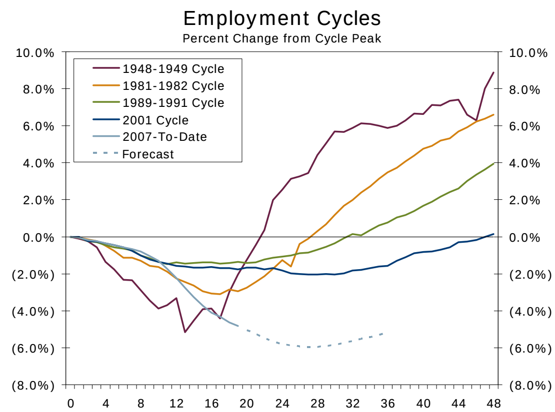


Figure 4



Source: U.S. Department of Labor and Wells Fargo Securities, LLC

In Figure 4, we illustrate the actual path of employment in the current cycle compared to a select subset of earlier cycles. In this exhibit, the data on employment corroborate the earlier conclusion that employment this cycle does indeed lag earlier cycles.

These observations on the path of employment also reinforce our research hypothesis and result - that over the post-WWII period, employment has become increasingly a lagging indicator (it improves after the turn in the overall economy) in contrast to the officially held view of the Conference Board that employment is a coincident indicator (improves at the same time as the economy).[3]

Industrial Production: Lagging Prior Experience

Another coincident indicator of the economy, industrial production, also lags the experience of prior cycles as illustrated in Figure 5. The latest monthly numbers hint at a bottom in the recession.

Manufacturing & Trade Sales: Bottoming Out and Slow Improvement

Real manufacturing and trade sales (Figure 6 and Figure 8) hint at an upturn in April and that is compatible with recovery in prior recoveries. Certainly, the strength of the improvement is not as great as the average of prior cycles but the turn is clear and there is some slight improvement off the bottom.

Figure 5

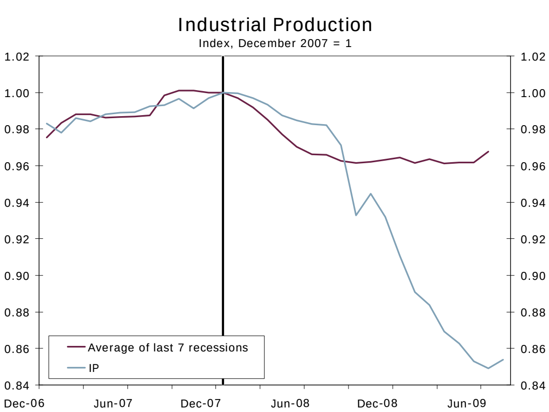
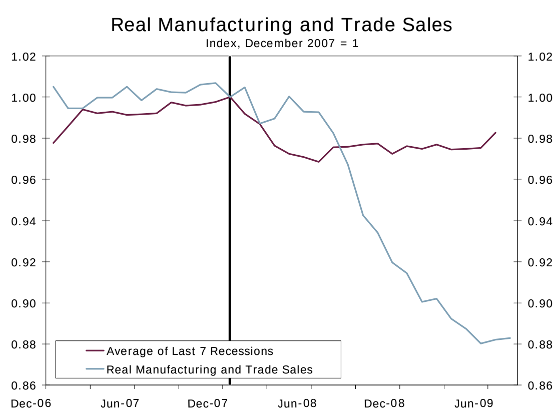


Figure 6



Source: Federal Reserve Board, U.S. Department of Commerce and Wells Fargo Securities, LLC

[3] **John E. Silvia, Labor Market Evolution: Realties and Romantics, June 19, 2009.**

Real Personal Income less Transfer Payments: Improvement

This measure of earned income, income not from government transfer payments (payments that are made independent of any work effort), connotes an improvement, although slight, beginning just before the April benchmark (Figure 7). This is very encouraging. As the income measure utilized here excludes transfer payments, this income upturn is likely to be sustainable and thereby would support further improvements in consumer spending.

Figure 7

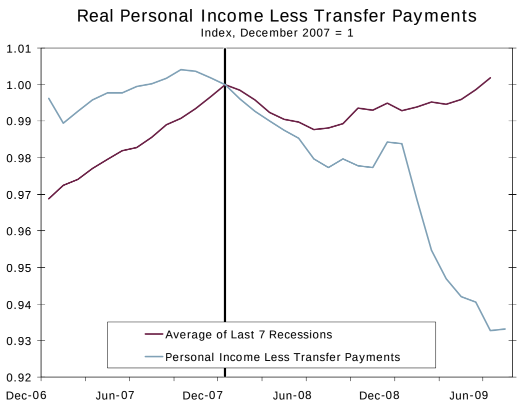
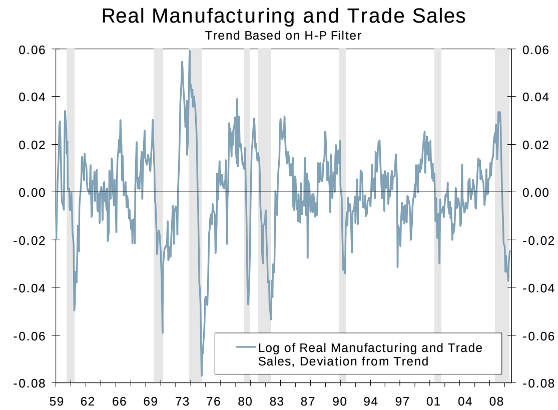


Figure 8



Source: U.S. Department of Commerce and Wells Fargo Securities, LLC

Another Test of the Upturn in the Economic Cycle: Changing Character of the Labor Market

We recognize that some may question the turn in both real sales and personal income. So to further evaluate the hypothesis that these benchmarks have turned, we employed a Hodrick-Prescott filter.[4] In Figure 8 and Figure 9, we illustrate the results of this filter application to both the real manufacturing & trade sales and the real personal income data. The results reinforce our view that both indicators have indeed turned the corner. We appreciate that the filtered series are volatile, but the upturn signal in both cases is there.

Figure 9

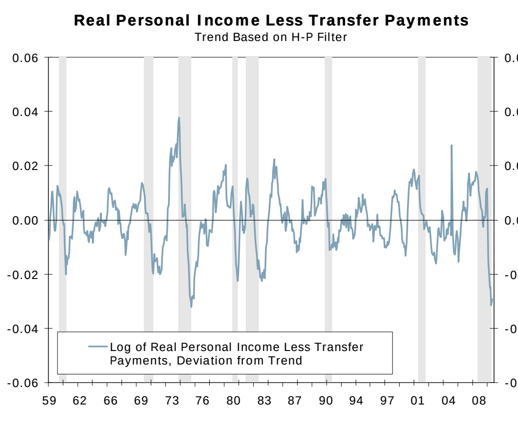
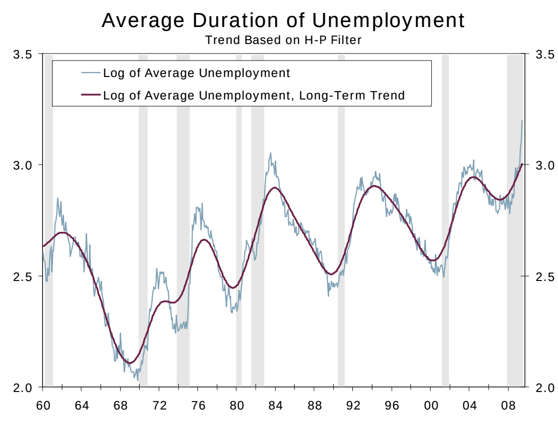


Figure 10



Source: U.S. Department of Commerce, U.S. Department of Labor and Wells Fargo Securities, LLC

While exploring the pattern of employment we also looked into reasons as to why the coincident character of employment is disappearing while the lagging pattern is emerging. One factor we examined was the average duration of employment. We again applied the Hodrick-Prescott filter

[4] **Hodrick, R.J. and E.C. Prescott, 1997, "Postwar U.S. Business Cycle: An Empirical Investigation,"** ***Journal of Money, Credit and Banking*****, 29 (1): 1-16.**

to distinguish the cyclical and trend components of this series. As illustrated in Figure 10, there has been a clear, rising average duration of unemployment since the 1970s. Over time, the trend has been for higher lows and higher highs in the peak duration of unemployment. In addition, these peaks lag the recovery, and the lags in the 1992 and 2002 recoveries were greater than the experience in the 1975 and 1982 recoveries. We would posit that the character of the labor market has changed over the years from both the supply and demand sides. On the supply side, perhaps, in part, the cost of unemployment has declined due to support programs and, therefore, workers are willing to be unemployed longer. On the demand side, lagging employment may be the result of the relative decline in manufacturing employment versus the rising share of the service sector, such that increased output needs can be met, initially, by the existing workforce in the service sector without firms seeking to immediately hire workers as they would in the traditional manufacturing sector.

Defining the Shape of Recovery? V, U, L, W or Just a Swoosh?

Nothing is more currently debated, except for healthcare, than the shape of the recovery. In our view this shape is not predestined but would be a result of decisions not yet made. These decisions include the following, for example. What will be the exit strategies for both fiscal and monetary policies, and how will these strategies be executed?[5][6] Second, how will investor/firm/consumer expectations on the dollar, interest rates, profits, and inflation unfold over the cycle in response to economic developments and policy actions? We construct a case for each of these recovery shapes.

The V (for Virginia)-Shaped Recovery: A Hollywood Ending

In this happy scenario the financial market assumption is that the Fed will execute its exit strategy effectively with little volatility in interest rates and no acceleration of inflation. Congress and the president reassert fiscal discipline after the current fiscal stimulus passes through the economy. In this case, long-term interest rates are expected to remain within the current range. Consumer spending and business investment will rebound sharply and thereby lead into a strong economic recovery. This would give rise to the V-shaped recovery. The major assumption is that both consumer durable and residential investment activity have access to financing in much the same manner as prior to the recession.

U (for Utah)-Shaped recovery: The Long Road to Recovery- The Nordic Experience

Fed actions to provide liquidity face continued credit problems. Consumers and businesses are reluctant to borrow, while lenders—banks and nonbanks—remain capital-constrained and limit lending to preserve capital. Fiscal stimulus runs through the economy but never generates that self-sustaining growth in the private economy. The financial system faces a drawn-out period of slow growth hampered by heavy public debt payments and limited private credit generation. Job growth in this scenario remains very weak, which combined with limited credit growth, gives rise to below-trend economic growth with higher-than-average real interest rates.

The Swoosh-Midway between U and L-Shaped Recoveries

Credit adjustments and fiscal challenges draw out the economic recovery. Job growth is even slower than in the U-shaped recovery but is positive relative to the L-shaped recovery. In the global economy, the adjustment period to a new, strong, pace of economic growth takes longer than generally expected as the exit strategies and the market adjustments to those strategies take much longer to run.

L (for Las Vegas)-Shaped Recovery: Japan 1990s, U.K. post-WWII

A maturing U.S. economy with a shrinking, aging, labor force and the burden of increased regulations and taxes undercuts the short-run monetary and fiscal stimulus. Consumer savings rates register a permanent shift upward compared to the prerecession experience, while private sector lending terms are permanently more constrained. There is no follow-through into the private sector from fiscal stimulus as job growth is minimal and regulations/tax burdens drive more production abroad. Inflation remains persistently higher than the Fed's target, because

[5] **Timothy Geithner, "Hard Choices on the Economy Loom,"** ***The Wall Street Journal*****, Aug. 2, 2009.**
[6] **Ben Bernanke, "The Fed's Exit Strategy,"** ***The Wall Street Journal*****, July 20, 2009.**

production falls short of demand. Real interest rates remain high as the economy struggles to attract foreign investors to an environment with expected future returns have significantly downshifted.

W (Washington D.C.)-Shaped Recovery—the 1980-1982 Experience, Policy Volatility

Domestic and global investors are unconvinced that the Federal Reserve will execute its exit strategy and the Congress and the president will exercise fiscal discipline. The short-run stimulus to the economy generates good statistical growth in gross domestic product for the next three quarters, but this growth is not carried forward. Investors discount a much higher pace of long-run inflation and thereby interest rates rise sharply and the dollar collapses. Investors, ever the bond vigilantes on a global scale, perceive the Fed as maintaining an excessive amount of liquidity in the marketplace despite signals of economic recovery. Higher interest rates compound the fiscal deficit problem, which is further aggravated by a lack of fiscal discipline and the encroaching aging of the baby boom and huge entitlement spending.

Efficient Markets and Inefficient Public Policy

In many ways all, the possible shapes of the recovery come down to the bet that public policy can do just enough to move the private economy forward and then step away adroitly such that no residue of unwanted inflation/debt problems are discounted in market interest rates, the dollar or commodity prices. Unfortunately, markets are forward looking and have in the past and are likely again in the near future to quickly discount the terminal or end point for interest rates, currencies and inflation. How quickly markets discount future interest rates and currency implications defined the difference of the 1970s and 1980s as well as the Nordic experience. Rapid discounting, in a very information-driven and rational-expectations world, will lead to quicker inflation expectations/interest rate adjustments with the possibility that the long-term future movement in inflation/interest rates arrives early.[7] Our suspicion is that the global capital markets are not likely to be fooled by rhetoric on exit strategies for both fiscal and monetary policy, while the evidence on the ground continues to denote otherwise.

[7] **See, N. Gregory Mankiw, Macroeconomics, Sixth Edition, p. 393-395.**

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