ECONOMIC OUTLOOK

REGIONS

September 2012

One Standout In The Not So Great Recovery

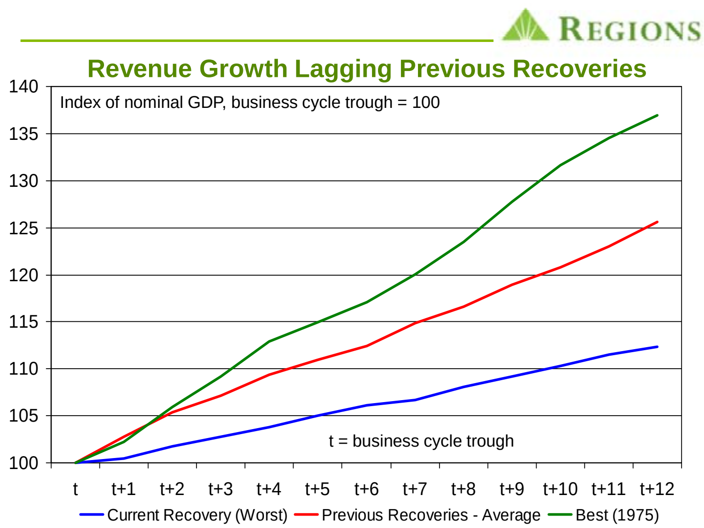
It has by now been widely documented that the recovery from the Great Recession has been, well, not so great. Now 12 quarters in to the recovery, real GDP has surpassed its pre-recession peak, albeit by just 1.79 percent, but this is not the case for any of the main indicators tracked by the National Bureau of Economic Research (NBER) to determine the economy's cyclical turning points. While nonfarm employment, still 3.42 percent below its pre-recession peak, is the most widely noted indicator, aggregate private sector hours (4.23 percent below), real personal income excluding transfer payments (2.87 percent below), real business sales (7.80 percent below), and industrial production (2.68 percent below) all remain some distance below the peak levels seen prior to the recession.

Having from the start been in the camp expecting a slow and plodding recovery, in stark contrast to those in the "V-shaped recovery" camp (where have they gone, by the way?), we nonetheless continue to be frustrated by the slow and uneven pace of the current recovery. To be sure, there has been progress made in curing some of the severe imbalances that had built up prior to the recession, such as a significant paring down of household debt (and debt service burdens) and what in many markets across the U.S. has been a meaningful reduction in excess inventories of homes. Even along these fronts, however, there remains much work to be done.

There is one area in which the current recovery, lackluster as it has otherwise been, continues to outperform previous recoveries. Compared to past recoveries at the same stage, corporate profits are performing not only better than average but better than all but one previous recovery in our sample. But, and you just knew one of those was coming, the flip side of that is that this outperformance of corporate profits comes largely due to the underperformance of the labor market, particularly in the form of worker compensation.

Before going into the details of the data, let's first define the peer group to which we are comparing the current recovery. The current recovery is now in its 39th month but, at this writing, we have data for 12 complete quarters (not yet for Q3 2012). There have, since 1954, been six economic recoveries that have lasted 36 months or longer as delineated by NBER. Two recoveries have failed to last this long – that which began in Q2 1958 and that which began in Q3 1980 – and, as such, have been omitted from our sample group. For the rest, we compare the performance of a set of metrics 12 quarters into each recovery so that we can benchmark the current recovery relative to those past recoveries.

As we noted above, the relative underperformance of the current recovery relative to previous recoveries has been widely discussed. Still, it is nonetheless striking to see the extent of this underperformance. For instance, the chart below shows the path of nominal GDP during the current recovery relative to the average performance over the previous six recoveries and also to the top performer out of that group. We have chosen nominal GDP as it is a useful proxy for top-line total revenue in the discussion of corporate profits. Twelve quarters in to the current recovery, nominal GDP has risen just

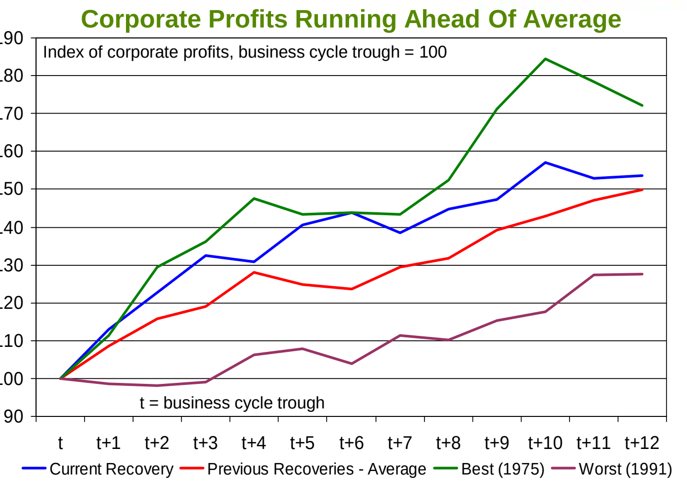


12.3 percent from the end of the recession, ranking as the slowest growth in our sample group. This compares to average growth at the same point in previous cycles of 25.7 percent and the fastest growth of 36.9 percent for the recovery that began in Q2 1975.

The above chart illustrates what people are referring to when they bemoan insufficient growth in aggregate demand. One significant drag on growth in aggregate demand has been the deleveraging in the household sector that has weighed on growth in consumer spending during this recovery. Of course, it is reasonable to argue that this merely represents payback for the years leading up to the Great Recession during which an abundance of cheap and readily available credit fueled unsustainable growth in consumer spending. Also acting as a drag on growth in aggregate demand during this recovery has been the government sector. Total government sector (i.e., combined federal, state, and local governments) spending has barely budged, in nominal terms, since the end of the recession and in real terms has declined for eight consecutive quarters, with combined state and local government expenditures having declined for eleven consecutive quarters.

Regions Financial Corporation, 1900 5th Avenue North, 17th Floor, Birmingham, Alabama 35203
Richard F. Moody, Chief Economist • 205.264.7545 • richard.moody@regions.com

That growth in total revenue has lagged so badly behind past recoveries makes the results shown in the following chart that much more surprising. When compared to previous recoveries at similar points, corporate profits have grown at an above-average rate during the current recovery. Of our sample group, the recovery that began in Q1 1991 saw the slowest growth in profits over the first twelve quarters, while the recovery that



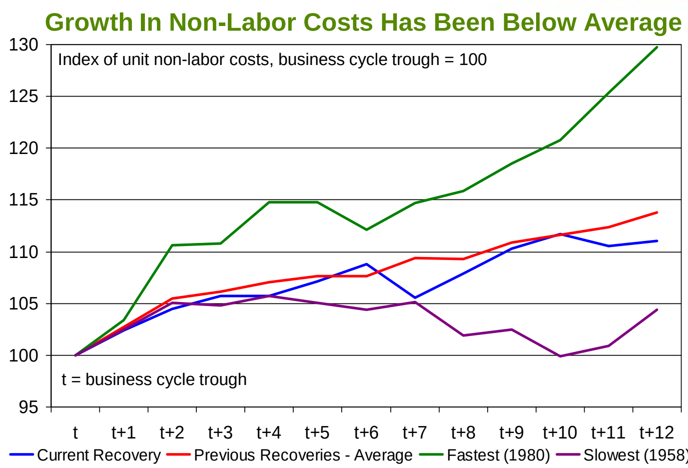
began in Q2 1975 saw the fastest growth. Since the end of the Great Recession, pre-tax corporate profits (with adjustments for inventory valuation and depreciation, as reported in the National Income and Products Accounts data) have risen by 53.7 percent, compared to an average of 49.9 percent for the sample group as a whole, 27.7 percent for the 1991 recovery and 72.2 percent for the 1975 recovery.

For those up on their historical data, or for those "seasoned" enough to have lived through it and still able to remember, it comes as no surprise to hear that the recovery that commenced in Q4 1975 saw the fastest growth in both top-line revenue (i.e., nominal GDP) and corporate profits, as this was a period of exceptionally high inflation during which corporations were able to exercise a far greater degree of pricing power than is the case today. Indeed, looking at the year-over-year increase in the GDP Price Index, the cyclical trough of the index during the 1973-75 recession is well above the cyclical peaks in all expansions from the 1980s on.

With this in mind, we thought it would be interesting to adjust for inflation and then do the same comparisons shown in the two charts above. Even though corporate profits are typically reported on a nominal, i.e., current dollar, basis, it is revealing that on a real, i.e., inflation adjusted, basis, the recovery that began in Q2 1975 falls back to the pack in terms of growth in revenue and profits. Comparing real GDP growth 12 quarters in to each expansion, the fastest growth was logged in the recovery that began in Q4 1970 (growth of 16.4 percent), with average growth across all recoveries of 11.6 percent. It will surprise no one to hear that the current recovery still comes in with the weakest growth, with real GDP having risen by just 6.8 percent since the end of the Great Recession.

When we compare corporate profits on a real basis, the fastest growth at the 12-quarter mark came in the recovery that began in Q4 2001 (up by 53.8 percent), with average growth over all recoveries of 33.3 percent. But, as is the case when comparing growth in profits on a nominal basis, the current recovery still comes in above-average, with growth of 46.0 percent since the end of the Great Recession.

At first glance, it may seem somewhat puzzling that the current recovery has seen far and away the slowest growth in top-line revenue but has yet managed to post above-average growth in corporate profits. In short, corporations are bringing in less but enjoying it more. With revenue growth being what it is, that leaves us with the cost side of the ledger to look to for an explanation. Using data from the Bureau of Labor Statistics' series on productivity and costs, we first look at the behavior of non-labor unit costs, i.e., the costs, aside from labor, incurred in producing each unit of output. As shown in the chart below, the current recovery has seen below average growth in these non-labor costs, with growth of 11.1 percent since the end of the Great Recession relative to average growth of 13.8 percent at the 12-quarter mark for our entire sample group.

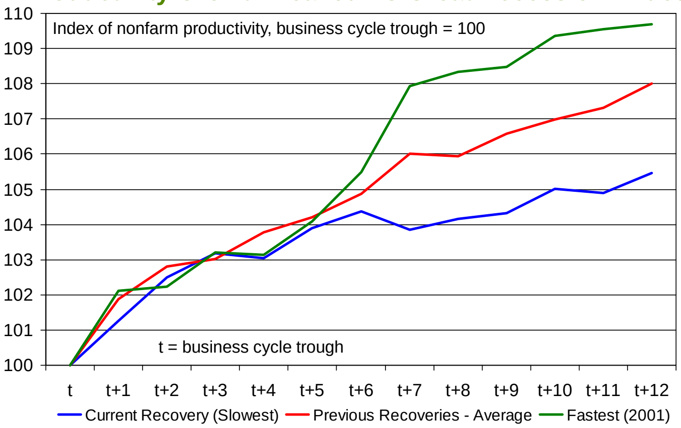


Growth in unit non-labor costs has been below average during the current expansion, but not by much and surely not enough to be the main factor behind the better than average profit growth, particularly since non-labor costs are a relatively small fraction of overall costs. This leaves us with labor costs as the means of reconciling below-average revenue growth and above-average profit growth.

In a typical recovery, the early stages would be characterized by accelerating labor productivity growth, which in turn pushes down unit labor costs (i.e., the labor-related costs of producing each unit of output), resulting in fatter profit margins. Over time, productivity growth begins to fade, unit labor costs begin to rise, firms begin to take on more workers in order to produce greater levels of output, and higher prices for final goods help firms to post profits, even if margins compress.

As our more astute readers will have no doubt surmised by now, the current recovery is anything but typical, meaning the scenario outlined above is not consistent with what we are seeing in the data at present. First, despite what are frequent references, in the media and amongst some analysts, to faster worker productivity growth being a factor behind what has been painfully slow growth in private sector payroll employment, the data do not bear this out, as seen in the chart below.

Productivity Growth Peaked As Great Recession Ended



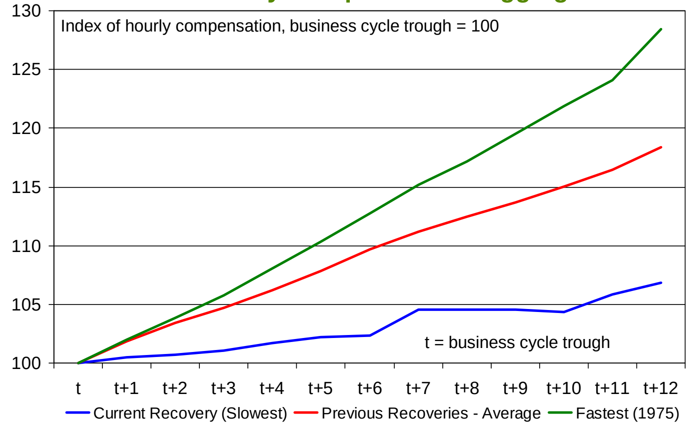
Twelve quarters in to the current expansion, nonfarm labor productivity is only 5.5 percent higher than at the end of the recession, compared to 8.0 percent for our sample group as a whole and 9.7 percent in the recovery from the 2001 recession. Note that the recovery from the 2001 recession was referred to, and not at all fondly, as the "jobless recovery," and it is this rapid productivity growth that led to nonfarm employment continuing to fall until September 2003, well after the end of the recession in November 2001. Recall also from above that this recovery saw the most rapid growth in corporate profits after accounting for inflation.

Aside from below-average productivity growth throughout the first twelve quarters of the recovery, the current cycle stands out in that the most rapid growth in worker productivity actually came during the first half of 2009 – the final two quarters of the Great Recession. Admittedly, the productivity data tend to be volatile from quarter to quarter, which can lead to erroneous inferences when comparing productivity growth over a given time frame. Indeed, over the last four quarters annualized productivity growth has fluctuated sharply between negative 0.5 percent and positive 2.8 percent. That said, the chart above nonetheless reflects what we view as an accurate portrayal of the underlying trends in the productivity data, which is borne out by our preferred way of looking at the data – on an eight-quarter moving average basis. Looked at from this lens, productivity growth has consistently decelerated after peaking in late 2010 and remains easily below the growth seen over the 1999 through 2004 period.

If it is not the cast that faster worker productivity growth is pushing down unit labor costs and in turn preserving profit margins, then it must be the cost of labor itself that remains contained. This can be seen in the following chart, which shows the behavior of hourly compensation in the nonfarm business sector in the current recovery compared to previous recoveries.

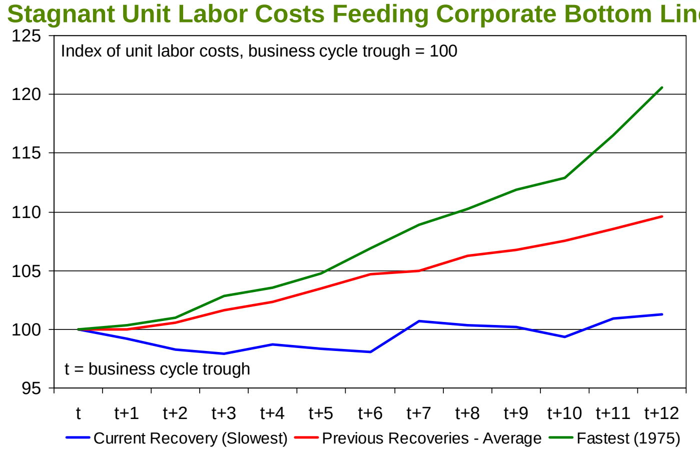
Clearly, growth in hourly compensation in the current recovery is badly lagging the field, having increased by only 6.8 percent to date compared with average growth of 18.4 percent at the 12-quarter mark in previous recoveries. And, to our earlier point about the impact of inflation during the 1970s, when we do the above comparison on the basis of real hourly compensation, the fastest growth (9.2 percent) came during the recovery that began in Q2 1958 with an overall average across all previous recoveries of 5.4 percent. And, as if the chart above isn't disheartening enough, during the current recovery, real hourly compensation is actually lower, as of Q2 2012, than when the recession ended.

Growth In Hourly Compensation Lagging Behind



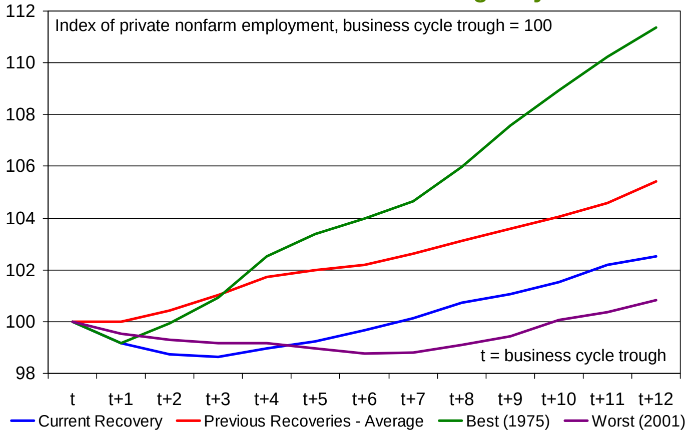
So, while unit labor costs remain well behaved, they remain so due to meager growth in worker compensation as opposed to faster growth in worker productivity. The chart below shows the growth of unit labor costs in the current recovery compared to previous recoveries.

Stagnant Unit Labor Costs Feeding Corporate Bottom Lines



That we have seen such meager gains in worker compensation is a reflection of the degree of slack that remains in the labor market – a point that Fed Chairman Bernanke has repeatedly made. Moreover, the published labor market data understate the degree of that slack, as workers who have left the labor force due to frustratingly weak labor market conditions are not fully accounted for. The following chart nonetheless offers a

Not The Worst Still Leaves Us A Long Way From Good



view of how weak labor market conditions remain relative to past recoveries at the same stage.

It is interesting, though of little consolation, to note that the current recovery has outperformed the "jobless recovery" that began in Q4 2001, a recovery that was characterized by much faster growth in worker productivity than the current recovery. That faster productivity growth helped offset gains in worker compensation and led to unit labor costs being well below the average of other recoveries. At present, however, while private sector hiring has outpaced that seen at the same point of the jobless recovery, the magnitude of labor market slack means wage pressures are virtually nonexistent. This is the reason why unit labor costs during the current recovery have grown at an even slower rate than during the jobless recovery.

What Does It All Mean?

There are many implications of the trends discussed above. One key, and highly debated, topic is the extent to which persistently high unemployment is cyclical or structural in nature. The answer to this question has its own implications, most significantly as it pertains to the efficacy of Fed policy – structural unemployment will be immune to the charms of quantitative easing while cyclical unemployment will, at least in theory, respond. While we do believe there is some measure of structural unemployment present, to a greater degree than Chairman Bernanke apparently does, we would argue that cyclical unemployment is more dominant.

That cyclical unemployment persists at such a high rate stems from weak growth in aggregate demand. It would, however, be wrong to expect stimulative fiscal and monetary policy to be the only cure. As noted earlier, what has been weak growth in aggregate demand during the current recovery is to some extent a payback for growth in final demand that was faster than it otherwise would have been in the years leading up to the Great Recession without the fuel provided by cheap and readily available credit. Household deleveraging and the painful paring down of excess inventories of housing units are a reflection of this payback, which has been magnified by lower levels of spending on the state and local government levels.

Over time, these imbalances will be resolved and demand growth will begin to accelerate. This is not to say that there is no room for policy in this process, but simply that policy cannot in and of itself remedy these imbalances. Going forward, however, this does suggest that businesses will be faced with faster growth in demand for their output which, in turn, raises the question of how they will meet this demand.

We do not believe, at this point in the recovery, that there is much more in the way of faster productivity growth that can be wrung out of existing workforces. This will of course vary across industries, but our point is a general one. To the extent that we cannot bank on faster worker productivity growth, firms either will have to raise the number of hours worked by their existing workers, take on additional workers, or some mix of these two. How firms respond will depend, amongst other factors, on just how much aggregate demand increases.

In the near term, this does not bode well for additional hiring. With worries over the fast approaching fiscal cliff taking an increasing toll on business confidence, the downside risk posed by Europe, and slowing growth in China and other emerging market economies, we are basically in a two-percent world for the next few quarters – i.e., we can expect real GDP growth to fluctuate around but not stray far from two percent. In such a world, there is little rational for firms to take on significant numbers of additional workers, and upping hours where needed along with whatever productivity growth we do get will likely be sufficient to meet any growth in demand.

Over the longer term, however, the uncertainties surrounding the U.S. fiscal cliff and the fate of the Euro Zone economy will ease – even if we don't like the outcome, we will at least know the outcome and businesses can plan and act accordingly. At the same time, further progress in curing the imbalances in the household sector and the housing market will contribute to improved growth in aggregate demand, improvement sufficient to lead to stepped-up hiring. Even at that point, however, it will take some time before we begin to see significant and sustained pressure on wages, given the degree of labor market slack still present. This will help preserve corporate profit margins for a time, but, eventually, unit labor costs will begin to rise at an increasing rate.

This sequence of events is fairly standard. What is not standard is the length of time it will have taken to occur in this cycle. But, while some have raised concerns over the sustainability of corporate profits, we are not yet at the point where higher input costs threaten margins, nor does the prospect of another few quarters living in a two-percent world necessarily spell doom for profits. It is by no means an optimal scenario, but it is one in which corporate profits can continue to rise, even if at a slower rate. If, however, our two-percent world becomes a one-percent world, or worse, profits would quickly fade.

Finally, a few thoughts as to why productivity growth has been relatively slow in the current recovery. First, many of the jobs added in this recovery have been in service sector industries in which productivity is more difficult to measure, compared to earlier recoveries in which manufacturing played a far more prominent role in the overall economy. While this was to some extent true for the 2001 recovery, that recovery was at the cusp of rapid and far reaching technological changes that helped drive faster productivity growth. With much of that technology already embedded in the economy, this recovery has not seen similar benefits to productivity growth.