

U.S. Macro Outlook: Turning the Corner



By [Mark Zandi](#) in West Chester

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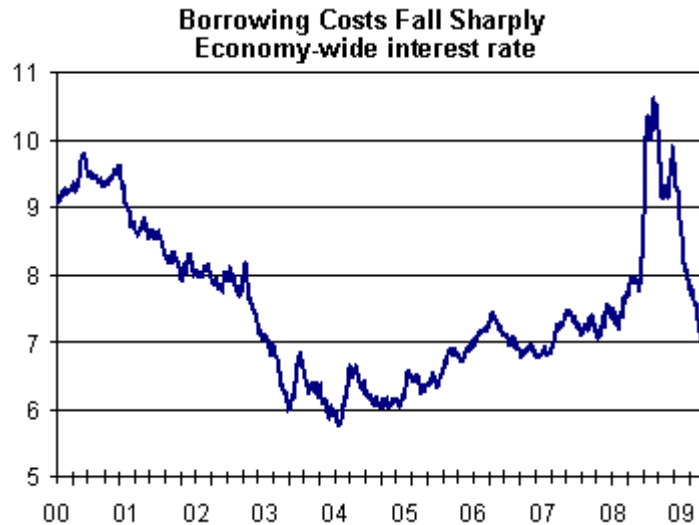
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- The economy has begun to expand again, thanks mostly to unprecedented monetary and fiscal intervention.
- The latest indicators of business sentiment suggest the recession ended in August.
- Relentless cost-cutting has preserved business profit margins, which augurs well for the recovery.
- Weak labor markets and stagnant incomes could keep the economy weak for an extended period.
- Growth will be robust in 2011, assuming continued federal support.

The economy is turning the corner from recession to recovery. After shrinking nearly 4% during the Great Recession, real GDP is on track to post a 3% annualized gain in the current quarter. Consumer spending is stable; business investment, exports and even homebuilding have turned positive; federal government spending is sturdy, and a large inventory swing has just begun.

Unprecedented monetary and fiscal support is mainly responsible for the economy's upturn. The Federal Reserve's aggressive actions, along with the stress tests conducted on banks this spring, have stabilized the financial system. Interbank lending rates, which had soared during the crisis, have returned to normal, and credit spreads have narrowed sharply. The economy-wide interest rate—a weighted average of consumer and business rates based on their shares of debt outstanding—is low by historical standards, though not as low as it was during the middle of the decade. Parts of the credit market remain dysfunctional, and hundreds of small banks are headed for failure, but credit flows are much improved.



Fiscal policy is also providing significant support. Hard-pressed unemployed workers and fiscally strapped state and local governments would be cutting back much more if not for the federal government's stimulus measures. The housing tax credit will generate up to 400,000 additional home sales this summer, and nearly 700,000 vehicles were purchased through the cash for clunkers program. Tax cuts for households and businesses are also adding to consumer spending and business investment.

All this has been costly—the federal budget deficit will approach \$1.6 trillion this fiscal year, up from \$450 billion last year—but the cost to the economy and ultimately to taxpayers would have been measurably greater without it. The economy would still be in a deep recession if not for policymakers' aggressive actions.

Dating the recession

The Great Recession that began in December 2007 likely ended in August 2009. The official arbiters of when recessions begin and end—academic economists on the business cycle dating committee at the National Bureau of Economic Research—consider a plethora of data and historically don't declare a recession over until well after the fact. The committee is more interested in being right than in being quick.

The committee's decisions closely mirror changes in the coincident economic indicator developed by the BEA but now maintained by the Conference Board. This indicator incorporates some of the data the NBER committee uses, including payroll employment, personal income less transfer payments, industrial production, and real manufacturing and trade sales. After falling steadily through the recession, the coincident indicator was flat in July and should turn positive for August. Employment, which accounts for just over half the indicator, fell during the month, but the three other components likely posted gains. The indicator seems set to strengthen even more this month as a wide range of data improves.

Our weekly business confidence survey confirms that the recession ended in August. Business sentiment generally reflects economic conditions and does not drive them, save at turning points in the business cycle. Recessions occur when businesses lose faith that their customers will purchase what they produce, then respond by cutting their investment and payrolls. Recoveries begin when that faith is restored.

In our survey, the best measure of business faith is the net percentage of positive responses from all respondents to the nine questions posed. The questions range from their broad assessments of sales strength and pricing to specific questions regarding investment and hiring. When less than 10% of responses are net positive, as was the case during much of 2008 and this year, the economy is in recession. The survey results definitively broke back above that key threshold last week.



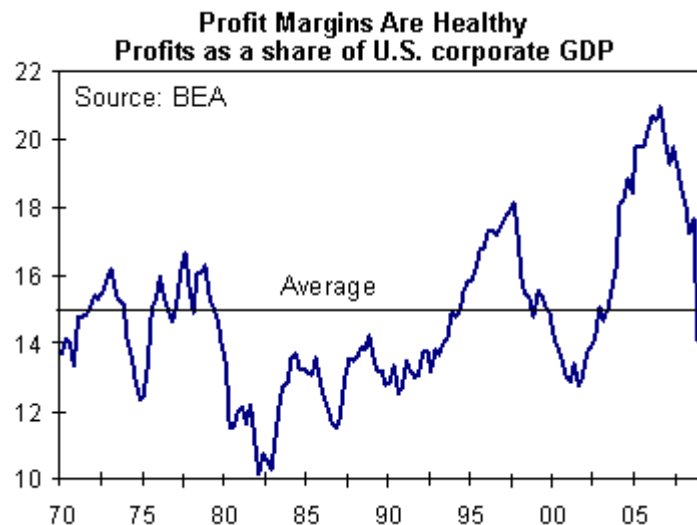
Sentiment could turn down again, but this seems increasingly unlikely, based on responses regarding the outlook for six months from now. These expectations are about as buoyant as ever in the survey's history.

Profits pick up

Behind firms' more upbeat views is a quickly improving profit picture. Total corporate profits had fallen by nearly a third between late 2006 and late 2008 but rose during the first half of this year. Some of this rise reflects banks' earnings as the financial crisis recedes, but even nonfinancial businesses' profits have stabilized.

This is a substantial achievement, given the free fall in sales, and it has been accomplished by relentless cost-cutting. Firms slashed investment and other expenses and were particularly successful in reducing labor costs. Unit labor costs, which measure compensation per unit of output, are falling. This reflects businesses' ability to raise productivity through layoffs and reductions in hours, and also a sharp slowing in labor compensation growth.

Despite the severity of the Great Recession, businesses have thus been able to hold on to reasonably strong profit margins. The corporate profit share of GDP—a good proxy for margins—is a more than respectable 16%, just above the average of the past 30 years. Margins are noticeably wider than they were coming out of past recessions.

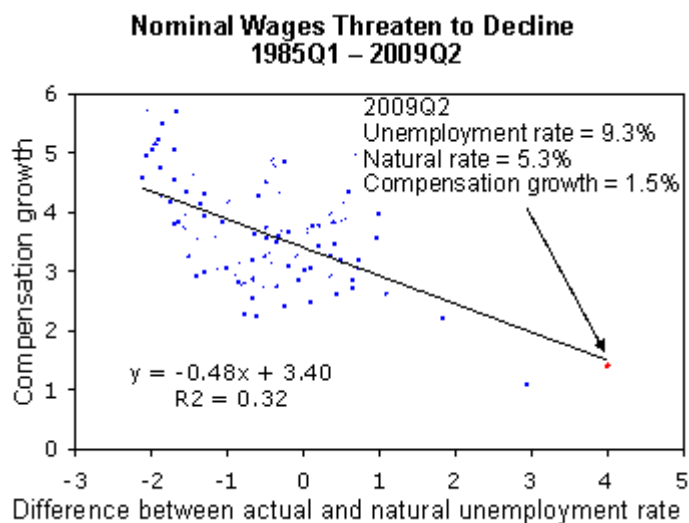


Good margins augur well for the recovery. As business confidence revives, managers at profitable firms will be encouraged to resume investing and hiring. This in turn will create the income and wealth needed to support increased sales, facilitating the transition to a self-sustaining economic expansion.

This dynamic is a regular feature of business cycles, but it may not take hold as readily this time because of stress in the job market. An astounding 7 million jobs have vanished since the start of the recession, and nearly 26 million workers—17% of the workforce—are unemployed or underemployed. For those with jobs, weekly hours are just above their record low, as many people are being furloughed.

Labor distress

There is such a surfeit of underutilized labor that workers' nominal wages and benefits threaten to decline. This is clear from the relationship between labor compensation growth and slack in the job market over the past quarter-century. By the second quarter of this year, the unemployment rate had risen to 9.3%—4 percentage points above the rate consistent with full employment and stable compensation growth. Compensation in the quarter grew 1.5% annualized. If unemployment rises into double digits—which seems quite possible given the current 9.7% rate—nominal compensation could stall—and even fall if joblessness continues to rise.



Declining nominal compensation would further discourage already-fragile consumer spending. Lower- and middle-income consumers who are saving little and cannot borrow would be forced to spend even less. The transition from recovery to expansion will be anything but graceful and could even be short-circuited.

Outlook

In the most likely outlook, the recovery will be tepid through at least this time next year but will evolve into a self-sustaining expansion soon thereafter. Real GDP is projected to decline 2.5% this year, rise no more than 2% in 2010, and to post robust annualized growth of 4% to 5% in 2011-2012.

This baseline assumes that policymakers will provide more support to the economy. Pressure to help will be particularly intense early next year as the benefits of the current monetary and fiscal stimulus begin to fade and the midterm elections approach.

Although the Federal Reserve is unlikely to do more—its only option would be more quantitative easing, something many at the Fed seem uncomfortable with—Congress and the administration will likely extend higher conforming loan limits for Fannie Mae, Freddie Mac and the FHA and provide more help to laid-off workers running out of unemployment benefits. There is even a chance that state and local governments will receive more help plugging their budget holes and that the housing tax credit will be extended or even expanded to all homebuyers.

There is also a reasonable likelihood that Washington will extend accelerated depreciation and net operating loss carryback benefits for businesses through 2010. Less likely, but possible, is a phasing in of the tax increases now set to take effect in 2011 on capital gains, dividend income, estates, and income earned by higher-income households.

Risks to the baseline outlook remain equally balanced and hang largely on what policymakers actually do. With more policy help, an expansion will take hold more quickly; with less, the recovery could falter.

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