Economic Commentary

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What is Next for the Economy?

Over the past few weeks we have been seeing increasing signs that the recession in North America is easing and that the economy is trying to make a bottom. If indeed economic activity is beginning to bottom out, the next question is how long will it be before a recovery takes hold and how strong will be the ensuing expansion? There are strong reasons to expect that the recovery will be slow and bumpy and that the expansion, when it comes, will be weaker than in previous cycles. Given the global scope of this recession, the overcapacity overhang and the strength of the US dollar, intense world-wide competition will keep inflation in check which in turn will suppress corporate profit margins, compress corporate profitability and restrain business capital investment.

The combination of low inflation and weak growth suggests that the current low levels of interest rates will persist for a longer period than in previous recoveries and that the rise in interest rates will be much slower and more protracted than in previous expansions.

Recession is waning and the economy is trying to find the bottom

Since the beginning of the year we have seen a string of positive economic announcements. According to initial estimates published by the US Department of Commerce on January 30th, output actually grew in the fourth quarter of 2001, at an annual rate of 0.2%. If this figure is not revised when the final figures are published later this month -an unlikely proposition- it suggests that the US may have narrowly averted the conventional definition of a recession, which is two consecutive quarters of decline in output. Even so, this does not change the fact that the US economy has been in recession since March 2001, as defined by the National Bureau of Economic Research (NBER) the official arbiter of economic cycles.

Fourth quarter growth was underpinned by a 9.3% rise in government spending, mainly for the war in Afghanistan, homeland security and reconstruction in NYC. It was also assisted by near-record 5.4% surge in personal consumer spending, driven by a 38.4% jump in durable goods sales -mostly automobiles- the result of the one-time zero financing incentives of US automobile producers in the last two months of the year.

In January 2002, payrolls in the US declined by 89,000 workers, but the job loss was the smallest since August 2001. Coupled with a decline in the labour force as more people abandoned their search for work, the unemployment rate declined to 5.6% in January from 5.8% in December. In the meantime, initial unemployment claims have been coming in at rates below expectations. At the same time a record $121 billion liquidation of inventory during the quarter helped bring closer the day when manufacturers will have to boost production to match demand in the economy.

The current state of economic activity was summarized very well by the FOMC at its meeting of January 30th when it announced that it was leaving the fed funds rate unchanged at 1.75% because economic conditions had “become more promising” for the first time in over a year. However, and this must be noted, it also stated that the risks are still stalked on the downside for the economy and that rates might still have to fall in the months ahead before the easing cycle is completed.

Why recovery might be some way off

There are a number of troublesome signs, however, that suggest that we may have not yet reached bottom and if we have, a recovery is still some ways off. What are these signs?

First, the minuscule annualized 0.2% growth in output in the fourth quarter was also accompanied with a -0.3% annualized drop in prices, meaning that nominal GDP actually fell slightly. This has not happened since the Great Depression of the 1930s! Second, most of the growth in demand came from aggressive zero-rate financing and cash back incentives in the automobile industry, which boosted durable goods sales by an unprecedented 38.4% during the quarter. The problem with these incentives is that they affect the timing but not the long-term level of demand for cars. As a result, consumer spending on durable goods may be much lower in the next few quarters which will dampen consumer spending when the economy needs it most to power the recovery.

Second, is the continuing plunge in corporate profits and business investment spending. In 2001, US corporations recorded the steepest year-over-year drop in profits since the Great Depression. In fact the drop in profitability reflects more than one-time cyclical factors. The profitability of US corporations has been falling steadily even before the recession begun. From 1997 to 2000, corporate profits as a share of GDP have fallen from 12.5 % of GDP to 9.0 % of GDP in 2000 and even less in 2001. The main reason for this has been the continued compression of corporate profit margins, the result of declining pricing power in an increasingly competitive and global market. The combination of excess productive capacity in the Far East, falling production costs and a strong dollar have been eroding the ability of US corporations to compete both at home and abroad. This lack of pricing power, far from going away now that the economy may be recovering will continue to persist especially now that the US dollar has made a 16-year high against all other currencies (trade-weighted basis).

Third, as global recovery stalls for a while with recession in Japan and anemic growth in Europe growth may take longer than usual to return to the world economy. Moreover, as the overcapacity glut continues to build up in North America and especially in South East Asia competitive pressures will persist. In fact, prices are falling in China, Japan, Taiwan, Hong Kong and Singapore, which together account for 20% of world GDP. In this environment, the capacity glut is exporting deflationary pressures to the USA. The implication of the above is that corporate investment might continue to decline over the next few quarters, which will act as a drag on any economic recovery. At the same time, productivity enhancing restructuring may put a lid on employment growth, an important source of consumer confidence and consumer spending.

The fourth factor has not been a problem in the 1990s but might well become a factor as we move on in this decade. The historically high US trade deficit at over 4.0% of GDP and the low American savings rate, which will be worsened by the Bush budget proposals to put the economy back into deficit mode in the next few years. How much longer will Americans continue to bankroll growth through consumer spending and low saving is a serious question that has not been answered so far.

Implications for interest rates

The combination of slower growth and low inflation implies that short-term interest rates in the US and by extension Canada will have to stay low for a longer period than has been customary in past recoveries and that provided they don't fall further still, not an unlikely proposition. In past recoveries, the Fed has not started raising interest rates until at least nine months after they begun. If we assume that the recession ended at the end of last year and that a recovery is underway right now, it should not be until September 2002, at the earliest that we should see the first hike in interest rates. Therefore, to the extent, that the above concerns prove right, we should probably not see a rise in interest rates this year and perhaps not until well into the next year (2003).

Although Canada's economy has clearly over-performed its US counterpart, with stronger GDP and employment growth so far, the economic recovery will be restrained by what is happening south of our border. With slower growth and falling inflation, the Bank of Canada will keep rates at current levels at least until the end of the year.

This forecast is at odds with the interest rate expectations that are currently built into financial futures prices. Based on the 3.33% yield on the December Eurodollar futures contract, investors are betting that the Fed will raise the overnight financing rate by one full percentage point this year from 1.75% right now to 2.75% by the end of the year, and that the first rate hike may occur as early as the June 26th FOMC meeting. Clearly, markets right now are seeing a "V" shaped growth pattern with a sustained recovery starting sometime during the first quarter, with a 37% rise in profits for S&P 500 corporations and with a return to inflationary concerns by the second half of the year.

It is my view that expectations of a quick rebound and return to sustained expansion in the economy are premature. That profit growth this year there will be, but much less than what equity markets are expecting and that corporate profitability and prices will remain weak for the rest of the year. Equity prices are at risk of significant correction, and interest rates -if they do not move lower still- will remain low for the rest of the year, a scenario that is positive for bonds. As far as the Canadian dollar is concerned, I would say that it will remain weak relative to the US dollar for most of the year and will not experience any significant appreciation until growth in the global economy has taken a firm hold, most probably some time in 2003.

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