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The Shape of Things to Come

L, V, or W? Perhaps a check mark, or something with a wiggly tail? Top economists debate what the recovery will look like.

Russ Banham - CFO Magazine

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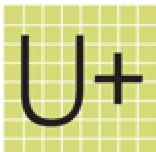
Much of the recent talk about an economic recovery concerns what shape it will take — literally. Will the plunge and rebound conform to the "V" shape that described the 1973–74 recession, be akin to the "U"-shaped recovery seen after the 1981–82 recession, or sputter into the dreaded "W" — twin recessions (the much-discussed "double dip") that keep the economy on the ropes for years?

We asked eight leading economists to get graphical with us and describe what shape they believe will ultimately win out. We present them here in descending order of optimism, if for no other reason than because to do the reverse would guarantee that you don't finish reading the article. And we give the last word to one economist who offers a refreshing dose of humility regarding his profession's ability to predict what lies ahead.

Employment Improves by Midyear

We're in a recovery that started in the third quarter of 2009, with real output growing. I anticipate we will see additional job growth by the end of this quarter, with unemployment falling by the third or fourth quarter in a meaningful way, given that we are producing more goods and services. Still, it will take time for people to believe this.

Mark Fratrik
Adjunct Professor of Economics, Johns Hopkins University



Consequently, I don't see a "V"-shaped recovery — a big, dramatic jump like we've seen in the past, such as the 1974–75 recession where output returned to its prior path quickly. This is more of a "U"-shaped recovery like the 1981–82 recession. I would like to say it will be a "V," but my profession tends to look for the clouds instead of the sun coming through, which is why we are called the "dismal science." The natural inclination is to err conservatively — not promise a big recovery and then end up with egg on your face.

We still need to work through problems like the housing market, unemployment, and consumer uncertainty. And there are some clouds on the horizon like continuing government spending and the specter of taxation to reduce the federal deficit. But I'm relatively optimistic. It was such a significant economic downturn, shaking our foundations and making banks and consumers apprehensive. As banks open their taps, we'll see new businesses formed that will employ more people, guiding decent employment levels by the middle of the year.

For well-funded companies that weathered the economic storm, the time is ripe for acquisitions. Good companies with a long history of running successful businesses that have solid relations with equity and debt investors should seize this opportunity.

Bill LaFayette
Vice President of Economic Analysis, Columbus Chamber of Commerce; former Professor of Economics at Ashland University

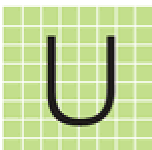
There Is Less to Fear

GDP went positive in the third quarter of 2009, improved in the fourth, and there are expectations of 3% growth or more for the first quarter of this year. To me, this suggests the shape not of a "V" but of a check mark — down really quickly and then back up fairly slowly.

The unknown in all of this is the consumer, and whether or not the federal stimulus money that is driving things for the moment will attenuate over the next several months. My assessment is that consumer spending will come back this year and the labor market will turn. When output increases as employment decreases, it means employees and processes are strained, and that is unsustainable. Even with a 3% "middle of the road" growth rate, employers will have to start rehiring. We're already seeing some of this — the November jobs report was very good, though December was somewhat less good. But that's still better than losing 700,000 jobs in a single month, which is what we saw during the recession.

As jobs are created or disappear at a lower rate, people will be less fearful, fueling their spending habits. Housing is equally crucial to consumer psychology, and we're beginning to see it stabilize at the national level, though not regionally in the formerly boom markets like Phoenix and Miami. Overall, I am cautiously optimistic. This is not the time to bar the doors and hide under the bed. Hunker down and you can miss the recovery. It's happening, and it's not a bubble. This is real growth tied to fundamental factors.

James Morley
Associate Professor of Economics, Washington University



Get Ready to Ramp Up

We are definitely out of the recession, so, yes, we are in a recovery. The recession began in December 2007 — the date that the National Bureau of Economic Research contends marked the peak of the previous economic period. The data will probably show that the trough came in June 2009. I say this despite the employment figures, which are a lagging indicator of overall economic activity, sometimes by just a few months, or, as with the 1991 recession, closer to a year. Clearly, we lack a strong labor market, with 80,000 jobs lost in December, though nothing on the magnitude of the 500,000 jobs lost monthly during the height of the recession.

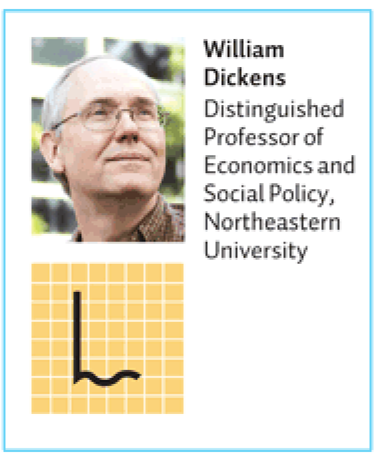
In terms of what type of recovery to expect, I predict a "U" shape, similar to the 1981–82 recession and recovery, in which the initial recovery after the trough is tepid and tentative, followed by a catch-up of economic activity on the previous upward path or at least part of the way. For example, we saw a flattening out of the recession going into the second quarter [of 2009], followed by a 1% GDP growth rate and then 1%–2% growth in the third quarter. The fourth quarter is looking like a 5%–6% annualized growth rate, reflecting what we saw in 1981–82, with companies on target to restock inventory and the contraction in output to lessen.

My advice to CFOs is that if there is a robust recovery, companies with a skilled and trained workforce already in place will do better than those that need to hire in order to ramp up production. Consumers will have little patience with "empty shelves."

History Offers Little Help

Are we in a recovery? If we are then it doesn't look like any recovery we're used to seeing. Typically, postwar recessions are caused by actions of the monetary authorities to stem inflation, but this recession has a very different cause. Resolving it, therefore, is complicated.

Normally at the end of a recession, what the Federal Reserve taketh away it can giveth, spurring a recovery. This has been successful in all the postwar recessions, but this time history is of no help, given the unique reasons for the past recession. The two main tools — fiscal stimulus and lower interest rates — have already been deployed and are no longer available. To the extent they headed off the financial crisis and kept the housing market alive — albeit on life support — they probably prevented a depression.



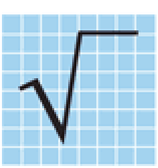
But, I don't have a terribly large amount of confidence in forecasting a full and fast recovery. We're as likely to be in a strong recovery as we are to experience more serious troubles ahead. There are problems looming that can toss us back into a serious downturn. The government's fiscal stimulus will soon peak and head down, much like "Cash for Clunkers." At best, this recovery, and I hesitate to call it that, is shaped like an "L" with the bottom line undulating like a snake. At worst, it is a "W" — a double-dip recession. I worry that we will repeat the Japanese experience — a long, long period of economic malaise. Despite my outlook, I would advise CFOs to look carefully at their own markets and not let macro-phenomena dictate their decisions. They know their circumstances better than I do.

2010 Does Not Look Good

The recovery in terms of GDP growth began in the third quarter of 2009, and will take the shape of a "square root" or radical sign. That is, an economic cycle marked by a sharp downturn in GDP beginning in December 2007, followed by a significant upturn in output beginning in the third quarter of 2009, and then followed by stagnating output (little real GDP growth) for 2010.

At this point in time, the lack of economic-policy clarity from Washington, along with higher taxes and interest rates for 2010–11, will restrain both consumer and business investment for 2010. There is even the potential, somewhat small but rising, for a "W"-shaped cycle — that is, a dip back into a recession in 2010. Even so, job growth will be muted as it was for the last recession in 2001.

Ernie Goss
Professor of Economics and MacAllister Chair, Creighton University



The recovery will be accompanied by an unemployment rate that remains very high by historical standards through 2010. Some people may expect a "V"-shaped recovery given the pop in GDP in the third and fourth quarters of last year, but I see things a bit more muted through 2010. [Despite claims of 5%–6% GDP growth] I see it closer to 2% annualized growth. Manufacturing sectors continue to shed jobs, construction is not really rebounding, and state and local governments will continue to cut spending. Plus, the federal government is just not going to be able to spend in 2010 like it did in 2009.

This is not a typical recovery, in part because of the uncertainties surrounding the government's positions on health-care reform and cap-and-trade (plans to reduce carbon emissions). Consumers also are not spending like you'd expect in a traditional recovery; their confidence was eroded by the unemployment numbers and the housing crisis. While other economists predict inventory restocking by companies after 15 months of reduced inventory levels, we do a monthly survey of supply managers at 900 companies, and only 5% said their current inventory levels were too low. That tells me we're not going to get that "bump" from inventory restocking and higher sales that we thought we'd get. Given the higher short-term and long-term interest rates that are coming, my advice for CFOs is you'd better be borrowing and issuing bonds today rather than tomorrow.

So Many Nagging Problems

There remains significant uncertainty as to where this economy is headed, based on fiscal policies and other variables. The Federal Reserve pushed interest rates to zero, and even that didn't fix things; there are so many problems. We're now seeing actual shrinkage of balance sheets for the first time since the postwar period.

David A. Levy
Managing Partner and Chairman, The Jerome Levy Forecasting Center

Consequently, I would say this recovery is the equivalent of a "dead-cat bounce," an "L" shape with the horizontal part of the "L" shaped more like a hump, dropping down and picking up ever so slowly. This is not a sustained recovery; it's merely a spurt in capital spending and a snapback in inventories. Companies have become comfortable with occasional stock-outs and telling customers it will take a while to deliver. They don't want to tie up cash, and the same is true with capital investments.

There are other nagging problems like housing, which is not recovering. We may have gotten past the mortgage derivatives crisis, but the foreclosures and home deflation it spawned are still with us. We're also experiencing a disinflation in compensation rates and an increasing portion of the workforce experiencing actual cuts in compensation.

Household debt is another mess. In 2001 the household debt-to-income ratio hit 100% — a record level, according to the Federal Reserve. We got out of that mess not by lowering the debt, but by dropping rates and keeping credit cards extremely liberal, which made things worse. By 2008 the debt-to-income ratio hit an insane 133%. Today, it's around 130%.

This is not the typical recovery following a severe recession like 1957, 1974–75, and 1982, where we had sharper upturns. Then, the financial system was intact and we had the wherewithal for a great deal of debt expansion and increasing profitability. We do not have that now. I'd be very cautious, preserving capital, cash, and access to credit as much as possible. This is not the time to be thinking long-term expansion, not just yet.

The Case for a "W"

Just because we're recovering doesn't mean we've recovered. A couple quarters of positive growth is formally defined as a recovery, but you can have illusory recoveries like what happened during the Great Depression, which had two "recoveries" through the 1930s that vanished as quickly as they arrived.

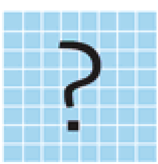
We can have another recession tomorrow, equating to more of a double-dip "W" shape. We still have 15 million people unemployed and a 10% unemployment rate, compounded by financial and economic anxiety. We have spent more on fighting this financial collapse than we spent on World War II, and still have no idea of the real problems at AIG, which the public essentially owns. I'm told that before the dust settles we will have seen more than a trillion dollars in write-downs among banks.

The public no longer trusts the financial industry. FDR said we needed to put an end to Wall Street gambling with other people's money, and that is no less true today. The fact that Bear Stearns's stock plummeted from $57 a share to $2 in a week means the executives running the place had no idea what they were doing. We're sitting with a financial system in worse shape than before the crash. The monetary base has roughly tripled since the beginning of the crisis, so we have the basis for hyperinflation. The Federal Reserve keeps buying assets with newly printed dollars, and we have no idea of the quality of those assets.

We need radical surgery, and that means a new economic team in Washington to restore trust in the financial system. We need a health-care fix laid out on a postcard by economic engineers and not members of Congress brokering votes.

I'd be very cautious about the future. You cannot rely on this economy when the government is running the financial system, writing 9 out of 10 mortgages, and running the biggest insurance company in the world. The silver lining is that it is a good time to borrow and refinance. If a CFO can borrow long-term and lock in low nominal rates, now is the time.

James Lothan
Distinguished Professor of Finance, Fordham University



A Bull Market in Uncertainty

The recovery is under way — there is no doubt about that, even though the National Bureau of Economic Research hasn't picked the month yet in which the recovery began.

Nevertheless, there remains quite a bit of uncertainty in this recovery. Banks are holding on to huge amounts of excess reserves to avoid risk; otherwise they would be making loans. Sure, the Fed is paying some minimal amount of interest on these excess reserves, which they never did in the past, but there is certainly more to be made through traditional loans.

The problem for banks has been assessing risk. The Fed took action to avoid a Great Depression−type scenario, but by the same token shoved all these reserves into banks that they are not releasing. Consequently, there is a real danger of hyperinflation. Too much money has been printed and it is chasing too few goods. Add this to uncertainty over housing, the deficit, and TARP, and now the government taking on health care, handling it in such a way that it will inevitably bollix it up.

At best, I see a "U"-shaped recovery, barring another shock that would cause a double-dip. I wouldn't rule that out. As Adam Smith once said, "There is a great deal of ruin in a nation." To me, that means that governments can only do so much.

When I talk to other economists, we can all come up with plausible scenarios that essentially cover the ballpark, with more letters describing the shape of the recovery than are in the alphabet. None of us, however, is willing to attach a whole lot of probability to any of them. I wouldn't bet the farm on any one of the cockamamie scenarios we economists predict, where there will be X% growth and companies can now [act on this assumption] in terms of their markets. There is just too much uncertainty, most of it regarding government policy.

Russ Banham is a contributing editor of CFO.