Shape Shifters

Top economists tinker with their projections for 2011.

Russ Banham - CFO Magazine

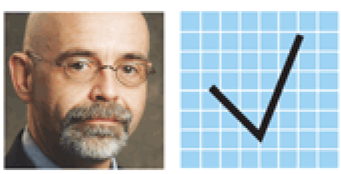
Nine months ago, *CFO* asked a number of leading economists to put themselves on the line — or the V, or U, or W, as they saw fit. That is, we asked them to predict the shape, literally, of the recovery (if any), and their collective response yielded one of the most popular articles we published all year. (See "The Shape of Things to Come," March.)

So it seems only fitting, as we look ahead to 2011, that we revisit a few of those fearless prognosticators to see if they stand by what they said then, or want to offer something that every CFO can relate to — a revised forecast.

While some made minor revisions, each is essentially sticking by what he said. What makes that particularly interesting is that now, as then, the predictions about the fate of the economy vary wildly. The intervening nine months have done virtually nothing to create a convergence of opinion, which calls to mind the George Bernard Shaw aphorism: "If all economists were laid end to end, they would not reach a conclusion."

Economists tend to be, depending on your point of view, touchy or precise. When we asked them to vote for the shape of the recovery earlier this year, for example, a few refused to pick a letter (and there were, after all, 26 to choose from) and instead described other shapes. One picked a check mark, while another selected a square-root sign. Talk about data visualization.

As we did in March, we present our intrepid panelists' opinions in descending order based on their level of optimism, an editorial trick designed to make sure you don't stop reading too soon.



Bill LaFayette
VP of Economic Analysis, Columbus Chamber of Commerce; former Professor of Finance and Real Estate at Ashland University and the University of North Texas

Slow Recovery, but Things Are Getting Better
I think I was right in picking a check mark the last time, but I have to believe the guy who picked the square-root sign [Ernie Goss of Creighton University, see below] was closer to describing the shape than I was. Back then we saw a bit of a pop from the stimulus package, which is now attenuating. If you dig below the surface of the GDP numbers, you see that growth is becoming internalized. What I mean by this is that we're seeing much slower growth and not the big jumps we saw from the stimulus package.

Stronger consumer spending and bigger investments by businesses, especially in equipment and software, are driving the incremental growth we're seeing. Obviously, people and companies are taking advantage of the low-interest-rate environment. One problem is that credit standards are still a hair too tight, not surprising since they were probably too low before the crash.

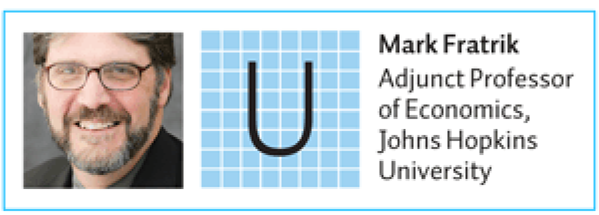
Many forecasters expect that we are going to experience slow, steady growth in the upper 2% range, like 2.7%, by the middle of next year. This still isn't what we want to see, but it's a far cry better than the economists who were predicting a double-dip "W"-shaped recession a few months ago. We were worried last spring about the euro and the debacle in Greece, but the latest bits of information on these economies indicate they're pulling things back together.

Labor also seems to be coming back together. Employment bottomed out in December 2009 and has been increasing by fits and starts ever since. We're up 0.5% nationally since then.

Domestically, we enjoyed a 7-month string in manufacturing-employment increases through July, and the last time we saw that in the United States was in late 1997 to early 1998. It took 21 months for the labor market to turn after the 2001 recession. Yet, after the most recent downturn — the worst in the postwar period — it turned after 6 months. That's pretty remarkable.

The one thing holding things up is housing; it's been a real drag on the economy. We knew it would take a good while for commercial and residential real estate to come back, and it still hasn't. Nevertheless, I just saw *Wall Street Journal* survey data showing that 53 out of 54 economists expect GDP to remain positive. Of course, the one pessimist could always be right.

My advice to CFOs is to not hunker down so completely that they miss the recovery. It's a slow recovery, certainly, but things are getting better. It's a lot less likely now than it was in March that we would have another recession on the heels of the last one.



It's Going to Take Longer than I Thought
In the previous article, I wanted to say the recovery would be a "V"-shape, but I hedged my bets and took the conservative "U+"-shape instead. I'm still positing an upward recovery to where we were before the recession hit, I just think that it's going to take longer than I thought — hence the flatter-bottom "U."

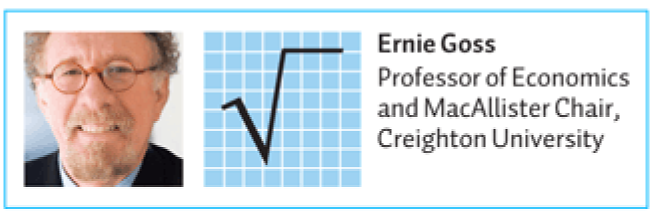
While we are technically out of the recession, and we do see some economic strength in certain areas, obviously the big lagging indicator is unemployment, which was 9.6% in September, down just a tad from the 9.7% recorded six months earlier. This breeds anxiety among the employed as they fear being laid off, which has an impact on their buying and spending.

We all know that unemployment is a lagging indicator — the only surprise, I guess, is how long it is lagging; we have yet to get the numbers down to a level where people feel comfort. There is still this aura of uncertainty, this cloud that won't go away. But, there are some streams of sunlight. We saw some decent monthly housing numbers in September, we saw exports grow a bit, and there are signs that some local economies are experiencing strong growth.

I believe that as more people get jobs, it will firm up housing prices. Foreclosed houses will work their way out of the system because people still want to move, or their jobs or the growing size of their families will force relocation. This dynamic always occurs and employment will kick it back into gear. I think that in the first quarter of 2011 we'll see the beginnings of this.

A Real Potential for a Double Dip

The unemployment numbers in September, at 9.6%, looked sort of good to me because I thought they would go higher. Still, Congress is dallying and there is little consideration of what its actions will do to business. We have a tax increase that is looming, and as a result, after January 1 the paychecks of all workers will show a pay cut. Equally problematical are the costs companies will incur to change their computer programs to effect these new tax rates, in terms of withholdings.



That square-root sign I chose is still looking pretty good to me. We came down very quickly in GDP, and then we came up a bit in the fourth quarter of last year and in the first quarter of this year. Now, things have flattened. I had thought then that we might see a bit of a slope upward, but now I think it will probably slope downward because of the tax increases.

Of course, if the new Congress decides to continue the Bush tax cuts for the next two years, I'm going back to the upwards slope. Not sure what shape that is — it doesn't fall neatly into a "V" or a "W" — maybe it's my square-root sign with a little rising curve at the end. If the tax cuts expire as planned, then the curve slants downward. Maybe we'd even see a "W." There is a real potential for a double-dip recession, although our survey numbers now don't point that way.

A lot depends on these tax increases and the housing stats. I salute President Obama for saying no to a national moratorium on housing foreclosures. At least he's trying to provide some certainty. But, the Federal Reserve's new program of quantitative easing to counter the possibility of deflation gives me pause. It's a mistake. By enacting quantitative easing, essentially creating or printing additional money, the Fed is telegraphing to everyone that rates will remain low for a very long time, so why go out and refinance your home today or buy a new one? The second problem with quantitative easing is that it could possibly cause excessive inflation.

I'm sticking with the square-root sign — for now.

Early Next Year Will Be Even Worse

We're sitting right now with a 60% probability of another recession next year. Our analysis of the net flow of profits to global companies indicates that they are growing, but a lot of it is coming from overseas economies. This doesn't help U.S. jobs, nor does it do the U.S. economy any good.

The enormous federal deficit that widened dramatically in late 2007 and early 2008 has basically held at about the same level, providing a big plus for U.S. profits. But, it isn't growing anymore. As for housing — well, we got a temporary boost from the home-buyer credit, but when that expired it dropped off. Nonresidential commercial construction is still in decline, and we will continue to see volatility in that sector. Overall consumer spending also is likely to come under further duress because incomes are growing so slowly. The pressure to save money will come at the expense of businesses.

The one bright spot has been capital equipment spending, but even that is not enough to outweigh the negative things. At best, profit trends will be more or less flat from this point on. Uncertainty continues to prevail — we don't know what the fiscal policy will be next year, or what the tax situation will be. We don't know what various initiatives to reduce the deficit or boost infrastructure will be. The possibilities are concentrated in a range between a decelerating economy and barely crawling ahead.

We have seen most of the rise in the "L" shape I described, with the bottom shaped like an upside-down "U." We may stay flat for a while, but then we're going down again. I'm holding on to that view. So far nothing has happened over the past several months, as far as how the economy has behaved, to change my opinions. The stock market in March was around 10,500, and now it's hovering just above 11,000 — not much of a change, really. We're surely not looking at a boom like we had after the 1990s recession and the one after the 2002 recession. There are more scares ahead.

We think the fourth quarter will not have the same positive surprises [in terms of aggregate corporate profits] as the first half. It will be an outright disappointment, and early next year will be even worse.

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