MarketWatch

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Economy is running out of gas
Commentary: Recession lurking with demand still weak

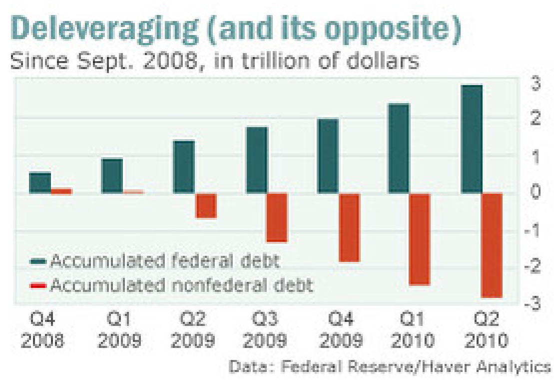
By Rex Nutting, MarketWatch

WASHINGTON (MarketWatch) — The U.S. economy is in danger of sliding back into another recession, even before we're fully recovered from the last one.

There's nothing surprising about the economic outlook. We know from reading our history that it takes a long time to recover from credit bubbles, but we've become impatient, expecting trends that evolved over decades to reverse themselves quickly.

We want the economy to fix itself, right now!

But it won't. The economy is slowly readjusting and rebalancing, but in the meantime it's also suffering from a lack of demand to keep everyone employed.



The federal government has taken on a lot of debt, but it's mostly offset deleveraging in the rest of the economy.

Our political system tried some half measures to keep demand up, but has apparently given up on even those.

The economy is running out of gas, and there's no fueling station in sight.

Consumers are still hunkered down, and without further growth in consumer spending, businesses won't have the profits they need to justify expanding their companies. Housing is still dead. Exports are benefiting from a weaker dollar (BOARD:DXY), but foreign markets aren't expanding as fast as they once were.

Forever blowing bubbles

The Fed has been inflating asset prices as part of policy since at least the mid-1990s. The wealth effect is the primary mechanism, make people richer and they'll spend more. So QE is there to goose asset markets. But this'll end badly. And the next time the Fed won't have any silver bullets left to kill recession.

And you can forget about any increased demand from the government.

Add it all up and you have to wonder: Where is the growth going to come from?

Despite this gloomy assessment, few economists are predicting an outright recession, just very slow growth.

Levy forecasts recession

One exception is David Levy, chairman of the Jerome Levy Forecasting Center, who looks at the economy from the unusual perspective of profits, not gross domestic product. Levy says he sees "domestic profits eroding, corporate earnings becoming increasingly disappointing, and a 60% chance of a recession in 2011." Read more about the Levy Forecast.

Broadly speaking, a recession is a period of contraction in economic activity, usually associated with job losses, reduced output and reduced sales. By that definition, the economy began to recover from the recession in July 2009. Since then, GDP has grown about 3.5%, but employment is still down about 400,000.

Levy doesn't use the typical economic models, which might be why he was one of the few who accurately predicted the housing bubble and the 2008 recession. Instead, he focuses on flows of funds through the economy, especially the flows that lead to profits, which play a central role in business cycles.

We're taught that savings are good, but we're not taught that it depends on who's doing the saving, and how much. If everyone saves, then no one will spend. If no one spends, businesses will have no revenue, and workers won't get paid. And no one will have anything to save.

In his latest forecast, Levy argues that deleveraging by consumers, banks, businesses, and state and local governments continues to hobble the economy. Balance sheets remain bloated by historic standards, which means the private sector will be saving more and spending less, probably for years to come. Federal government deficits made up for those private-sector savings, but only for a while.

Corporate profits were also bolstered by cost-cutting, especially by firing workers and cutting back the hours of the survivors. But in the aggregate, such tactics can't be sustained, because reduced compensation across the whole economy ends up depressing corporate revenue. After all, consumer demand is dependent mostly on what consumers earn on the job.

Businesses aren’t investing, not because they don’t have the capital, but because they don’t see the demand coming back soon.

“Net fixed investment, normally the most important profit source, remains less than 2% of GDP (the postwar range until the last recession was about 4%-10%) with limited prospects for improvement in the year ahead,” Levy wrote. “Deep problems mar the outlook for investment in commercial and residential structures, while overcapacity and slow topline growth expectations limit the potential of the present spurt in capital equipment outlays.”

Hatzius says recession can be avoided

Most other economists are bearish, but haven’t come to the point of forecasting a recession.

For instance, Jan Hatzius of Goldman Sachs is sticking to his prediction that the economy will avoid a recession, barely. He puts the odds of a recession in 2011 at 25% to 30%, but worries that one of his favorite recession indicators is flashing a red alert.

Since World War II, the economy has never once avoided a recession once the unemployment rate rose by more than 0.3 percentage points (on a three-month average). And it’s about to do just that, Hatzius says.

The jobless rate, now at 9.6%, is expected to rise to 10% or more later this year or early next year. The economy is creating a few jobs, but not enough to keep the unemployment rate from rising.

Despite the 11-for 11 track record of this indicator in predicting recessions, Hatzius thinks we’ll avoid one this time, mostly because economic activity is already at such weak levels that the cyclical forces that usually push the economy into a recession aren’t in play.

Most companies have already cut their payrolls to the bone, and won’t cut much more even if demand falters.

In other words, the economy isn’t strong enough to plunge into a recession. When you’re crawling, you don’t have far to fall.