



## Too Soon to Sound the All-Clear Bell

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By now, it is pretty obvious that the financial crisis is behind us and the global economy is experiencing a synchronized recovery. The marked improvement in financial conditions suggests a V-shaped recovery is possible (*Chart 1*). But it is too soon to wave the all-clear signal.

The biggest impediment to a sustained rebound is rising unemployment, especially in the U.S. where the underemployment figure (*Chart 2*) hit a record 16.8%. The average duration of unemployment is at a record high, and the jobless rate for teenagers is a whopping 25.5%. Those who are working are pumping out record productivity numbers, which might suggest to businesses that additional hiring is unnecessary for now. Although the pace of layoffs has slowed, there are no indications yet that business is about to staff up. Data for temporary workers remain muted and part-time employment continues to rise relative to full-time.

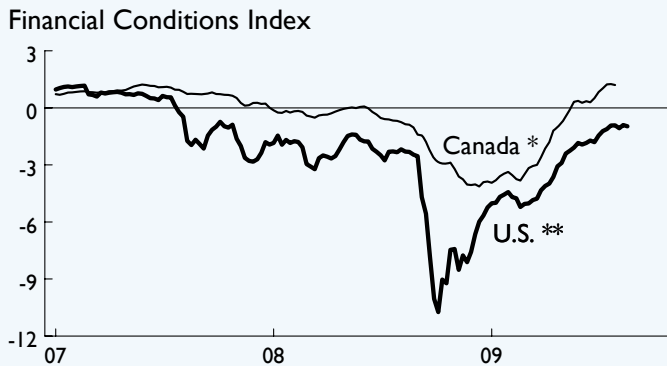
State and local governments are laying off workers, freezing salaries and cutting hours. For

example, public schools are down to the bare bones when it comes to their budgets. This month, one Georgia school moved to a four-day school week in order to save money. All staff are on a three-day furlough. Schools across the state have been told to drastically cut costs. Similar cutbacks in public services are occurring across the country. Governor Schwarzenegger in California is facing a dire situation: the unemployment rate is near 12%, thousands of state workers have been laid off, and the state college system has suspended admissions for spring of 2010, raised fees 20% and forced its faculty to take unpaid leave two days a month. In the private sector, if you have a contract with the state, you're liable to get an IOU instead of a cheque. The California state legislature is even closing roughly 220 state parks.

Across the country, deep budget cuts are exacerbating the unemployment problem and straining the ability of many families to cope with the downturn. Many programs to forgive student loan debt are being changed or reconsidered, and special needs programs are being cancelled. Even the heavily endowed private

Chart 1

### V-Recovery?



\* BoC Financial Conditions Index    \*\* Bloomberg Financial Conditions Index

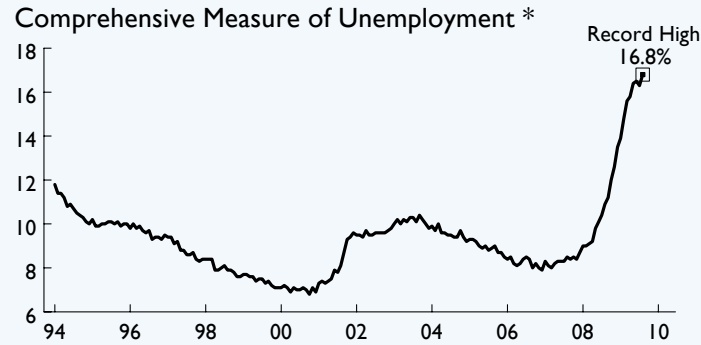
The **Bank of Canada's Financial Conditions Index** is a weighted average of credit conditions, corporate bond spreads, the overnight rate, the average yield on 10-year (and over) GoCs, real exchange rate, the ratio of the TSX index to GDP, and real house prices. Values above zero indicate that conditions are better than the average over the last ten years, while negative values denote that conditions are worse than average. Downward movements capture tighter financial conditions (consistent with weaker economic activity) while upward movements represent improving financial conditions (consistent with stronger economic activity).

**Bloomberg's Financial Conditions Index** "tracks the overall stress in the U.S. money market, bond market, and equity market", using money market spreads, bond market spreads, the S&P 500 index, and the VIX.

Chart 2

## Broadest Measure of U.S. Unemployment

United States (percent)



\* includes workers who are unemployed, marginally affected, and part-timers who are unable to get full time

universities are feeling the pinch. With plunging endowment returns, many Ivy League and other prestigious schools are laying off workers, delaying plans for ambitious new buildings, freezing wages, suspending hiring, and slashing travel budgets and other nonessential expenditures. Many schools are reporting a slowdown in executive education and evening MBA programs, an important source of revenue for those institutions. Meanwhile, public universities are reeling from state cutbacks, slashing student services, eliminating classes and, in at least one instance, asking students to help them cover the shortfall.

The ability of state and local governments to raise funds has been killed by the credit crisis and many are suffering

downgrades in their existing debt. Moreover, the hardest hit states in the housing crisis—such as California, Florida, Nevada and Arizona—have experienced the biggest declines in tax revenues. Income, sales, and property tax flows have plummeted while tourism, a vital industry in these states, has nosedived. Joblessness has led many to exit these states in the hope of finding greener pastures elsewhere. For the first time since WWII, Florida lost population in the year ending April 2009. Even during the Great Depression, new residents swept into the state in search of work and leisure. But the severe housing contraction, combined with the sputtering Florida economy, has eclipsed the state's former gravitational pull.

In a state with no income tax, state and local governments count heavily on migrating retirees to boost revenue and create jobs. In fact, the lack of an income tax is part of the allure. The recession-fueled collapse of stock prices last year stopped some of that. Retirees wanting to move to Florida either couldn't sell their homes up north or lacked a down payment after investment accounts took a pounding.

Many households with prime mortgages are now facing foreclosure. For some, the clock is ticking on a mortgage reset that will force them out of their homes in the next one-to-three years. These are the folks that were burdened by so-called 'exotic' mortgages—interest-only or even worse, negative-amortization loans—on which the monthly payments are scheduled to skyrocket at reset time. Loans of this kind were once rare, but their popularity surged during the housing bubble, allowing people to buy homes more expensive than they could previously afford. By 2004, half of all loans made in California, Nevada and Florida were interest-only loans. Homebuyers believed when they took these loans that they would refinance at much higher house values well before the reset date. Now, however, their mortgages far exceed their house value, making refinancing or even selling impossible. Across the U.S., about 18% of prime interest-only loans are at least 60 days delinquent, while California's rate is 21%, although that is

still below Florida and Nevada. This negative overhang on residential real estate has already triggered significant belt tightening. Some homeowners took out interest-only loans to reduce their monthly mortgage bill so they could make college tuition payments. Now, they too face an untenable situation with no easy exit and certainly no government bailout.

And these are not isolated situations. With the aging of the population and the decline in household net worth, many will need to work longer to rebuild their nest eggs. The fastest growing age cohort in the U.S. labour force is the group of workers age 65 and older. It's hard enough for anyone to find jobs in most parts of the U.S. today without dealing with ageism and a very uncertain future.

For all of these reasons, the U.S. consumer is not likely to lead the economy out of recession. Although consumer confidence has picked up recently, it remains well below the level in Canada

(*Chart 3*). Canadians are in much better financial shape than Americans having never been allowed the luxury of 100% loan-to-value mortgages or government subsidization of mortgage interest and property tax payments (*Chart 4*). Most American households are having trouble making ends meet, let alone paying down debt or putting money away for retirement. The burden of tuition bills looms large for many boomers and their kids and public assistance is drying up at the same time that U.S. banks are restricting consumer credit. The average American household spends more than it earns and has been doing so for a very long time. While the top 10% of income earners are saving money, the bulk of the remaining 90% are stretched. Even though people have cut their budgets and their expectations, there remains a limit to how far they can stretch their dollars. When breadwinners lose their jobs, the situation quickly becomes dire.

**Bottom Line:** Financial markets have improved and the economy has been boosted by inventory rebuilding and improving net exports (in the U.S.), but there is little sustained impetus for a consumer revival. The back-to-school season has been disappointing and, while Christmas is expected to be significantly stronger than last year (which isn't saying much), consumers will continue to be bargain hunters and the Fed and the federal government will continue to prime the pump.

Chart 3

## Consumer Confidence Picking Up

Conference Board (January 2006 = 100)

Consumer Confidence Index

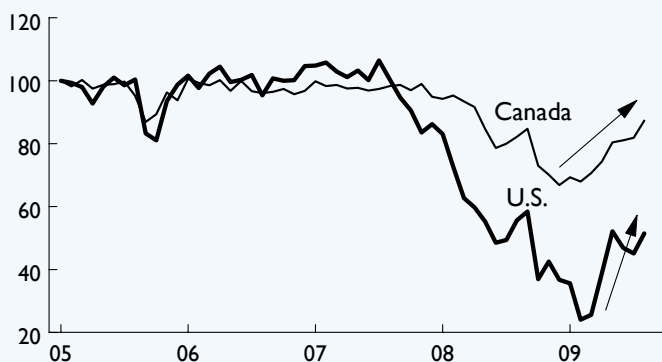
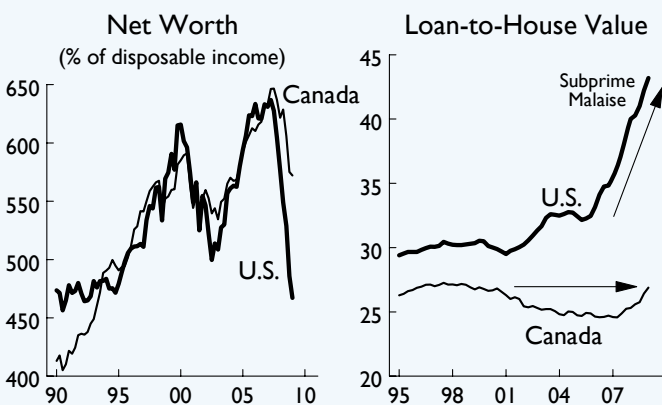


Chart 4

## Canadian Household Sector in Better Shape



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