

When Will We Know the U.S. Recovery Is for Real?

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Investors remain fearful of a double-dip recession (or as NYT columnist Thomas Friedman says, “a double dip with a back flip”) despite two consecutive quarters of growth. The concern is that the economy will lose momentum in the wake of “formidable headwinds” such as high unemployment and contracting credit (as discussed in last week’s *Feature*) once inventories are rebuilt and stimulus programs end. With equities up 60% from their lows and corporate bonds enjoying a banner run, any sign of backsliding in the economy could unhinge markets. Although the ultra-steep yield curve and improved credit spreads suggest the recovery will carry on, doubts may linger until the following five signposts emerge:

1. Businesses start hiring: Employment growth may never have been more important for a recovery than in the current one. With bank credit still tight and households rebuilding savings, income growth is badly needed to drive spending higher. Moreover, the rate of employment growth must be fast enough to reduce

the unemployment rate. This requires job creation in excess of projected 0.9% annual growth in the working age population this year, or about 100,000 new jobs per month. Furthermore, an additional 20,000 monthly jobs may be required if the one-half million discouraged workers who gave up looking during the recession seek work over the next two years. **Current prognosis:** While the labour market has stabilized, more than 120,000 new positions will be required each month to reduce the jobless rate and support spending (*Chart 1*).

2. Consumers start enjoying life again: During recessions, consumers cut back on things they can do without. Spending on discretionary items like recreational goods (e.g., video and sports equipment) and services (e.g., amusement parks and gambling) tends to drop sharply, only to pick up after people become more confident in their financial future (*Chart 2*). Never in the past half century has recreational spending (which represents almost one-in-ten purchases) fallen as hard as in the Great Recession. **Current prognosis:** Recreational expenditures have risen in five of the past six months to November, a sign that shoppers are gaining confidence.

3. Home buyers no longer depend on tax incentives: Probably more than one-half of the upturn in existing home sales since last spring stems from the first-time home buyer tax credit. Sales plunged a record 17% in December, retracing a good one-half of their previous gains, on doubts about whether the tax credit would be extended (*Chart 3*). Meantime, new home sales continue

CHART 1
MORE HELP WANTED
United States

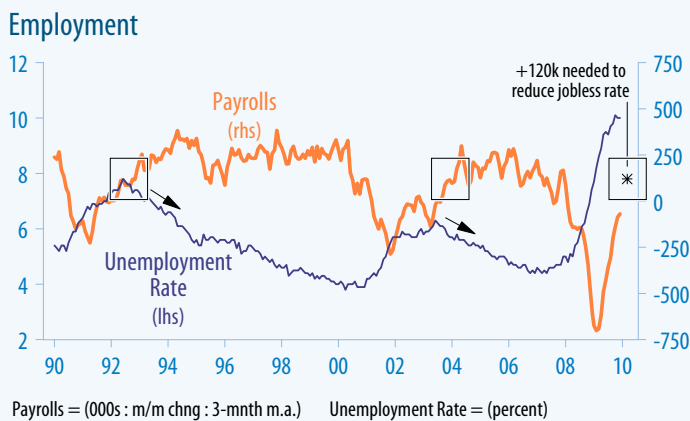


CHART 2
GIRLS (AND BOYS) JUST WANT TO HAVE FUN
United States (3-mnth m.a. : y/y % chng)

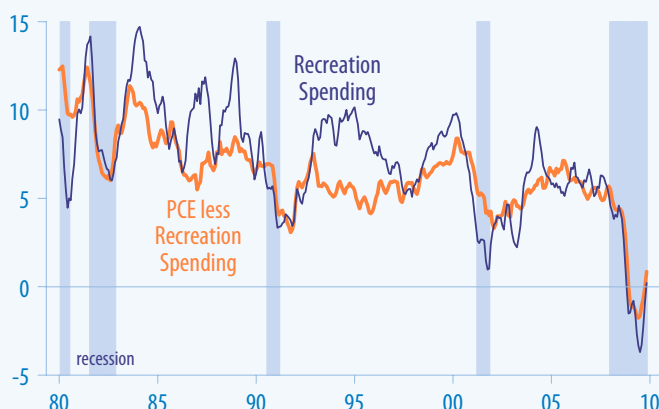


CHART 3
STILL SHAKY FOUNDATION

United States (mlns:s.a.a.r.)

Single-Family Home Sales

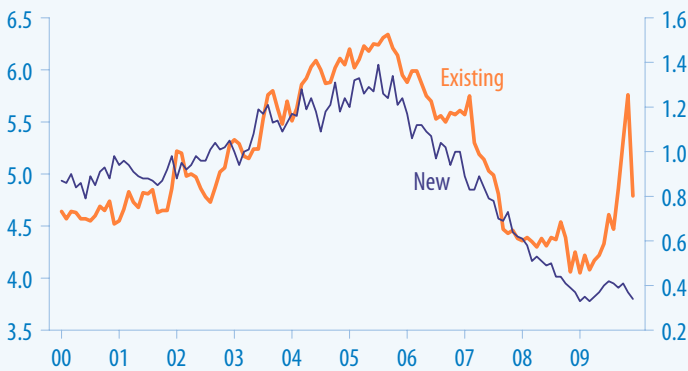


CHART 4
BUSINESSES UNCOMMITTED TO RECOVERY

United States (y/y % chng)

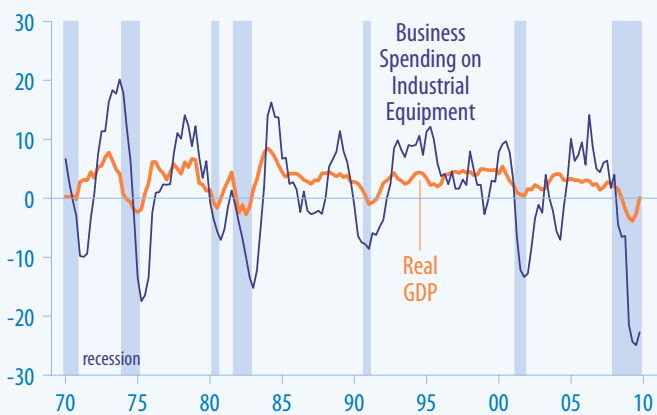
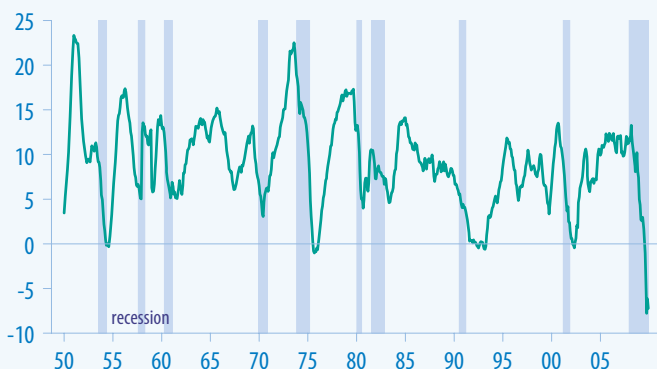


CHART 5
NO CREDIT FOR RECOVERY

United States (y/y % chng)

Commercial Bank Loans and Leases



to hover near all-time lows. Recent weakness in homebuilder sentiment and new mortgage applications (12-year lows) suggests demand remains soft even after the tax credit was extended and expanded to repeat buyers. The real test will come when the credit expires in April, especially if mortgage rates climb after the Fed stops buying mortgage securities around that time.

Current prognosis: Although affordability remains attractive and prices have steadied, the housing recovery remains tenuous as a consequence of tight credit, high unemployment and ongoing foreclosures.

4. Companies spend large: Companies often wait until they see the whites of the recovery's eyes before committing to large expansion plans. Next to non-residential construction, the type of expenditure that tends to lag the most (about two quarters) is industrial equipment (e.g., turbines, metalworking machinery). Compared with transportation or computer gear, industrial equipment is often undertaken to boost production or create new product lines, and usually proceeds only after careful consideration of the medium-term business outlook. **Current prognosis:** While total capital expenditures have turned up, spending on industrial equipment declined further in Q4, albeit at a slower rate than in Q3 (Chart 4).

5. Banks increase lending: Bank lending is procyclical, slowing in recessions and increasing in recoveries. Never in the past six decades has it contracted as much as in the Great Recession (Chart 5). An upturn in lending would signal that the deleveraging process for banks (and households) is ebbing, a strong signal that the tide has turned. **Current prognosis:** Although the rate of decline has slowed, bank lending continues to shrink, down 7% y/y to December.

Bottom line: While the recent upturn in recreational spending is promising, the fragile housing market, lack of job growth and ongoing declines in bank lending and business spending on industrial equipment suggest the economic recovery is still fragile. Until it becomes more robust, the Fed will likely stand pat on rates, and further gains in equity markets could be limited.

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