

The Double-Talk in Double-Dip Speculation

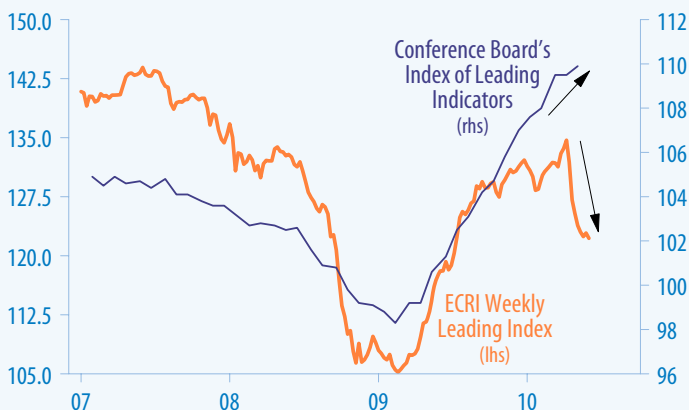
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Recent U.S. economic indicators are signalling slower growth ahead, compared to the 3.7% annualized clip recorded through Q1 (since positive growth resumed in 2009 Q3⁽¹⁾). However, **a loss of momentum at this stage, by itself, doesn't signal a return to negative growth**, also known as the dreaded "double dip". **In fact, such slowdowns are more the norm.**

TABLE 1
MOMENTUM USUALLY SLOWS

Business Cycle Trough	Recovery/Expansion		Ratio (Second / First)
	1st 3 Quarters (% chng a.r.)	2nd 3 Quarters (% chng a.r.)	
1949:Q4	15.5	6.4	0.41
1954:Q2	8.2	4.8	0.58
1958:Q2	9.2	3.7	0.40
1961:Q1	7.6	5.2	0.69
1970:Q4	5.6	6.0	1.08
1975:Q1	5.1	4.8	0.93
1980:Q3	4.2	-2.2	-0.53
1982:Q4	7.5	7.9	1.05
1991:Q1	2.0	4.3	2.17
2001:Q4	2.5	1.6	0.64
Average / Median (all periods)			0.74 / 0.67
(periods with ratio < 1)			0.45 / 0.58
(periods with ratio < 1 excluding 1980)			0.61 / 0.61

CHART 1
LEADING OR MISLEADING?
United States



In the early stages of recovery, GDP growth often finds an extra lift from inventory rebuilding and the unwinding of pent-up demand. But, these forces invariably ebb over time, causing reported growth to slow (presuming little change in underlying performance). In seven of the past 10 recessions, growth during the second three-quarter period after the trough was weaker than during the first three quarters (Table 1). And, there has been only one bona fide double dip in the past six decades... during the early 1980s.

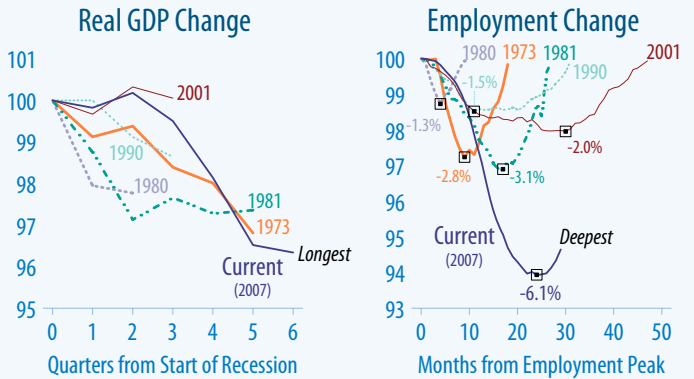
The average ratio of growth rates (2nd period divided by the 1st) among these seven episodes was 0.45, meaning that economic growth tends to slow to less than half its prior pace. Even excluding 1980, average growth slows nearly 40%. To put this in perspective, if the current GDP growth trend of 3.7% slows to 2.3% during the remainder of the year, this would be perfectly consistent with historical norms. Our own view is that, after a mid-3% reading for Q2, real GDP growth will slow to an average of 2.2% in the second half of the year (which translates to a 2.7% three-quarter performance).

The double-dip proponents have been pointing to one indicator in particular, the weekly leading index (WLI) constructed by the Economic Cycle Research Institute (ECRI). The WLI turned negative last month, in terms of year-on-year growth, something that has occurred before prior recessions. However, other leading indicators, such as the Conference Board's composite, point to continued expansion (Chart 1). More importantly, by construction, some economic indicators are more sensitive to

⁽¹⁾ It is uncertain whether the National Bureau of Economic Research, when it finally comes around to dating the trough in the business cycle, will choose any month in 2009 Q3 as the start of recovery. Given the patterns in personal income and payroll employment, a case could be made for a November 2009 or 2009 Q4 "official" start.

CHART 2
WORST SINCE GREAT DEPRESSION

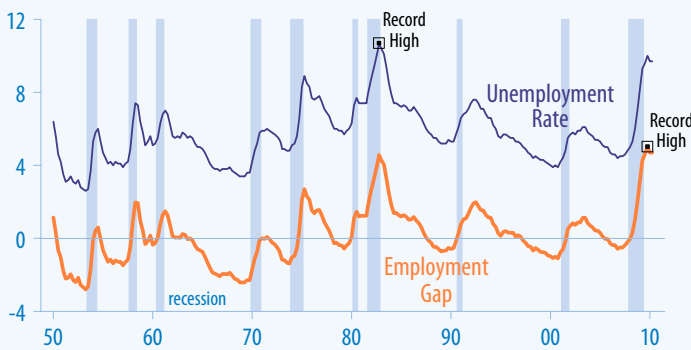
United States during Recent Recessions



Dates refer to start of recession Real GDP = (start of recession = 100) Employment = (peak = 100)

CHART 3
RECORD LABOUR MARKET SLACK

United States

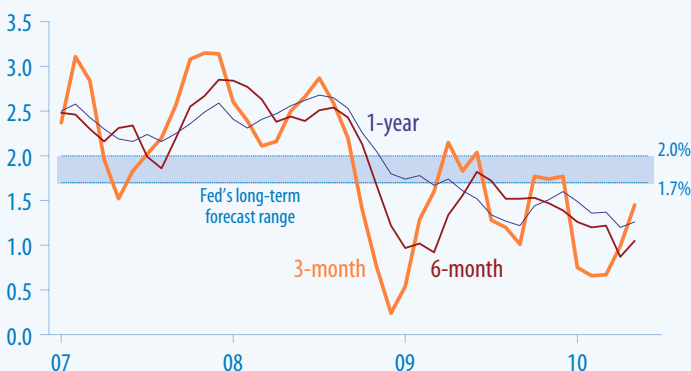


Unemployment Rate = (percent) Employment Gap = (ppts)
Source: CBO

CHART 4
US INFLATION TURNING?

United States (% chng : a.r.)

Core PCE Inflation



slowdowns than others. Indeed, seeing that its index has been adopted by the “double dippers”, the ECRI issued a public statement recently, emphasizing that since 1983 cyclical downturns have pulled the WLI into negative territory 12 times. But, on only three occasions did it portend recession (that’s 25% accuracy if you’re counting).

The probability of recession was also discussed in a recent study by the Federal Reserve Bank of Cleveland, which determined the odds based on the slope of the yield curve (flattening curves imply decelerating growth, steepening curves imply accelerating growth). Based on mid-June spreads between 10-year Treasury yields and three-month bill rates of 317 bps, the study estimated the probability of recession (within a year) at 12.4%. Since then, the curve has flattened further, as market worries about a double dip, along with concerns over European and Chinese prospects, pushed 10-year yields below 3% (and the spread under 280 bps). There’s no doubt that the Cleveland Fed’s model would now estimate higher odds, but 280 bps is still a historically very steep yield curve.

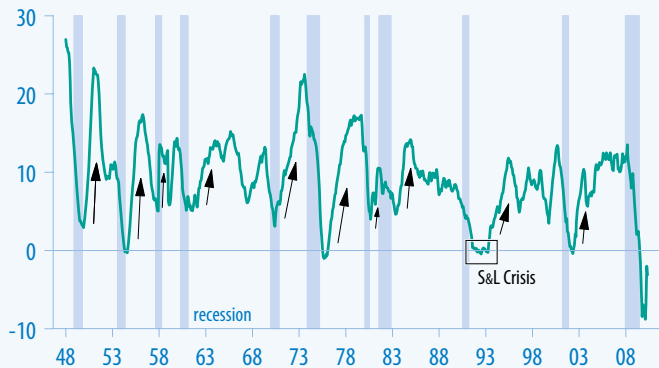
On balance, the double-dip talk appears more puff than proof, at least at this stage. However, **there remain two lurking factors with the potential to cause the coming slowdown to be much more pronounced than the historical norm, and push any outcome closer to negative territory.** The two factors have been on Fed Chairman Bernanke’s radar for a while now. He dubbed them the “formidable headwinds”: labour market slack and lack of credit creation.

Even if the forthcoming slowdown is historically normal, the recession that preceded it was anything but normal. In terms of lost output and jobs, it was the worst recession since the Great Depression (*Chart 2*). Although the recovery started out okay (particularly compared to the two previous recessions in the early 1990s and 2000s), a slowdown now would mean that the already large amount of economic slack would linger for longer. For example, when you adjust the reported unemployment rate by the natural rate of unemployment, the resulting “employment gap” hit a post-WWII high late last year, and has since improved only begrudgingly (*Chart 3*).

CHART 5
CREDIT CREATION KEY TO ROBUST RECOVERY

United States (y/y % chng)

Bank Lending



If economic slack lingers for longer, so too does its disinflationary influence. This raises the risk of outright deflation. Despite a firmer May reading (*Chart 4*), we look for core PCE inflation to continue cooling through the end of the year, before stabilizing at a record (since 1960) low of 0.7% y/y to start 2011. The proximity to negativity will no doubt keep the Fed on its toes, in order to avoid a double-dipping (or worse) deflationary spiral.

Economic recoveries and expansions are propagated by credit growth (*Chart 5*). Not only is bank credit currently not growing, but it's actually contracting at the greatest rate in the post-WWII period (note that the recent "improvement" reflects an accounting change that required banks to bring back on balance sheet loans previously held off balance sheet). Banks remain cautious

to make loans because of weak labour and housing markets, along with uncertain future liquidity and capital requirements. Households remain cautious to take out loans because of tight bank lending standards, weak labour and housing markets, along with a desire to restructure balance sheets (more saving, less debt).

The motivations for these cautions reveal a vicious circle that will be hard to break until labour and housing markets have strengthened significantly, and the pall of U.S. and global regulatory uncertainty has been lifted. Ultimately, this is where the risk of a deflationary double dip is rooted. If there remains no credit growth, resulting output growth might not be sufficient to offset the "natural" slowdown, allowing disinflation pressures to persist. However, this risk is unlikely to crystallize. If the U.S. economy appeared on a certain path to a deflationary double dip, the Fed would surely employ its balance sheet to reflate the economy.

Bottom line: Slowdowns after the surge of economic recovery are normal. And, while the headwinds facing the U.S. economy are indeed formidable, it's simply way too premature to be shouting "double dip" from the roof tops.

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