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Economic Outlook

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Hope Floats

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"Just give hope a chance to float up—and it will."
—Birdee Pruitt, *Hope Floats* (1998)

January ended on a note of diminished hope for a sustainable global recovery as stock markets retreated from their midmonth highs. Since mid-February, however, higher hopes for a sustainable global recovery have returned. Equity markets have rallied along with markets for corporate and global sovereign bonds. Some mitigation of perceived risks facing global investors has provided a chance for hope to "float up," and it has done so. Tension over the cohesion of the European Monetary Union and, in particular, concerns over a possible sovereign-debt default by Greece have eased, and investors continue to hope that the debt problems in Greece will not spread to the rest of Europe.

The sustainability of the U.S. economic recovery suffered minor setbacks in February from weakness in housing demand, shaky consumer confidence, and mediocre employment data, but such setbacks have, so far, been attributed to temporary factors, including bad weather and atrophy of temporary stimulus measures in the housing and automobile sectors. Signs of stronger consumer spending in February, based on retail sales data, along with continued moderate strength in the manufacturing sector, have been sufficient to overcome uncertainties about whether demand growth can be sustained through the middle of the year, when certain fiscal stimulus measures and Federal Reserve purchases of mortgage-backed securities will have ceased.

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In China, fears of overheating and a tightening of money and credit have, so far, been overcome by confidence that Chinese policymakers will successfully navigate a path to slightly more moderate, sustainable growth.

Europe

The "hope floats" motif aptly characterizes the progression through the Greek financial crisis during February. The number of basis points involved in new contracts for sovereign credit default swaps, a measure of the cost of insuring Greek debt, rose to over four hundred in mid-February but has since fallen well below three hundred.

The proximate source of tension in Europe—the rapid run-up of debt in southern Europe—was thought to be signaling that participation in the European Monetary Union amounted to a currency overvaluation for some countries. This prompted calls for increased fiscal stringency in southern Europe, where growth is weak, within a weakening European economy. The most dramatic example, Greece, saw a sharp rise in budget deficits that signaled a needed rescheduling of Greek debt in the absence of substantial aid from northern Europe. Because of the high level of exposure of European banks and the questionable debt of southern European governments, European finance ministers cobbled together a support package for Greece conditional on the imposition of extreme fiscal stringency in that country.

A sharply contractionary fiscal policy for Greece at a time when European growth has slowed considerably is unlikely to reduce its deficits relative to falling GDP. That said, hope has emerged that Europe has reached a credible holding position regarding the marketability of sovereign debt in southern Europe. The Greek government issued five-year bonds with a coupon of approximately 6.3 percent early in March. Most buyers of Greek debt apparently feel confident that European governments will provide adequate support for Greece and that the European Central Bank will continue to accept Greek sovereign paper at par as collateral for loans to European banks.

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The underlying problem for Greece—not to mention Spain, Portugal, and Italy—is a currency union in which European Central Bank policy is set to maintain stable prices in northern Europe while southern Europe suffers from what is, for at least that region, an overvalued currency. The modest weakening of the euro has helped to relieve stresses somewhat but probably will need to proceed further as the stresses tied to the heavy debt load in Spain and elsewhere persist.

Sustainability of U.S. Recovery

In the United States, the easing of Europe's sovereign debt crisis, a willingness to attribute weakness in some economic data to bad weather in February, and sustained profit growth and confidence among producers have combined to improve the market's outlook for a sustainable U.S. recovery. The major uncertainty attaches to the strength of consumer incomes and demand growth, along with the prospects for investment by U.S. firms.

Broadly speaking, we can say that the United States is experiencing a normal recovery on the production side of the economy and a subnormal recovery on the consumption side. As a result, core inflation is falling steadily as producers make price concessions to sustain sales volume. The ability to make those concessions has been enhanced by substantial cost reductions attributable to a sharp reduction in workforce; the impact of this on output has been largely mitigated by cost savings driven by productivity gains. The significant reduction in employment that U.S. producers have tied to cost savings jeopardizes the sustainability of demand growth unless employment and labor incomes begin to rise. This need for a return to employment and income growth is made more urgent by the fact that during 2009 household disposable income was supplemented with government support from a combination of tax rebates, smaller tax bills, and lower borrowing costs that totaled approximately $400 billion and more than offset the $250 billion decline in household incomes tied to lower wages and workforce reductions.

Even given optimistic assumptions for 2010, the absence of ongoing government support means that real income growth may be flat. A forecast of moderate, 2 percent consumption growth therefore requires the reduction of 2 percentage points in the saving rate, which was recently revised down to 3.3 percent in January from 4.8 percent in December. The downward revision to the saving rate resulted from a modest rise in spending growth in the face of a drop in disposable income in January, along with substantial negative revisions to household income data during the second half of 2009. U.S. households, while deleveraging largely by defaulting on mortgage debt, have made no progress toward higher saving. This outcome is not surprising in view of the combination of weak income growth with last year's government incentives to hasten spending on automobiles and housing. Falling prices of consumer durables may also have played a role.

Hopes for sustained consumption growth were lifted—somewhat incongruously—by a report of 0.34 percent month-over-month retail sales growth in February, because bad weather had created an expectation of a drop of approximately 0.2 percent. Moreover, markets ignored negative revisions to retail sales data during January and December that left the February report in line with forecasts. The market also ignored much weaker automobile sales. The annualized growth rate for retail sales for the three months ending in February was 1.2 percent, down sharply from the comparable 9.7 percent rate reported for January. That was due largely, but not entirely, to weak February automobile sales and sharp negative revisions to automobile sales reports in January and December.

During February, half of the headline growth reported for retail sales came from stronger sales at grocery stores, as households rushed to stock up on groceries in advance of two widely predicted, heavy snowstorms. The other half came from electronics, home furnishings, and retailers, as reflected in strong same-store sales data for February. Consumers are shifting away from housing and automobiles as special incentive programs have ended, and they have been substituting more spending on televisions and furniture by running down savings, especially as the Super Bowl, the Olympics, lower prices, and bad weather boosted such sales. The fact that consumers know that this cannot continue without further special help or a strong and unlikely employment rebound is reflected in weaker consumer-confidence readings.

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For the balance of the first quarter of 2010 and probably into the second quarter, expectations of sustained growth of exports, hope for improving employment data to help sustain demand growth, and expectations of a resumption of modest investment growth during the second quarter should help to support current optimism for a sustainable U.S. recovery, with growth at a 2.5 percent to 3 percent annual rate during 2010. For that to materialize in the absence of substantial employment growth, however, U.S. households will have to be prepared to draw more on savings in order to keep consumption growth at 2 percent. That scenario requires some resumption of employment growth—perhaps at a rate of 100,000 per month—to stabilize the unemployment rate, coupled with sustained improvement in the stock market, which is probably necessary to maintain consumer confidence going forward.

China Outlook

Since the Chinese New Year, markets have grown more confident that China's policymakers will be able to navigate the tricky path toward containing higher inflation pressures while, simultaneously, sustaining China's robust economic recovery. That recovery is critical to continued strong growth in Asia and attendant support for moderate growth of U.S. exports. The annual session of the National People's Congress has produced signals that China's policymakers are well aware of the risks attached to maintaining an expansion while containing inflation pressures. Premier Wen Jiabao's remarks at the People's Congress suggested that Chinese policymakers would maintain the substantially accommodative stance of monetary and fiscal policy while employing selective measures to contain signs of overheating in real estate markets. The official growth target for 2010 continues to be 8 percent with an inflation target at 3 percent for 2010, below the 4 percent target set out in 2009.

A lower inflation target, given the powerful growth momentum from last year's highly stimulative fiscal and credit policies, is ambitious. It means that if year-over-year inflation exceeds 5 percent by midyear, more restrictive policies may have to be implemented. Such a response would increase uncertainty about China's ability to continue as an important source of support for global demand growth. Support from China is especially important in view of the weakness of demand growth in Europe, the United States, and Japan.

During February, China's consumer inflation rate (year-over-year) accelerated sharply to 2.7 percent from 1.5 percent in January. The 2.7 percent inflation rate is at once unsurprising—in view of the powerful monetary and fiscal stimulus in place in China since the end of 2008—and disconcerting—in view of the 3 percent inflation target for 2010 Wen set early in March. While China's inflation rate may not rise linearly, it will trend upward and, by April, will be above the 3 percent target. Actual inflation at 5 percent seems likely by mid-2010. That probable outcome will prompt China to raise interest rates to contain further inflation pressure, prompting doubts about the persistence of global demand stimulus coming from China and from Asia generally.

A scenario where China's inflation overshoots the target, thereby forcing more aggressive tightening measures, is consistent with the constraints faced by China's leaders. China's decision to maintain a proactive, stimulative policy in 2010, conditional on the outlook for inflation, is consistent with Wen's stated view that the recovery in developed markets is far more tentative than in emerging markets. He apparently sees risks tied to an absence of demand growth outside of China and the fragility of global market confidence in the face of possible further disruptions in the coherence of European unity. The fragility of sustainable demand growth in the United States is of particular concern to Wen. He will be reluctant to allow tighter policies aimed at containing destabilizing inflation in China. That said, he will direct policymakers to raise interest rates, curtail credit, and perhaps even to revalue the yuan when—as is likely—the 3 percent inflation target is not achieved.

Still, Hope Floats

With all of these moving parts contributing to ongoing uncertainty about the economic outlook in 2010, markets have demonstrated, so far, that in the absence of an acute crisis, such as the recent fears of a Greek debt default or an inflation scare in China, the updraft in stock markets, corporate bond markets, and sovereign bond markets will continue. Slowing—not negative—U.S. growth, with falling inflation and the Fed remaining highly accommodative, creates crosscurrents for U.S. stocks. Can an extension of accommodation by the Fed offset earnings compression driven by a lack of pricing power? The "slower-growth, lower-inflation" scenario is probably better for corporate bonds—and certainly for Treasuries—than it is for stocks.

With nothing holding it down, hope floats—especially as spring approaches. Moving toward summer, the buoyancy of hope will depend on the path of U.S. consumption, Chinese inflation, the Fed, and northern Europe's willingness to accommodate southern Europe's rising need to borrow.