TD Bank Financial Group

TD Economics

Special Report

July 31, 2009

THE NASCENT RECOVERY: IS THE END NEAR FOR THE U.S. GREAT RECESSION?

At -1.0% (annualized), the Bureau of Economic Analysis' (BEA) estimate of second quarter real GDP growth was relatively on par with our Quarterly Economic Forecast (QEF) of -1.3%. However, near term tracking of data suggest that the third quarter is likely to produce a positive print in economic growth relative to our original forecast of -0.5% The return to positive growth signals that the U.S. recession may be over (see text box for more on recession dating).

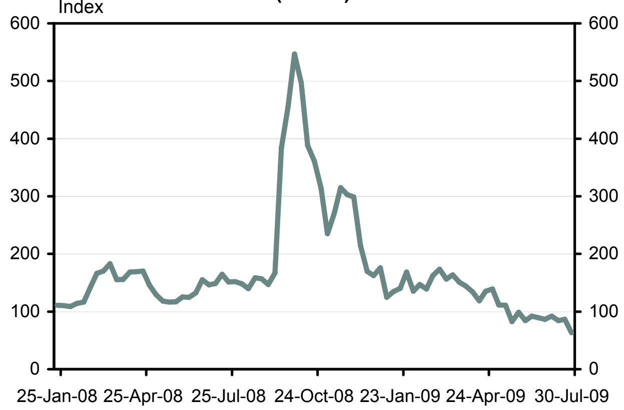
HIGHLIGHTS

- **Real GDP fell by 1.0% (annualized) in the second quarter, the smallest contraction since the Great Recession began.**
- **Recent developments in the U.S. housing market, fiscal stimulus, and the emergence of Chrysler and GM from bankruptcy suggest that Q3 may well show positive economic growth, a good signal that the U.S. economy has emerged from the Great Recession.**
- **While the recession may be coming to a close the road to recovery will not be swift. A pummelled labor market and shrunken household net-worth imply a slow-go recovery in 2010.**

Credit conditions continue to improve

In our last two QEFs we outlined five key assumptions behind our economic outlook. Primary among these was an improvment in credit conditions. On that front, over the past several months TD Economics has been monitoring conditions in credit markets weekly using theTD Financial Stress Index (TDFSI), which includes conditions in both short and longer term funding markets. The most recent version of the TDFSI, dated July 27th, shows the level stress in financial markets at its lowest level since August 27th, 2007. Mark one down for the recovery.

TD ECONOMICS U.S. FINANCIAL STRESS INDEX (TDFSI)



US TDFSI is weighted average of seven financial series. Index value of 100 denotes the peak stress level during the 2000-2002 period.

Housing is stabilizing...

Another crucial condition for the U.S. economic recovery emphasised in our QEF was a stabilization in U.S. housing. Happily, recent data suggests that the U.S. housing market is showing clear signs of improvement. Perhaps the best indicator of this is the recent 11% rise in new home sales in June. While some analysts have pointed to the fact that the rise came along side a 5.8% decline in median prices, the fact remains that demand is returning to the new housing market, sufficient enough to bring down the month's supply of unsold homes to 8.8 months – the lowest inventory reading since July of 2007. Moreover,

Recession dating not as easy as it looks

Unfortunately, recession dating is not quite as simple as just looking at the level of real GDP. The National Bureau of Economic Research (NBER) – the official arbiter and dater of U.S. recessions – characterizes recessions as "significant decline in economic activity spread across the economy, lasting more than a few months." The NBER uses higher frequency indicators such as real personal income (less transfers), employment, industrial production, and wholesale-retail sales, in order to date the peaks and troughs in economic activity. In dating the current recession as beginning in January of 2008, the NBER did so despite the fact that the BEA's most recent estimates of quarterly real GDP did not actually peak until the second quarter of 2008.[1]

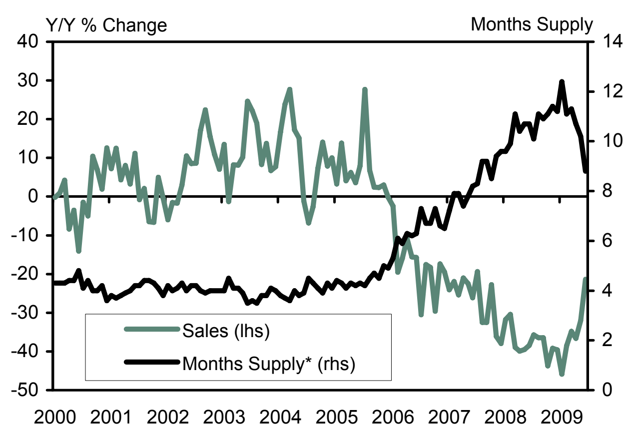
The NBER referenced in particular the decline in non-farm payrolls and real personal income less transfers as important to their recession dating. Nonetheless, dating the end of the recession may not be as simple as looking just at these indicators either. Employment could very well lag the economic recovery, as it did after the 2001 recession. Real personal income less transfers is perhaps a more promising higher frequency measure but is also imperfect as it excludes corporate profits from the calculation[2]. Moreover, in the current environment, where so much of total personal income is in fact government transfers, it is likely that a measure that excludes transfer payments will bottom later than the turn in other measures of economic activity.

a myriad of other (arguably superior) indicators of home prices have in fact shown clear signs that stabilization may be at hand. Most recently, the S&P Case-Shiller index in May showed its slowest pace of decline since February 2008.

And that's good for real GDP

In terms of real GDP growth, signs of budding demand in the new housing market mean that residential construction investment could well be turning a corner. As our recent report (*Anatomy of a U.S. Housing Rebound*) argues, home builders anticipating rising demand (as indicated by reductions in housing inventories), will begin construction of new homes even before the level of inventories returns to historic norms. Already, housing starts have risen by 2.5% in the second quarter, due to an 18% rise in single-family homes (partially offset by a decline in multi-family residences). The greater rise in single-family construction, which embodies a higher real level of investment per unit, means that real residential construction investment will quite likely turn positive in the third quarter of this year - a first in three years.

US NEW HOME SALES & INVENTORIES

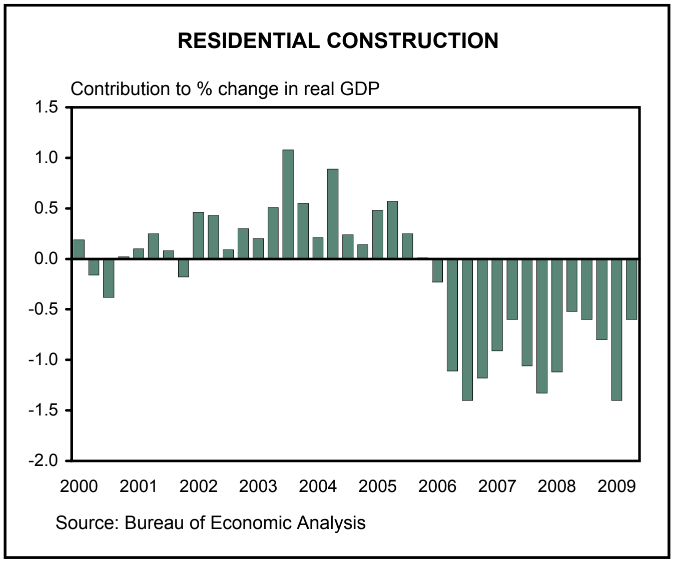


*At current sales rates. Source: Census Bureau

The turn in this component of real GDP, should it prove lasting, should not be diminished – residential construction has subtracted an average of 1 percentage point from real GDP growth in each of the last two years. Given the very low levels from which residential construction is starting, and the gap that has formed between the current pace of housing starts and the rate needed to keep up with long-run demographic fundamentals, a rebound in residential construction will go a long way to lifting growth into positive territory not only over the next several quarters, but the next several years.

Job losses main risk to housing recovery

Nonetheless, while all of this is very positive news, we must temper our optimism with a dose of reality informed by conditions in the U.S. labor market. A sustained rebound in housing construction depends on a sustained rebound in housing demand, which requires jobs and income growth. While lower mortgage rates, lower home prices and government incentives for new home buyers to enter the market make it more likely that meaningfully employed households will become new homebuyers, the fact remains that in the current environment, this pool of potential demand is still shrinking. A budding rebound in housing is certainly possible without a return to positive



job growth, but further significant job losses (especially combined with negative equity) are the greatest threat to the nascent housing recovery.

Fiscal stimulus is supporting incomes...

Another of the assumptions incorporated into our U.S. economic forecast was the impact of fiscal stimulus (see *A Primer on Fiscal Stimulus*). Fiscal stimulus is coming in the form of both tax cuts and government transfer payments to individuals and state governments, as well as in the form of spending on infrastructure. The first of the U.S. stimulus checks have already been received by U.S. households. In fact, as a result of government transfers, personal incomes grew in the second quarter, despite the fact that the U.S. economy shed 1.3 million jobs and the unemployment rate rose a full percentage point. While a small part of the increase in transfers was a rise in government unemployment benefits, the vast majority of the increase in personal income was due to one-time payments of $250 to the close to 52 million individuals who receive Social Security and Supplemental Security Income (SSI), as part of the American Recovery and Reinvestment Act (ARRA).

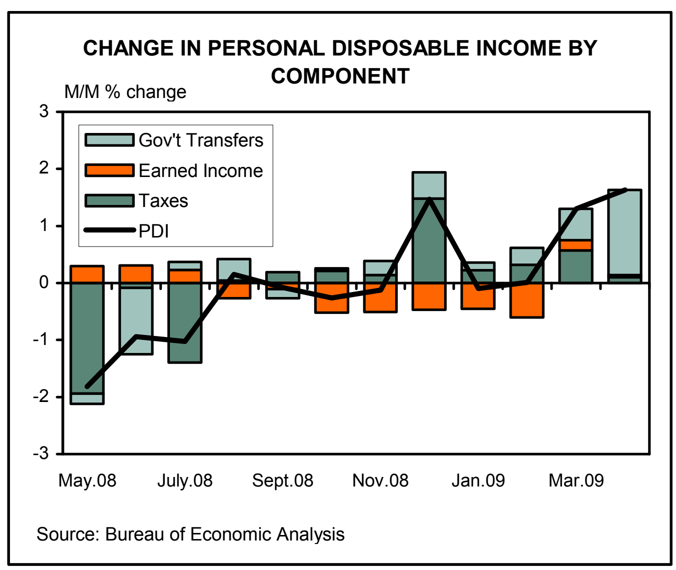
But households aren't too willing to spend

In terms of the impact of this stimulus on real GDP, the data out so far are not too encouraging. Saving as a percent of disposable income rose from an average of 4.0% in the first quarter to 5.2% in the second quarter, indicating that households are indeed socking much of these transfers away confirmed by the 1.1% decline in personal consumption in the advanced second quarter estimate. This would seem to indicate that in an age of deleveraging, fiscal stimulus is just not the stimulus it used to be. On the bright side, recipients of the ARRA funds likely have not had much opportunity to spend their checks, and the spending of the stimulus will likely show up in the months ahead. According to the Office of the Inspector General of the Social Security Administration, close to 25% of the recipients did not receive their checks until after the 20th of May [3]. We expect that after declining in the second quarter, consumer spending, aided in part by a rebound in auto sales, will turn positive in the third quarter, giving some much needed support to economic growth.

And recovery depends on jobs and wealth

A rebound in consumer spending – even a minor one – is absolutely pivotal to a recovering U.S. economy. While fiscal stimulus should help to pull consumer spending up in the next few quarters, we must be careful to recognize the two still significant sources of risk for consumer spending going forward. The first is the decline in household wealth, which will require households to rebuild their nest-eggs with higher levels of saving. Household net-worth has fallen by 13.8 trillion, or 22%, since the second quarter of 2007. Standard estimates of the wealth effect suggest that this decline in wealth will subtract around 1 percentage point from consumption growth over the next few years.

Another area of risk to personal consumption is the same one that plagues the housing market – the weak conditions in the U.S. labor market. Since March of 2008, real wages and salaries have fallen by 2.1%. Real personal



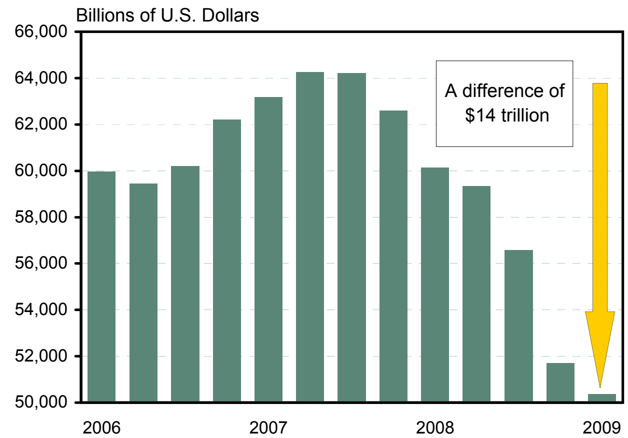
disposable income has been supported by transfers and tax cuts, but many of these are temporary and government budget constraints may well limit them from being extended. The weakness in these two underlying fundamentals leaves us cautious about expecting any significant rebound in the pace of consumer spending going forward. Our forecast for employment calls for slower job cuts through the remainder of 2009 before positive job growth finally re-emerges in 2010. Given this forecast, a slow return to modest consumption growth, with perhaps a few hiccups along the way, remains the most likely scenario.

North American automakers to get back to business

One of the main contributors to the contraction in economic growth in the second quarter was the large decline in inventory investment. One of the contributors to this decline was the bankruptcy of Chrysler and General Motors. In fairness, the cut in production by U.S. automakers was necessary even outside of their restructuring plans, in order to lower the level of auto inventories, as a result of falling car sales. As recently as last December, it took 120 days to clear the inventory of unsold vehicles of the Detroit-Three automakers (significantly higher than the long run average of around 70 days). As a result of production cuts and some rebound in sales, supply had fallen to 71 days as of the beginning of July.

Chrysler emerged from bankruptcy in early June and General Motors in early July. Both have scheduled a return to production in July and August. Given that car sales will likely see a rebound in the third quarter, a higher level of auto production will result in a fairly significant increase in the contribution of inventory investment to GDP growth in that quarter. In terms of its impact on GDP, all that is needed in order for inventories to contribute positively to economic growth is a deceleration in the pace of inventory liquidation. After subtracting from growth through most of 2008 and the first quarter of 2009, the auto sector looks to contribute to growth in the third quarter of this year. Nonetheless, while a restart to auto production bodes well for near-term economic growth, a rebound in auto sales is

U.S. HOUSEHOLD NET WORTH



Source: Federal Reserve

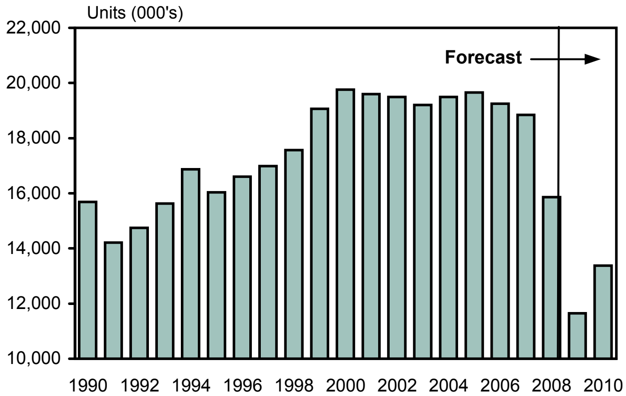
Cash for Clunkers

In addition to the near-term support to incomes as a result of tax breaks and government transfers, the Car Allowance Rebate System (CARS), or as it is perhaps more commonly known, "cash for clunkers" is a relatively new development that was not fully accounted for in our previous U.S. forecast. The CARS program with a total budget of $1.0 billion, allows for rebates of up to $4,500 on new cars in exchange for the scrappage of less energy efficient vehicles. While the aim of the program is to take more energy inefficient vehicles off the road, the program is also toted as an effective way to jump start new car sales.

The effectiveness of the cash-for-clunkers program depends on how many individuals who own clunkers will be swayed by the $3,500 to $4,500 rebate to trade up. In that regard, incentives put in place by the automakers themselves will help. Several dealers are doubling the incentive put in place by the CARS program, implying possible savings of up to $9,000 to those who participate in the deal. In all likelihood, a fair number of the individuals who accept the grant will be those who were contemplating getting rid of their old car for a new one in the near future anyway. For these individuals, the extra rebate creates a nice incentive to speed up the process.

Indeed, the program kicked off with a bang, as it is estimated to have already generated over 22,000 trade-ins since commencing on July 1st. And while the program is intended to run until November 1st (or until the $1.0 billion is exhausted), analysts suspect that the fund will be depleted much sooner – even as early as August. All told, while cash-for-clunkers is likely helping to bring forward new car sales, and therefore help boost personal consumption expenditure growth in the third quarter of the year, this will likely come at the expense of spending growth in the fourth quarter of 2009 and early 2010.

NORTH AMERICAN LIGHT VEHICLE SALES



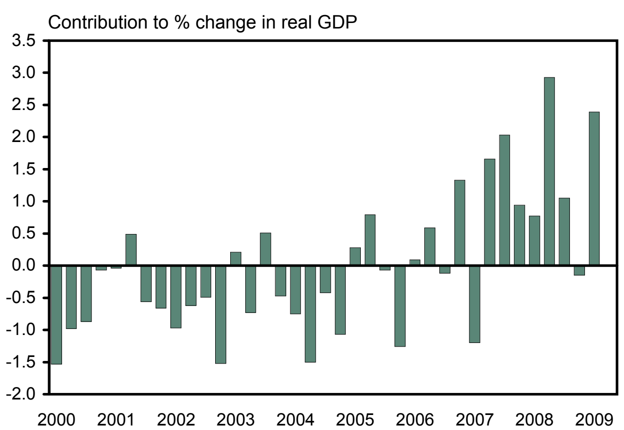
Source: WardsAuto.com;
Forecast by TD Economics as at July 2009

the ultimate determining factor behind the pace of future new production. Given the challenges still facing households that will remain through 2010, the recovery in auto sales will be gradual.

Will international trade help or hurt recovery?

One component of GDP that was a strong net-positive to growth in the second quarter was net exports. Unfortunately, the contribution was not due to any significant new demand for U.S. products. On the contrary exports declined by 7.0% (annualized) in the quarter. Instead, the improvement in the trade balance was due to an even greater decline in U.S. imports of 15.0%. The decline in imports was mainly in industrial goods and materials, reflecting the dramatically reduced pace of U.S. industrial production. The amount by which the fall in imports contributed to real GDP growth is slightly worrying to the near term outlook for GDP growth. That is because U.S. imports are primarily a function of U.S. domestic demand and while imports are a much more volatile series, the between the decline in year-over-year gross domestic purchases (-4.8%) and the much larger decline in imports (-18.6%), suggests that imports are due for a rebound. Put another way, in the second quarter of this year the ratio of imports to personal consumption (which has generally been on an upward trend over the past 20 years reflecting the increased importance of international trade to the U.S. economy), fell to its lowest point in over 10 years. As demonstrated in a recent TD Economics report (*Growing Signs of Global Trade Rebound*), leading indicators already present suggest a rebound in U.S. imports is more than likely.

NET EXPORTS



Source: Bureau of Economic Analysis

While this would seem to point to a potential turnaround to the contribution from net-trade in the immediate quarter, several positive developments are emerging that imply net-exports will likely be one of the sources of strength to the U.S. economy going forward. Foremost on this list are signs of life in Europe (see *Could the Eurozone Economy See the 'Mother of All Rebounds'*) and Asia, but equally important is the impact of a depreciating U.S. dollar (see *U.S. Exports: The Rise of The Machines*).

Putting it all together

Several positive developments in the U.S. economy, including: stabilization in the U.S. housing market, the impact of fiscal stimulus checks and cash for clunkers, and the return to production of Chrysler and General Motors, imply upside risk to our outlook for growth in the third quarter of 2009. A move to positive economic growth gives a strong signal that the end of the U.S. recession may well be nigh. Nonetheless, there remain significant headwinds that will slow the pace of recovery in the U.S. economy over the next several quarters – the decline in household wealth and deleveraging in the financial system first among these. While the second quarter of 2009 may mark the end of the recession, the road to recovery – as gauged by the change in real GDP – is a long one. It will likely take several years before economic activity returns to the level it would have been absent the Great Recession.

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Endnotes

[1] As stated by the NBER Recession Dating Procedure document, "the committee places particular emphasis on two monthly measures of activity across the entire economy: (1) personal income less transfer payments, in real terms and (2) employment. In addition, the committee refers to two indicators with coverage primarily of manufacturing and goods: (3) industrial production and (4) the volume of sales of the manufacturing and wholesale-retail sectors adjusted for price changes."

[2] Even this measure is not quite perfect because it relies on an interpolation of the quarterly Gross Domestic Product deflator.

[3] Direct deposits began distribution on May 7th, 2009. Payments continued through June.