TD Economics

Topic Paper

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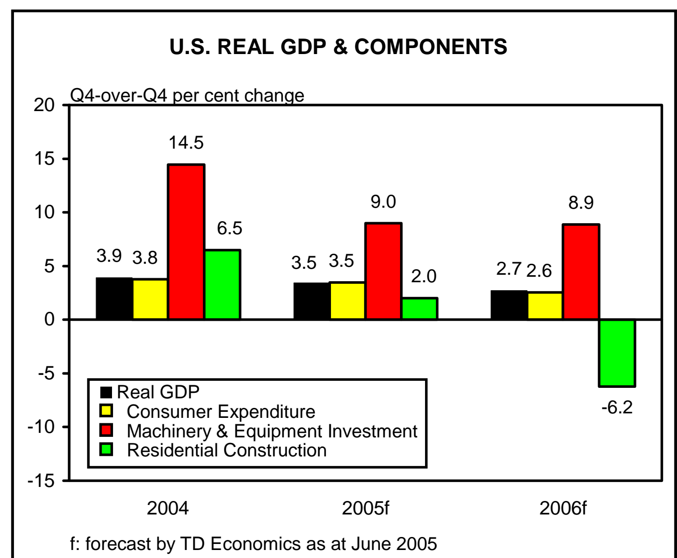
LAST HURRAH FOR U.S. ECONOMY IN 2005, MID-CYCLE SLOWDOWN ON TAP FOR 2006

A weaker pace of economic activity at the tail end of the first quarter and an unintended buildup in business inventories have sparked a debate among market pundits and economists as to whether the U.S. expansion has finally lost its footing. As we see it, the U.S. economy is on the brink of a mid-cycle slowdown – a phase that will reflect some payback for the way in which the prior expansion borrowed against the future.

Before hitting the panic button, it's important to note that low borrowing costs and the ongoing strength in personal incomes and corporate profits mean that consumer spending and business investment should retain a fair amount of momentum over the next few quarters. But beyond that, the challenges will intensify. By mid-2006, we expect the expansion to slow to less than 2.5 per cent, as the economy grapples with higher interest rates, record consumer debt loads, a tapering off in mortgage refinancing activity, an absence of new fiscal stimulus and only modest growth in global demand. To be sure, a sub-2.5 per cent pace of growth would represent quite a mild slowdown by historical standards. However, given financial markets' apparent dissatisfaction with the U.S. economy's current tracking of 3.5 per cent growth in the first half of this year, there is a real risk that they will not take the deceleration in stride.

The rear-view mirror

In order to know where the U.S. economy is going, we need to know where it has come from. For all the hype that surrounded the bursting of the high-tech bubble in 2000 and the subsequent plunge in the stock market, the resulting recession was actually the mildest in U.S. history. Although the economy did experience three quarters of contraction, those quarters did not occur in succession. And, over the first three quarters of 2001 – which corresponds to the period the National Bureau of Economic Research (NBER) has designated as the official recession – real GDP declined by only 0.7 per cent, as compared with the 1990-91 recession, when real GDP fell by 5 per cent.



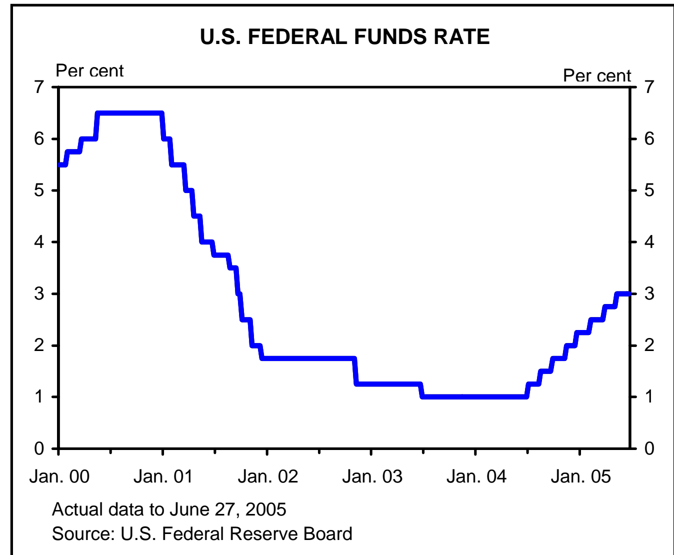
The 2001 recession was distinguished by three factors that facilitated the quick recovery. First, the Federal Reserve Board shifted to a stimulative stance much earlier and more aggressively than it had in previous economic downturns. The Fed had the latitude to do so, thereby jump-starting activity more quickly, because it had successfully kept a reasonably tight lid on inflation prior to the economy's loss of momentum. In fact, when things first started to go wrong for the U.S. economy in the third quarter of 2000, core CPI was holding steady at around

2.5-2.6 per cent on a year-over-year basis, which was within the central bank's tolerance range. Spared the difficulty of having to curb inflation while also trying to prop up growth, the central bank didn't tarry when the economic data began to sour, delivering a surprise 50 basis point inter-meeting interest rate cut on January 3, 2001. This turned out to be the first of many cuts that took the Fed funds rate down by 550 basis points to just 1.00 per cent in June 2003. And, the stimulus provided by the reduction in short-term rates was amplified by a 200 basis point decline in 10-year Treasury yields and a 14 per cent decline in the trade-weighted value of the U.S. dollar over the same period.

The second unique attribute of the 2001 recession was that consumer spending did not contract, a key feature since consumption represents nearly 70 per cent of the real economy in the United States. From the point at which the U.S. economy first recorded a contraction (the third quarter of 2000) to the point where NBER officially declared the recession over (the third quarter of 2001), consumer spending expanded at an average annualized quarterly rate of 2.4 per cent, with monetary stimulus providing an almost immediate boost to spending on interest-sensitive, big ticket items like appliances, autos, and home furnishings. It was a far cry from the 1990-91 recession, when consumer demand contracted at an average annualized quarterly pace of 1.0 per cent, dragged down by durable goods spending, which dropped by an average annualized 8.8 per cent per quarter.

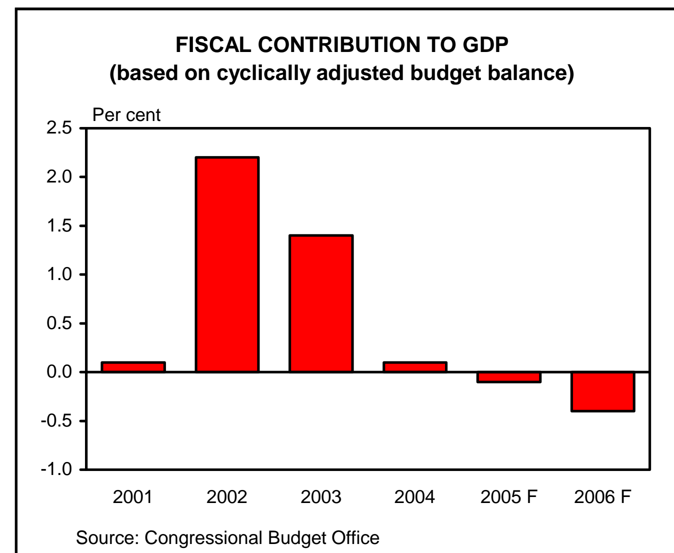
Last but not least, the Fed did not wage the cyclical battle alone. It was joined by the Bush Administration, which stepped in in 2001, and again in 2003, with a generous package of personal income tax cuts and business investment incentives. The swing in the federal government's cyclically-adjusted budget balance added 2.2 percentage points to U.S. GDP growth in 2002 and 1.4 percentage points in 2003. The end result was hyper-stimulative settings along both macro policy dimensions.

Of course, once the recession was "officially" over and the U.S. economy had returned to an expansion phase, economic growth was still being sapped by rising crude oil prices. According to research by the OECD, a US$15 increase in the price of crude oil subtracts 0.45 percentage points from U.S. real GDP growth in the first year of the price increase and 0.55 percentage points in the second year. The rise in the price of West Texas Intermediate (WTI) crude oil from an average of US$30 per barrel in



U.S. ECONOMIC DOWN-CYCLE	
	Q3-2000 to Q3-2001*
Real GDP	0.2
Consumer Expenditures	2.4
Durable Goods	3.2
All Other Expenditures	2.2
Residential Construction	0.4
Business Investment	-4.3
Government	2.2
Final Domestic Demand	1.4
Exports	-5.7
Imports	-2.8

*Average annualized quarter over quarter per cent change over period
Source: U.S. Bureau of Economic Analysis



2003 to more than US$50 per barrel in 2005 shaved 0.3 percentage points off U.S. real GDP growth in 2004 and another 0.8 percentage points in 2005. And, with WTI still well above the US$50 per barrel mark, the lagged impact of higher energy costs will trim another 0.5 percentage points from GDP growth next year.

The comeback kid

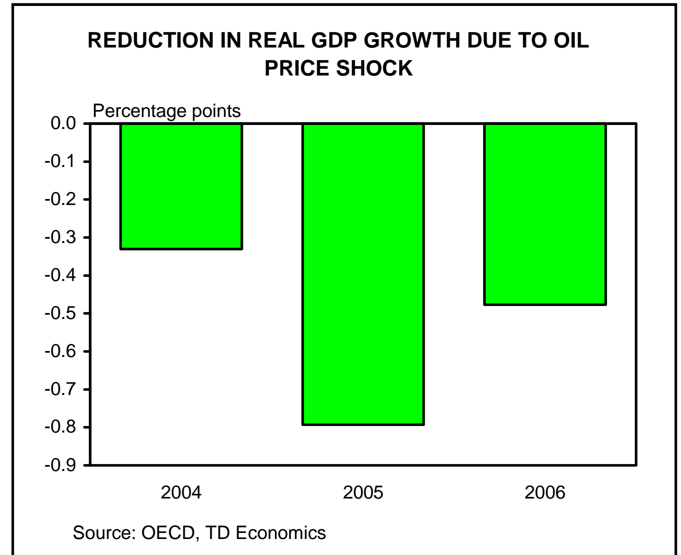
Even so, given that there was so little to recover from, the U.S. expansion has been robust. Real GDP growth has been running at an annualized pace of 3.4 per cent since the fourth quarter of 2001, and an even more impressive 4.1 per cent since the first quarter of 2003. Not surprisingly, the strength has come primarily from the interest-sensitive components of household spending. Since the end of 2001, consumer spending on durable goods has risen by an annualized 7.9 per cent on average, and residential construction hasn't been far behind, climbing by 7.3 per cent.

The power of easy money has nowhere been more evident than in the mortgage refinancing market, where U.S. homeowners cashed out equity worth 1 per cent of GDP in 2002 and 1.3 per cent of GDP in 2003. Some of these funds were directed toward paying down personal debt, but one-quarter went to discretionary spending and about 40 per cent to home renovations. And, even though the Fed has raised the funds rate by 200 basis points over the last twelve months, equity financing continues to underpin consumer spending, in large part because longer-term bond yields – and hence, mortgage rates – have shrugged off the rise in short-term rates, trending steadily lower over this period. The rate of equity cash-outs has eased slightly, but is still expected to reach 0.9 per cent of GDP this year, more than double the share registered prior to 2001.

Not to be forgotten, the main driver of the 2001 recession – the U.S. business sector – has also staged a powerful comeback. Although business investment continued to contract for six consecutive quarters after the recovery officially began, the tide turned in mid-2003, with business investment posting an average quarterly gain of almost 11 per cent in the eight quarters since, led by a 13.6 per cent increase in equipment and software investment.

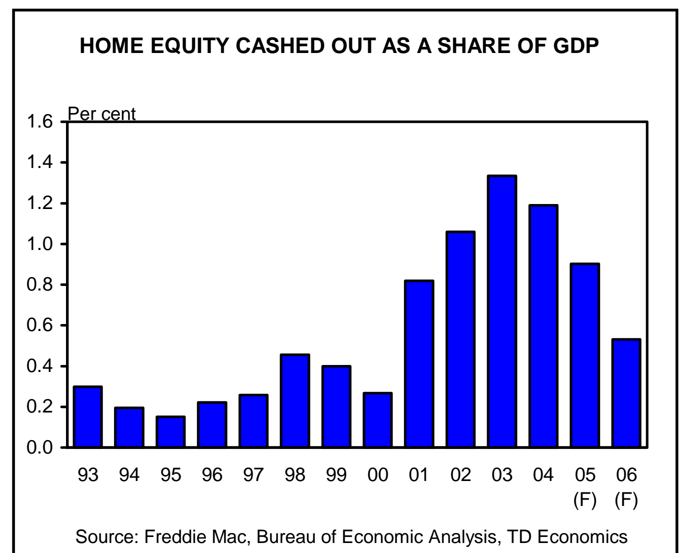
Capacity limits becoming an issue

As a consequence of the relatively mild recession and hearty recovery, the U.S. economy is now approaching full capacity. That would normally be a signal that monetary



U.S. ECONOMIC EXPANSION	
	Q4-2001 to Q2-2005*
Real GDP	3.4
Consumer Expenditures	3.6
Durable Goods	7.9
All other expenditures	3.0
Residential Construction	7.3
Business Investment	3.9
Government	2.7
Final Domestic Demand	3.6
Exports	4.7
Imports	7.3

*Average annualized quarter over quarter per cent change over period
Q2-2005 estimate by TD Economics as at June 2005
Source: U.S. Bureau of Economic Analysis



conditions should have returned to a "neutral" setting. The emergence of major imbalances in the economy also points to the need to remove monetary stimulus.

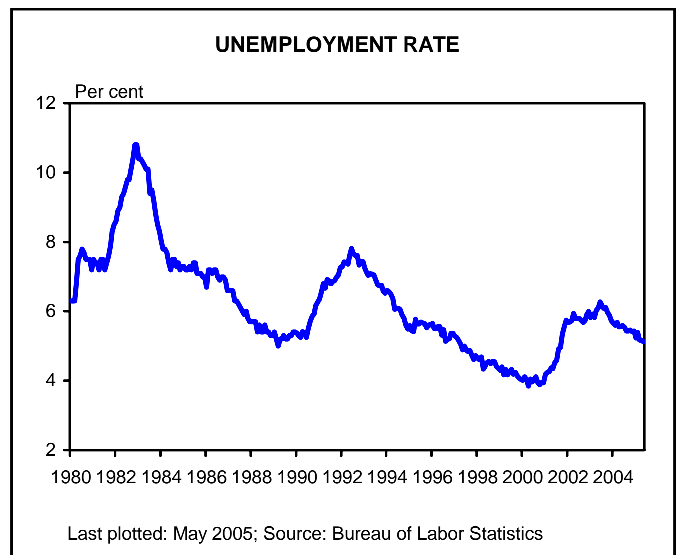
With respect to capacity pressures, there are no widely accepted formal estimates of the U.S. output gap – a measure of the degree of slack in the economy – but it is possible to piece together enough data to make a reasonable inference about its size. Despite anemic employment growth, the number of people employed in the U.S. relative to the size of the population (*i.e.*, the employment rate) is well above its historical norm. And, perhaps more important, it is not far below the peak recorded at the beginning of the current decade, when the U.S. economy was unambiguously in a situation of excess demand. Likewise, the unemployment rate has been trending down since mid-2003 and at 5.1 per cent, it corresponds to the level seen during other periods of tight productive capacity, such as the late 1980s and late 1990s.

Capacity pressures can also be observed indirectly through the behaviour of prices and costs. Unit labour costs have trended up over the past year, with the year-over-year increase accelerating to 4.3 per cent in the first quarter of 2005. Although some of the gain in compensation in that quarter reflected more generous stock option and bonus payouts, the wages and salaries component is shaping up to be the bigger driver in the second quarter. Coupled with the increase in aggregate hours worked in April and May, this suggests that another big quarterly increase in unit labour costs is in store. Although core consumer price inflation has been better behaved, with the year-over-year change in the core CPI holding steady at 2.2 per cent for the last two months, this is still double the rate seen at the start of 2004, which suggests that producers are finding it easier to pass on higher prices in the current environment of still-robust demand. Piecing it all together, it seems rather likely that the U.S. economy is very close to, if not already at, full capacity.

Imbalances tipping the scale

While overall supply and demand may be close to balance, almost every aspect of the U.S. economy beneath those broad aggregates is out of kilter. For one, household debt relative to disposable income has risen to unprecedented levels, and despite low and falling interest rates, total debt service costs have also trended up to record highs. In regard to the mortgage component of household debt, individuals are dedicating 10.35 per cent of their af-

Last plotted: May 2005; Source: Bureau of Labor Statistics



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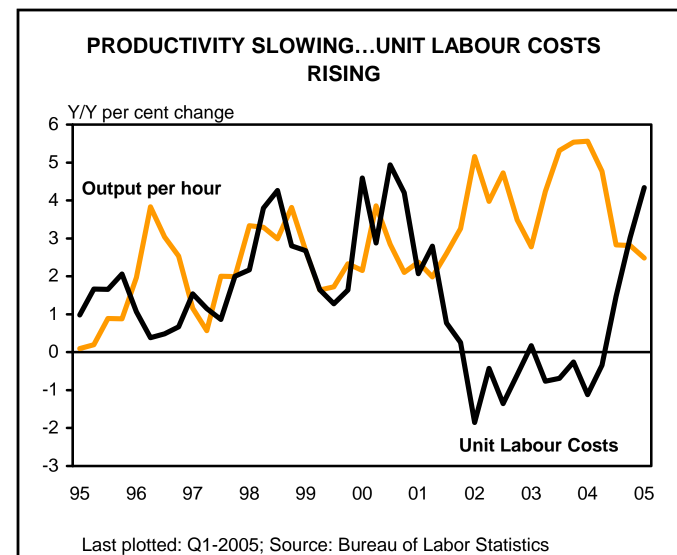


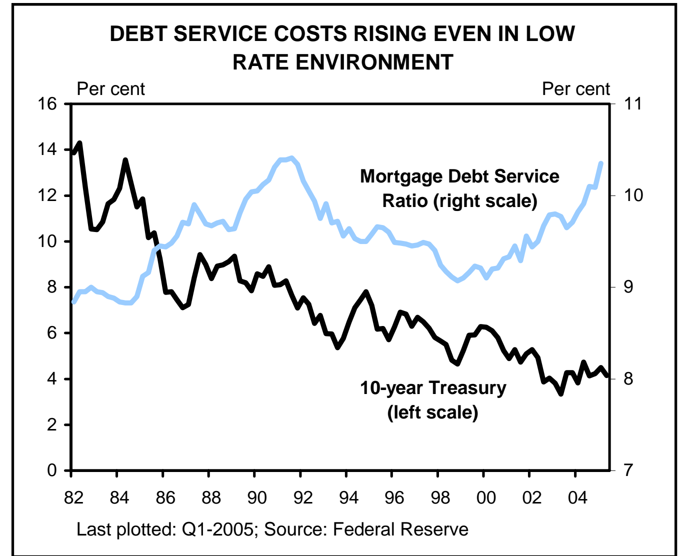
Last plotted: Q1-2005; Source: Bureau of Labor Statistics

ter-tax income to servicing their mortgages – a level not seen since the implosion of the housing market bubble in the early 1990s. And, the fact that a significant portion of household debt is underpinned by increasing wealth, reflecting a higher rate of homeownership, does not provide much cause for comfort. This just means that asset appreciation is disproportionately being driven by rising house prices. In recent testimony to Congress, Federal Reserve Chairman Greenspan stated that some local housing markets in the United States look "frothy", but that there is no evidence of a nationwide bubble. As a result, he argued that a price correction in those markets would not have a significant impact on macroeconomic conditions in the broader U.S. economy. However, many of those "frothy" markets – which include most of the U.S. Northeast, Florida, California and Nevada – also happen to be major economic engines. It is hard to see how a housing market correction in these states would not undermine confidence nationwide and have knock-on effects on prices in other regions, worsening the aggregate household asset position.

The U.S. economy's other major structural weakness is its dependence on foreign savings, with both the household and government sectors heavy borrowers. Although the net saving position of the government sector has shown some improvement of late, government and household balance sheets are still dripping in red ink. Indeed, the increased reliance on foreigners to fund Americans' appetite to spend has produced a current account deficit that now measures 6.4 per cent of GDP, more than two percentage points greater than it was in 2001.

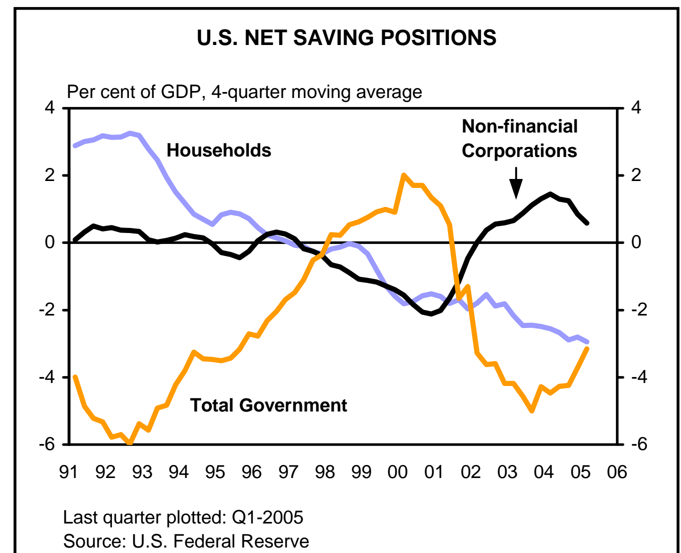
The seventh inning stretch

Counter-cyclical monetary policy swings have traditionally been used over relatively brief periods in order to smooth out economic activity. However, in the current cycle, conditions have been highly accommodative for several years. So, it is not surprising that many of the imbalances that have emerged are byproducts of applying that stimulus over such an extended period of time. Accordingly, if the Fed wants to prevent these imbalances from triggering a boom-bust cycle in the broader economy, the prudent course of action is to continue edging rates higher. With the Fed funds rate at 3.00 per cent, monetary conditions remain quite loose, especially with longer-term yields having resisted the rise in short-term rates, instead declining to multi-decade lows. This has left considerable momentum in the pipeline for consumer and busi-



REGIONAL RE-SALE HOME PRICES		
	Q4 2000-Q1 2005	
	Total price gain in current cycle	Historical price gain over a four-and-a-half year cycle
Pacific	70.1	34.2
New England	56.7	35.2
Middle Atlantic	54.3	30.1
South Altlantic	47.9	22.6
Mountain	33.9	25.1
West north central	31.2	20.3
East north central	24.0	23.9
West south central	20.4	18.4
East south central	19.9	20.4
U.S.A.	42.8	24.7

Source: Office of Federal Housing Enterprise Oversight



ness spending – a fact that we believe will prompt the Fed to raise the funds rate to 3.75 per cent by the end of this year and to 4.00 per cent early next year. And, longer-term rates will follow suit to some degree, with the yield on the 10-year Treasury bond climbing to around 4.75 per cent in the first quarter of 2006.

However, as 2006 progresses, we expect that household imbalances will finally come home to roost, setting off a deceleration in real GDP growth to less than 2.5 per cent in the second half of the year. To be clear, we do not anticipate a collapse in household spending. But, we are of the view that the combined impact of debt fatigue, a drop-off in mortgage refinancing activity, and a pullback in average house prices means that the mighty U.S. consumer can no longer be a driver of growth. And, this time around, highly indebted federal and state governments no longer have the budgetary scope to come to the rescue with tax cuts.

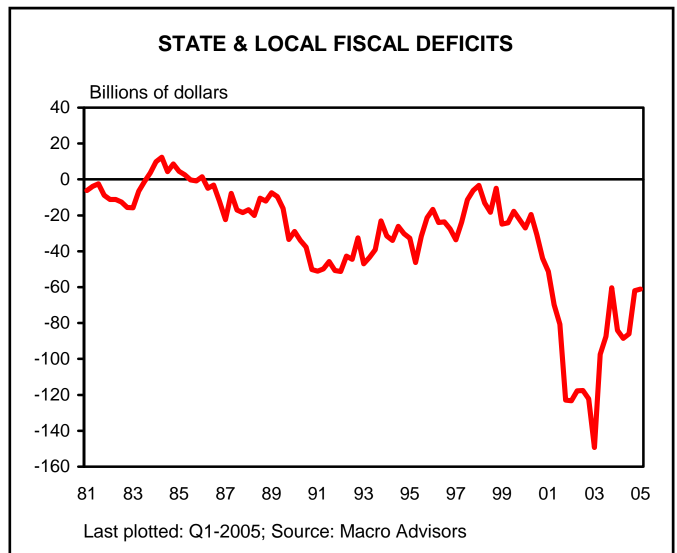
On the external trade side, a weaker U.S. dollar will continue to support exports, allowing net trade to add marginally to GDP growth in 2006, but exports do not have the capacity to be the saviour for the overall economy. Many of the United States' major trading partners – including Europe, Japan, and even Canada – will be coping with soft economic conditions. This not only limits the possibility of a meaningful acceleration in demand for U.S. exports, but it also reduces the likelihood of a further substantial appreciation in those currencies relative to the U.S. dollar. The prospect of a pronounced sell-off in the U.S. dollar looks even more remote considering that our forecast for only 2.7 per cent growth in the U.S. economy from the end of 2005 through the end of 2006 will still be greater than the performance of most of its industrialized trading partners – in some cases, by a healthy margin.

Readers should take heart that there will still be important pockets of strength in the U.S. economy over the 2005-06 period. In the business sector, the key drivers of investment in machinery and equipment are firms' financial resources and their longer-term strategic plans. With respect to the former, the restructuring activity that has depressed employment growth since the 2001 recession has not only resulted in strong productivity gains, but has also shored up corporate balance sheets to the point where retained earnings and profits as a share of GDP are both at record levels. It is not in firms' best interests to sit on cash indefinitely – indeed, excessively conservative business practices can be detrimental to underlying profitability and

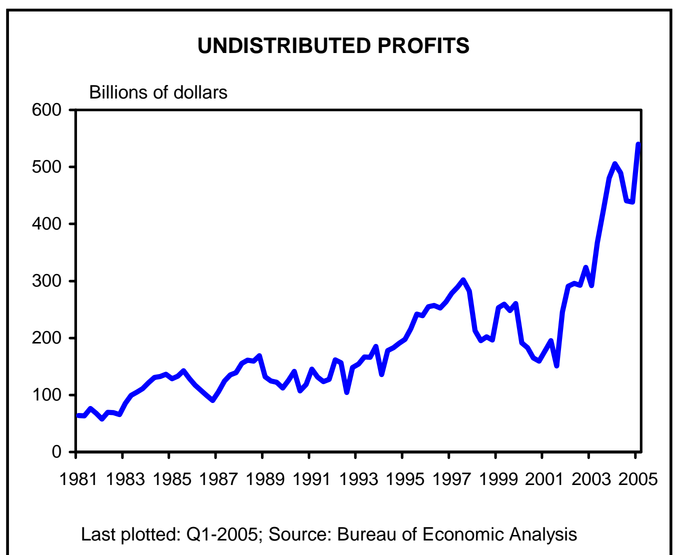
U.S. FIXED INCOME OUTLOOK

(%)	2005F			2006F			
	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Fed Funds Target	3.25	3.50	3.75	4.00	4.00	3.75	3.50
3-mth T-Bill Rate	3.20	3.55	3.80	4.05	4.05	3.75	3.50
2-yr Govt. Yield	3.59	3.85	4.05	4.20	4.25	4.05	3.80
5-yr Govt. Yield	3.70	4.05	4.25	4.45	4.50	4.30	4.05
10-yr Govt. Yield	3.92	4.30	4.55	4.75	4.75	4.50	4.25
30-yr Govt. Yield	4.21	4.60	4.70	4.80	4.85	4.65	4.45
10-yr-2-yr Spread	0.33	0.45	0.50	0.55	0.50	0.45	0.45

F: Forecast by TD Economics as at June 2005
All forecasts are for end-of-period



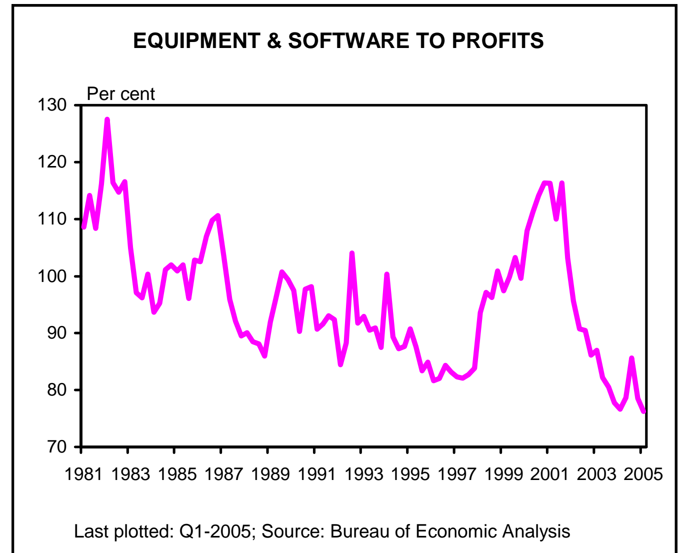
Last plotted: Q1-2005; Source: Macro Advisors



Last plotted: Q1-2005; Source: Bureau of Economic Analysis

competitiveness. Accordingly, we firmly believe that businesses will continue to deploy available resources into investment initiatives, especially since there is plenty of room for "catch-up", with investment in machinery and equipment as a share of profits currently at historic lows. Some readers may find this of little solace given the numerous risks on the consumer side, but ultimately, heightened machinery and equipment investment will make a far greater contribution to keeping the United States a major competitive player on the global stage beyond 2006.

That said, Americans' present dissatisfaction with the U.S. economy's recent performance suggests that a slowdown to sub-2.5 per cent growth later next year will not be well-received. There will no doubt be accusations that the Federal Reserve Board over-shot in the current tightening cycle. And indeed, we expect the Fed to be cutting rates again before the end of 2006, sending 10-year Treasuries back down toward 4.25 per cent. But, such criticism surely sets the bar too high. Given the nature of the shocks to the U.S. economy, a more reasonable perspective is that the Fed will have handled things quite well. The so-called recession of 2001 was extraordinarily mild by historical standards, the subsequent recovery kicked in quickly and was quite robust, and a mid-decade slowdown to a growth rate just slightly below 2.5 per cent isn't much to cry about. This latest cyclical experience offers hope that business cycles of the future will be shorter and shallower than in the past.



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