

Lost and Found

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The first decade of the 21st century is over. Good riddance! It has truly been a lost decade for labor and capital. In stunning contrast with the ebullience of late 1999, there are now a half million fewer people on nonfarm payrolls than at the start of the decade. To be sure, late 1999 represented a business cycle peak while late 2009 represented a trough, but make no mistake, the recent recession established postwar records for declines in employment, home and stock prices. Concomitantly, the federal budget swung from a \$91 billion surplus in FY 1999 to a record \$1.4 trillion deficit in FY 2009. All of the gory details are presented in the following table.

Selected Economic Indicators: Late 2009 vs. Late 1999

Economic Indicator	Late 1999*	Late 2009**	Percent or Level Change
Real GDP-\$Bil.	11,014	12,990	17.90%
Industrial Production	102.4	98.6	-3.70%
Nonfarm Payrolls	130,532,000	129,993,000 a	-539,000
Pvt. Nonfarm Payrolls	109,487,000	108,401,000 a	-1,086,000
Unemployment Rate	4.00%	10.20%	6.20%
Avg. Hourly Earns.-\$	13.7	18.72	36.60%
Real Avg. Hrly. Earns.	8.12	8.65	6.50%
Fed.Def/Surp.-\$Bil.	91	-1,417	-1,508
S&P 500 Index	1469.25	1091.38	-25.70%
Real S&P 500	870.41	504.33	-42.10%
U.S. Treas. 6s/26	91.47	122.63	34.10%
Trade Wght.\$-Major	96.21	72.97	-24.20%
NYM-Oil/bbl.	25.6	76.35	198.20%
Gold/oz.-Comex	289.6	1146.4	295.90%
Median Home Price-\$	141,800	173,100	22.10%
Real Med. Home Pr.-\$	84,000	80,000	-4.80%
CPI-U	168.8	216.4	28.20%

* Market data as of yearend 1999, economic data as of December, 1999 or Q4 1999.

** Market data as of November 20, 2009, economic data as of latest available month or quarter.

a. Adjusted for preliminary labor market rebenching. Total October 2009 payrolls adjusted down by 824,000 and total private payrolls adjusted down by 855,000.

Source: Bloomberg, Global Insight

Despite the 64% stock market rally off the March lows, both nominal and real stock prices are far off their year-end 1999 levels by 26% and 42%, respectively. In sharp distinction, oil, gold, and of all things, very staid U.S. Treasury bonds enjoyed spectacular bull markets during the decade. Gold and oil prices nearly tripled and quadrupled, respectively and long-term U.S Treasury bonds that offered current yields just above 6.5% advanced

by 34% during the decade. Along the way, the trade-weighted foreign exchange value of the U.S. dollar declined by 24%. Median existing home prices, after soaring earlier in the decade, went into free fall after 2006 and ended up a modest 22% in nominal terms and actually **declined** by 5% in real terms. Nevertheless, we would like to think that the next decade is the mirror image of the last where we start from a cyclical trough and end at a peak.

The Near-Term Outlook

Similar to last quarter, we continue to believe that the economy is on a modest growth path that will be accompanied by extraordinarily high rates of unemployment.¹ Specifically, we forecast that after growing at 2.8% in the most recent² and current quarters, real GDP growth will settle into a 2% growth path for much of 2010 and be closer to 3% in 2011. With such sluggish growth, the unemployment rate will likely peak at 10.5% in the first quarter and remain at or above 10% for almost all of next year. Further exacerbating the employment situation is uncertainty about tax, healthcare and energy policies coming out of Washington.

The slow growth outlook reflects the lagged effects of the implosion of consumer balance sheets and is a result of the economy in transition from being an import-oriented/low-savings rate one to a more export and higher-savings oriented one. That transition is being pushed along by the administration's weak dollar policy which encourages exports and discourages the consumption of imports. The combined effect will cause real consumer spending to grow at a modest 2% rate, well below the more historical 3-3.5% rate.

We would be remiss if we did not discuss the current situation with respect to housing activity. In terms of prices and home sales it appears that housing is finally on the road to recovery. To be sure, with 23% of the nation's houses with mortgages underwater, foreclosures continue to rise; but we believe that is already factored into the decision making process of both buyers and sellers.

The Highly Medicated Economy

Let's be clear, policy makers are highly medicating the economy with record federal deficits and a zero interest rate policy coming from the Federal Reserve. While necessary to abate the free fall in the economy that took place in late 2008 and early 2009, both fiscal and monetary policies are not sustainable in the long-run. Deficits will have to be reduced and interest rates will return to more normal levels. In fact, our longer-term deficit projections do not include another stimulus package nor the inevitable cost-overruns associated with the healthcare package now moving through the legislation.

With all of the stimulative "medication" in the system it would be logical to assume that the most likely side effect would be a ramp up in inflation. Indeed we believed that is the message coming out of the foreign exchange and gold markets. Nevertheless with so much excess capacity in labor and product markets, we believe that inflation will not manifest itself within the 2011 forecast horizon. Indeed we are forecasting consumer price inflation to average a modest 2% over the next two years.

Conclusion

When economic historians look back on the recent recession and the sluggish recovery we are forecasting, we believe they will note that the 2007- 2010 era signaled that the U.S. economy entered a period of transition. The characteristics of the period involve the inability of export growth to completely offset growth declines in consumer spending and state and local spending. Over time the savings rate will increase and once it stabilizes in the 5-7% range, consumption will once again grow with the economy. By mid-decade, 3-4% economic growth accompanied by mid-single digit unemployment rates will once again become the norm. Thus instead of being a lost decade, we will once again find our way back to the economy's historical growth path.

¹ See Shulman, David, "The Long Goodbye", UCLA Anderson Forecast, September 2009.

² Third quarter GDP has since been re-estimated from 2.8% to 2.2% Source: Bureau of Economic Analysis.