

Times Are Better.

By Anirban Basu



But Will They Last?

You Have Come a Long Way, Baby

There is certainly much more to look forward to in 2010 than there was in 2009. The months preceding 2009 were brutal and associated with the near-collapse of the U.S. financial system. September 2008 by itself produced enough bad economic news for an entire decade, with Lehman Brothers failing, Freddie and Fannie effectively becoming part of the federal government and stock prices crumbling.

Economic pain swiftly spread from Wall Street to Main Street and in January 2009 the nation shed over 700,000 jobs. Since the beginning of the recession that began in December 2007, more than seven million jobs have been lost and despite recent improvement the U.S. unemployment rate is still in double-digits.

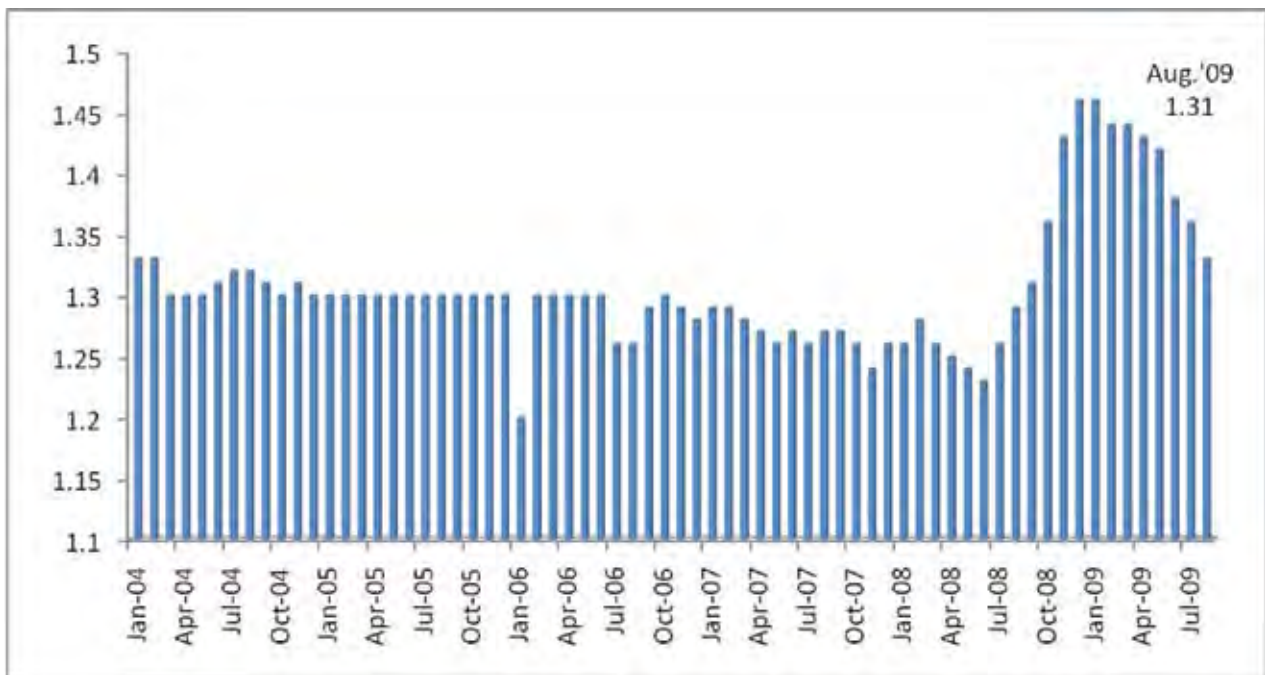
That said, the U.S. economy is now expanding. Third quarter gross domestic product (GDP) expanded at a 2.8 percent annualized pace and momentum continues. Retail sales have generally surprised to the upside and industrial production is also growing. The nation lost just 11,000 jobs in November 2009, the best monthly performance since late 2007.

Virginia has been a particularly impressive performer, boasting one of the nation's lowest and most stable unemployment rates that has been declining since June 2009. However, the question remains whether economic conditions will continue to improve or whether at some point in the near future the economic recovery will begin to sputter.

The Case for the Next Prolonged Expansion Cycle

Recent data indicates that growth continues to exceed pre-existing expectations and that a shift in the mix of expansion drivers renders circumstances more conducive to sustained expansion. Both industrial production and retail sales were stronger than anticipated in September 2009. If one strips out the up and down impacts of the Cash for Clunkers program, retail sales have generally been edging higher. This should be viewed positively for a number of reasons, but arguably the most important is that inventories continue to plunge, setting the stage for ongoing improvements in industrial production, capacity utilization and ultimately job creation. Within the nation’s business sector that includes wholesale, manufacturing and retail segments, inventories declined nearly four percent over a recent three month period while business sales rose by 2.3 percent. Consequently, the inventory-sales ratio has fallen back to its pre-existing trend line. It is for this reason that many economists predict that the U.S. economy will expand three percent or more on an annualized basis during the fourth quarter of 2009 after expanding nearly three percent during the third.

Exhibit 1: U.S. business inventory to sales ratio (total), January 2004 – August 2009/ Source: Dismal Scientist

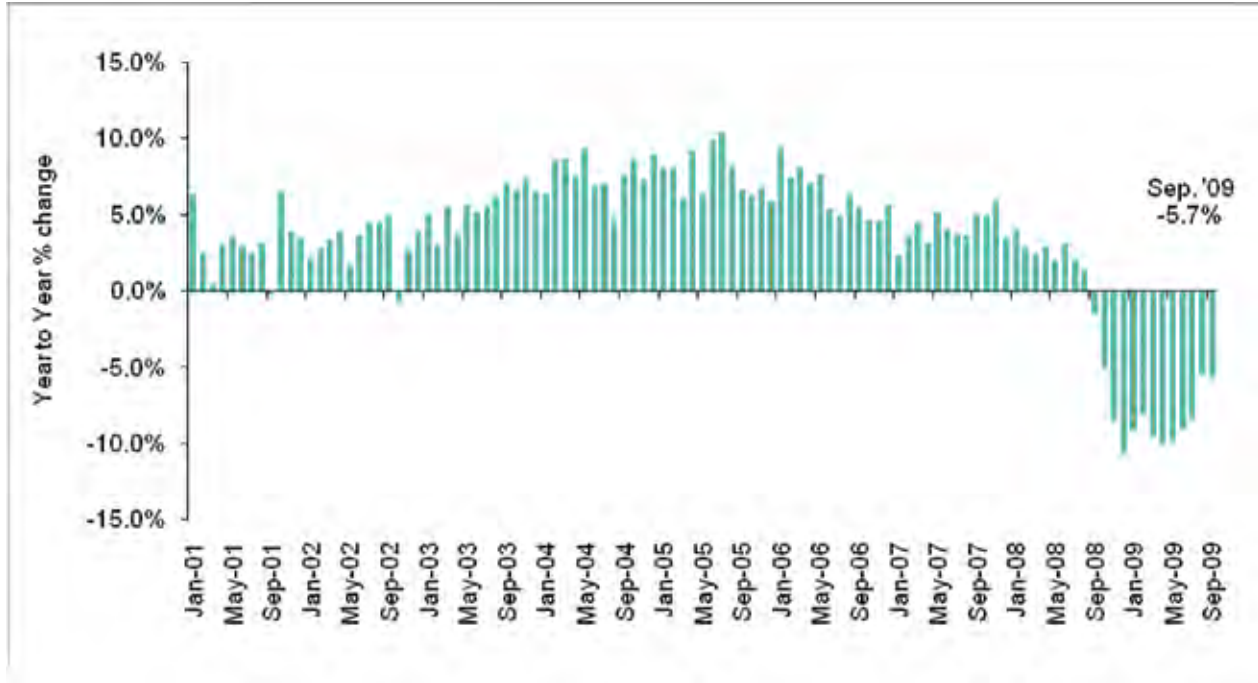


A closer inspection of third quarter GDP reveals a promising shift away from pure dependence upon government spending to a broadening economic expansion. According to the U.S. Commerce Department’s November 24 GDP report, nonresidential fixed investment decreased 4.1 percent during the third quarter of 2009 compared to a 9.6 percent loss in the previous quarter.

Contributing to the loss was investment in nonresidential structures, down 15.1 percent in the third quarter. Residential construction has now bottomed out and is firmly in recovery mode. The extension and expansion of the federal tax credit for first-time purchasers effectively insures that the housing market’s momentum will continue through mid-year 2011 and perhaps beyond.

Consumer spending nationally was up 2.9 percent in the third quarter following a slight decrease of 0.9 percent in the second quarter as spending on durable goods spiked 20.1 percent. However, the increase was due in large part to brisk motor vehicle sales from the government’s Cash for Clunkers program. Both exports and imports also rose significantly at 17.0 percent and 20.8 percent, respectively.

Exhibit 2: U.S. retail and food sales, January 2001 – September 2009/ Source: U.S. Census Bureau



This is not intended to imply that we anticipate a brisk recovery. We do not; many of the reasons we have cited in earlier reports remain firmly in place, including tight credit, an unsettled and unsettling federal policymaking environment, subdued expansion in various parts of the world, high unemployment rates and the expectation that policy support for the economy may begin to wane within the next 12 months. In the words of Wells Fargo economists, “We are not expecting a double dip but do expect growth to remain relatively modest through 2011.” We generally concur.

One of the other reasons to believe in the sustainability of the nation’s nascent recovery is the recent performance of financial markets. On March 9, 2009, the Dow Jones Industrial Average reached a cyclical low 6,547.05 after dipping to an intraday low of 6,469.95. Since that time, stock prices have enjoyed a roughly 60 percent retracement, replenishing wealth and signaling confidence in corporate earnings.

During the third quarter, roughly five in six large U.S. companies reported earnings that exceeded expectations. Moreover, if U.S. stocks were valued at 15 times their expected 2011 earnings by the end of 2010, the S&P Index would be approaching 1,365; about

23 percent higher than the level at the time of this writing. This implies even more wealth generation that could be enough to allow for sustained economic momentum into and through 2011 despite expectations of rising interest rates and taxes at that time.

The Case for the Dreaded Double Dip

Around 30 percent of economists believe that the most likely outcome is for a double-dip recession to begin during the latter half of 2010 or in 2011-2012. Associated Builders and Contractors (ABC) puts the risk of a double-digit recession at around one in three through 2012.

That said, we are now approaching the exit period for monetary support for Treasuries and, by next March, for mortgage-backed and asset-backed securities. This will represent the first real post-recession test for the economy, financial markets, the Federal Reserve and the Obama Administration.

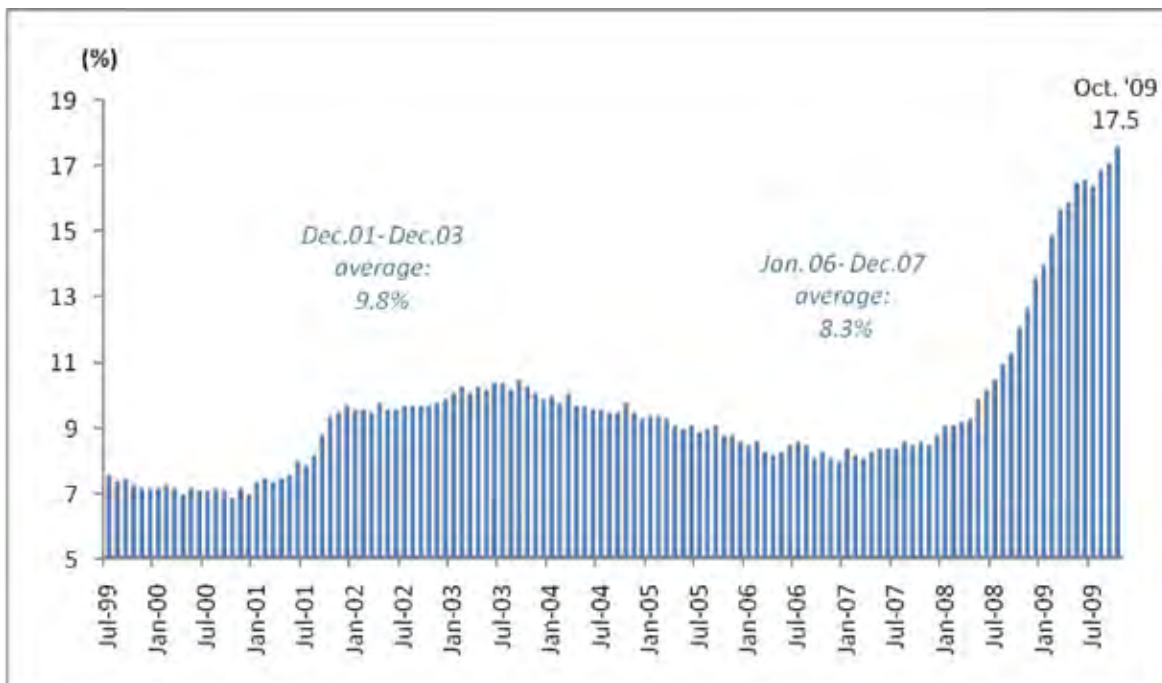
Subsequently, stimulus monies related to the American Recovery and Reinvestment Act of 2009 will begin to dry up. By late 2010, federal spending will likely be slowing while interest rates will be

rising. Still fiscally troubled state and local governments may be ratcheting up taxes by that point and in 2011 the Bush 2001 and 2003 tax cuts will lapse. Add it all up and the recipe for the next recession is being cooked up right now. In the latest Wall Street Journal survey, economists expressed a collective expectation that the Federal Reserve will begin to raise interest rates around September 2010. Because inflationary expectations are already building in the economy, including among business owners and managers, the Federal Reserve may act a bit sooner than that even if the economy is unable to expand much more than two percent on an annualized basis during 2010's first half.

To give a sense of just how important federal spending has been, demand for the federal government sector effectively sustained the Northern Virginia commercial real estate market during the third quarter of 2009. Net absorption was flat because of the top 10 deals executed during the quarter; 50 percent involved the federal government.

Virtually all economists believe that for the recovery to become self-sustaining, firms must respond to improving profitability and revenues by expanding their operations; however, presently there is little indication that the bulk of U.S. businesses are actually ready to expand. Hiring remains dormant and though layoffs have slowed, they remain high enough to keep the nation's unemployment rate edging higher. While most observers are aware that the U.S. jobless rate leapt 0.4 percentage points to 10.2 percent in October (the highest level since April 1983), a broader measure of unemployment surged even more, rising half a point to 17.5 percent. This more comprehensive gauge of labor underutilization, known as U-6, also accounts for people who have given up looking for work or who can only find part-time jobs. As of October, the U-6 rate stood at its highest level since the Labor Department began monitoring this particular series in 1994.

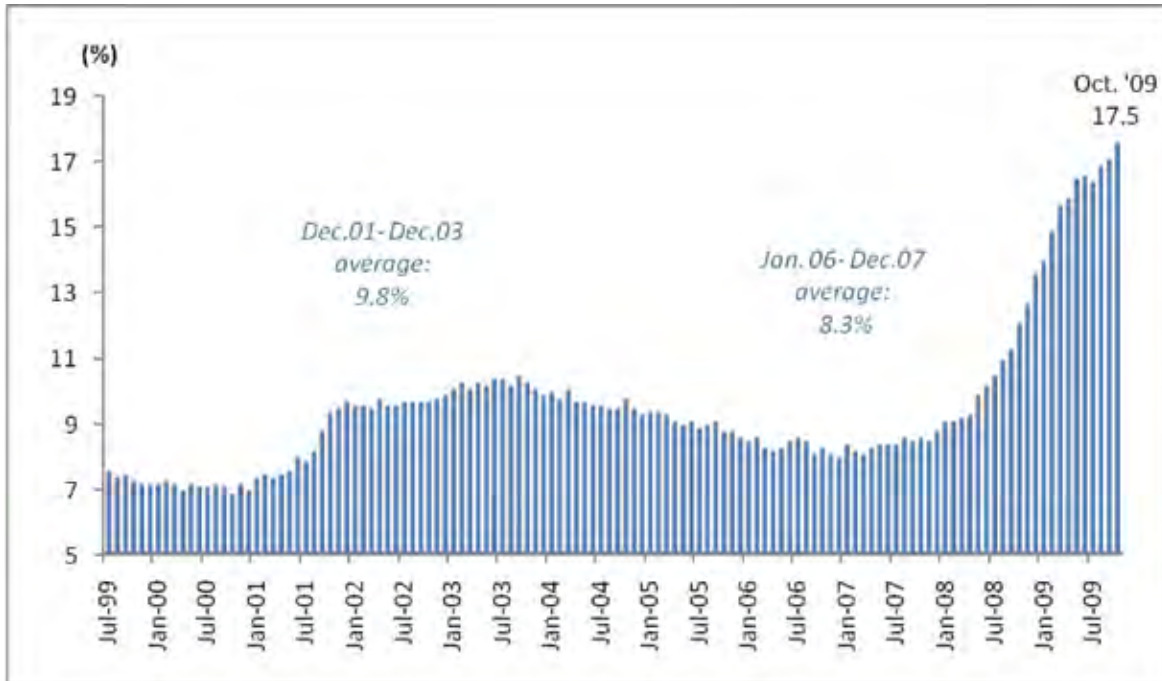
Exhibit 3: National U-6 unemployment rate, July 1999 - October 2009/ Source: Bureau of Labor Statistics



With so many people unemployed or underemployed, expansion in labor compensation is weak and actually becoming weaker. The broadest measure of wages and benefits, the employment cost index, grew just 1.5 percent on an annualized basis during the third quarter. According to Mark Zandi at Moody's Economy.com, the historical relationship suggests that at an official unemployment rate of 11 percent, compensation growth would be non-existent and would actually go negative at 12 percent. This could trigger a deflationary episode that would be harmful to state government revenues.

Construction's ultimate recovery is heavily dependent upon the return of job growth. Because of its absence, no major development projects broke ground, according to CB Richard Ellis, during the third quarter of 2009 in Northern Virginia and the office construction pipeline shrank to below 1.4 million square feet, just 23 percent of the 6.1 million square feet under construction at the same time two years prior. In the Hampton Roads area, office vacancy continues to rise and now stands at 14.4 percent.

Exhibit 4: National Nonfarm Employment Net Change, October 2005 - October 2009/ Source: Bureau of Labor Statistics



Looking Ahead

The next several months represent the most intense period for stimulus money spending. Observers will notice even more lane closures and road repaving projects in the months ahead, particularly as we edge toward spring and weather becomes less of a constraint on construction. The Federal Reserve is still committed to maintaining low interest rates through that time and the now extended and expanded first-time home purchaser tax credit will keep home sales humming on a seasonally-adjusted basis. Auto sales are also rebounding, even in the absence of Cash for Clunkers (though it will be many years before the 17 million new vehicle sales peak enjoyed earlier this decade is reestablished). In other words, the first half of 2010 is shaping up to be rather promising from the perspective of economic expansion.

Our concerns revolve largely around the second half of 2010 and 2011. By the mid-term elections, there needs to be some indication that the nation is adding jobs again; enough jobs to stabilize the unemployment rate. The nation requires the creation of roughly 120,000 new jobs per month to accomplish this and ABC's current expectation is that this threshold will be met.

To determine whether or not the recovery will become self-sustaining, ABC is looking to a number of key economic variables. The first is the performance of financial markets that have recently done more than a passable job in predicting the trajectory of the economy. The Dow Jones Industrial Average peaked at 14,164.53 on October 9, 2007 before beginning what was then a slow, steady descent. Two months later, the economy was in recession. The market bottomed in early-March of 2009. Several months later, the recession ended.

The second set of indicators relates to business investment, staying keen to observe increases in business investment that do not appear directly related to government spending. Industries that appear best positioned to ramp up investment include exporters and energy suppliers, though still tight business credit will serve to limit the pace of investment expansion.

A third indicator will be the pace of bank lending. As confidence spreads throughout the economy and as weaker banks fall by the wayside, the expectation is that bank lending will normalize; a critical factor to construction's full recovery.

Anirban Basu is chief economist of Associated Builders and Contractors.