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How the U.S. Economic Recovery Might Unfold

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With most economists now estimating that the U.S. economic recession is drawing to a close, the big question ahead is what type of recovery will follow. Many experts remain skeptical about the likelihood of a strong and sustainable economic recovery, and the accuracy of this consensus will have significant implications for the trajectory of the financial markets in the months ahead.

Historical early-stage recovery patterns

History offers some clues about the typical patterns of economic recovery. For instance, in the post-WWII period, there have been four severe recessions during which the U.S. economy contracted by 2.5% or more. In each case, the subsequent pace of growth during the first two quarters of recovery was robust, averaging more than 6% on an annualized basis. Economic growth during the entire first year of recovery averaged more than 7% (see Exhibit 1, page 2).

In contrast, mild recessions have tended to be followed by more modest early-stage recoveries. The last two recessions (1990-91 and 2001) were the mildest economic contractions on record, and the subsequent bounce in economic growth averaged just over 2% during the first two quarters after the recession, and only 2.5% during the first year of recovery.

Thus, when economic recessions have been deeper and more severe, the early stages of the subsequent recovery have been stronger. Much of this has to do with simple math. Larger contractions leave an economy further below its full-capacity potential, allowing for a quicker pace of growth to get back to its former level. Smaller contractions leave economies nearer their potential level and thus require less growth to return to full capacity. (Among all post-war recessions, output returned to prior peak levels within one year or less.)

Going back to the Great Depression, the historical pattern appears to hold. The economy contracted by a massive 26.6% from 1929-1933, but in 1934, economic growth reached nearly 11%. Although it took roughly three years to get back to its prior peak level of total economic output, the pace of growth was brisk from 1934-1936 (before the economy fell back in recession in 1937).

Assessing today's expectations

The 2007-2009 recession will likely go down as the longest and most severe of the post-war era. Although most economists believe the U.S. is exiting recession, current expectations for the next few quarters of economic growth remain tepid. A Wall Street Journal survey of economists in August showed an average projection of 2.3% growth during the next two quarters, with 2.4% over the next year. These growth rates align almost exactly with the pace of recovery that has historically occurred after mild recessions. In other words, current expectations

KEY TAKEAWAYS

- **Though the U.S. economy is near or has already exited recession, there are many factors that may inhibit the strength of the recovery.**
- **However, steep economic contractions (similar to the 2007-09 recession) historically have been followed by sharp early-stage recoveries.**
- **With most experts projecting a tepid early-stage recovery to the recent recession, it is possible expectations for near-term economic growth are too low.**

EXHIBIT 1: Historically, the early stages of economic recovery have featured more robust growth following the most severe recessions.

	Recession dates	Size of contraction	Recovery over first 2 quarters	Recovery over first year
Mild	1990-91	-1.4%	2.2%	2.6%
	2001	0.1%	2.4%	2.3%
	Average	-0.7%	2.3%	2.5%
Severe	1953-54	-2.5%	6.4%	7.9%
	1957-58	-3.7%	6.0%	7.5%
	1973-75	-3.2%	5.0%	6.2%
	1981-82	-2.7%	7.2%	7.7%
	Average	-3.0%	6.2%	7.3%
Great Depression	1929-33	-26.6%		10.8%
Today's estimates	2007-09	-3.7%	2.3%	2.4%

Contraction size reflects peak-to-trough GDP contraction in chained 2005 dollars. Source: Bureau of Economic Analysis, Wall Street Journal, Haver Analytics, FMRCo (MARE) as of 8/31/09.

are that an extremely severe contraction will give way to a mild early-stage recovery—something that has not happened in the U.S. in modern history.

Near-term: signs of economic improvement

During the next several months, several signs are pointing in the right direction. Many leading economic indicators (e.g. home-building permits, stock market performance)—which tend to point the direction of economic activity—continue to move into positive territory [see MARE article, *U.S. Economic Update: Improving But Still Fragile*]. Sales in the housing and auto industries have begun to tick up, suggesting a possible bottom in these important but long-suffering markets [see MARE article, *U.S. Housing: Glimpses of Stabilization Offer Hope*]. Businesses slashed inventories and cut costs so drastically in the early part of 2009 that corporate earnings were better than expected during the second quarter, and some firms may need to increase output to replenish low inventory levels. Policy stimulus, both here in the United States and abroad, remains supportive of growth amid low interest rates and heavy government spending. Growth in large developing countries, including China and India, has already reaccelerated, providing a boost to global trade.[i]

Medium-term concerns

Of course, despite these near-term improvements, economists have many good reasons to expect a weak overall recovery. The medium-term economic environment is likely to remain challenging due to a variety of factors. First, there is little evidence to this point that the recent bounce in economic activity is being driven by sustainable growth in end demand. Of biggest concern is U.S. consumer spending, which still accounts for roughly two-thirds of economic output. After having accumulated record levels of debt and lost one-fifth of their net worth in the housing and stock market downturns, consumers have begun to borrow less and save more, both trends that detract from spending. The high levels of unemployment and continued job market weakness are likely to keep confidence fragile and income growth tepid. This concern has been given credence by disappointing consumer confidence and retail sales reports for July and August.

A second major reason for pessimism is that economies historically have taken longer to recover after financial crises than subsequent to recessions that did not involve trauma in the financial system. One study by economists Carmen Reinhart and Kenneth Rogoff found that unemployment on average rose for nearly five years after a financial crisis, with the unemployment rate climbing an average seven percentage points from pre-crisis levels.[ii] While the U.S. banking system has stabilized in recent months, still-rising loan defaults and bank closures may make lenders less able or willing to restore credit to previous levels.

A final concern is the future of policy stimulus. The unprecedented monetary and fiscal response to the late-2008 crisis has placed policymakers at the heart of the near-term economic outlook, leaving plenty of room for error as they consider when and how to wind down the extraordinary measures. Even if the timing and execution are perfect, ending these policies will involve a tightening of monetary and fiscal policy on a sequential basis, meaning the private sector will have to compensate for lower stimulus levels by making large enough gains to offset them. Over the longer term, the enormous increase in

projected government budget deficits may provide upward pressure on taxes and interest rates.

Investment implications

One of the most difficult things to gauge as an investor is what expectations are reflected in security prices. It is, after all, the unexpected changes in economic and corporate data that move market prices. With most market participants expecting a weak economic recovery, it may be difficult for U.S. economic data to disappoint investors over the next few quarters. If the data is better than expected, positive ripple effects may do more to create a sustainable economic recovery than is currently projected. This does not mean there are clear skies ahead; in fact, the medium-term macroeconomic and policy risks are real and perhaps create more uncertainty for the outlook than at the beginning of any economic recovery in modern history. But if past historical patterns are any guide, it is possible that current expectations for the early stages of the U.S. economic recovery may be too low. ■

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Investment decisions should be based on an individual's own goals, time horizon, and tolerance for risk.

[i] China (8%) and India (7%) posted increased real GDP growth rates in Q2 2009 relative to the prior two quarters. Source: Central Statistical Organisation of India, China National Bureau of Statistics, Haver Analytics, FMRCo (MARE) as of 6/30/2009.
[ii] "The Aftermath of Financial Crises," Carmen Reinhart and Kenneth Rogoff, December 19, 2008.