

Specialists

Has the Economy Bottomed?

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The ghosts of the past, the present and the future economy all revealed themselves last week with a plethora of economic data to digest. Our key takeaways: the backward-looking indicators like investment spending looked horrendous, current indicators like GDP looked bad but showed signs of improvement, while the more forward markers such as manufacturing new orders and initial unemployment claims were very encouraging. Net, we are at or very near a bottom in the economy in our opinion. We expect the June quarter to be very near the flat line and for the economy to show some signs of growth in the September quarter. However, unemployment will continue to worsen throughout the year, perhaps peaking in the 9%-10% range, up from 8.5% currently.

To the layman, and even some professionals, reading the news headlines over the past few weeks has proven extremely confusing. One day we read of capital goods shipments being the worst since World War II and the next we see sharply improving new orders. We have seen unemployment go through the roof month after month, but consumer spending actually increased in the first quarter. The juxtaposition of all the divergent economic statistics is behind some of the volatility in the stock market lately and the confusion among even experienced money managers.

The mixed economic numbers begin to make a little more sense if one considers the typical flow of a recession. While no two recessions are identical, some patterns tend to repeat themselves. The consumer, which represents more than 70% of the U.S. economy, generally leads our economic train. As consumers loosen their purse strings and spend more, businesses initially may ship from their inventories before stepping up production. Next we might see manufacturers place orders for raw materials to up their production rates, then actual industrial production might pick up. The final car in the train is capital equipment. Businesses will step up their capital spending (or stop cutting it) only when consumer spending has picked up and production at current facilities is maxed out. The time between the beginning (consumer spending) and the end (capital goods) is large enough that one metric can be showing some nice improvement while another still looks like it is falling to pieces.

That is exactly the situation we were in with regard to some recent data. GDP in aggregate shrank by 6.1% during the March quarter, better than December's 6.3% but worse than the consensus of about 5% and our own thinking of down 3%-5%. But embedded in the number was a 2.2% *increase* in the consumer spending segment. That is better than almost anyone was expecting (though it could be revised down some). This is potentially the leader of our train (see table below). However, both changes in inventories (down substantially) and investment spending (e.g., capital spending) dwarfed the positive news from the consumer. We believe the poor investment statistics are just a reflection of the awesomely bad consumer spending numbers of both the third and fourth quarters.

Postwar	Year	Quarters Before
Recession	Recession	Investment Trough

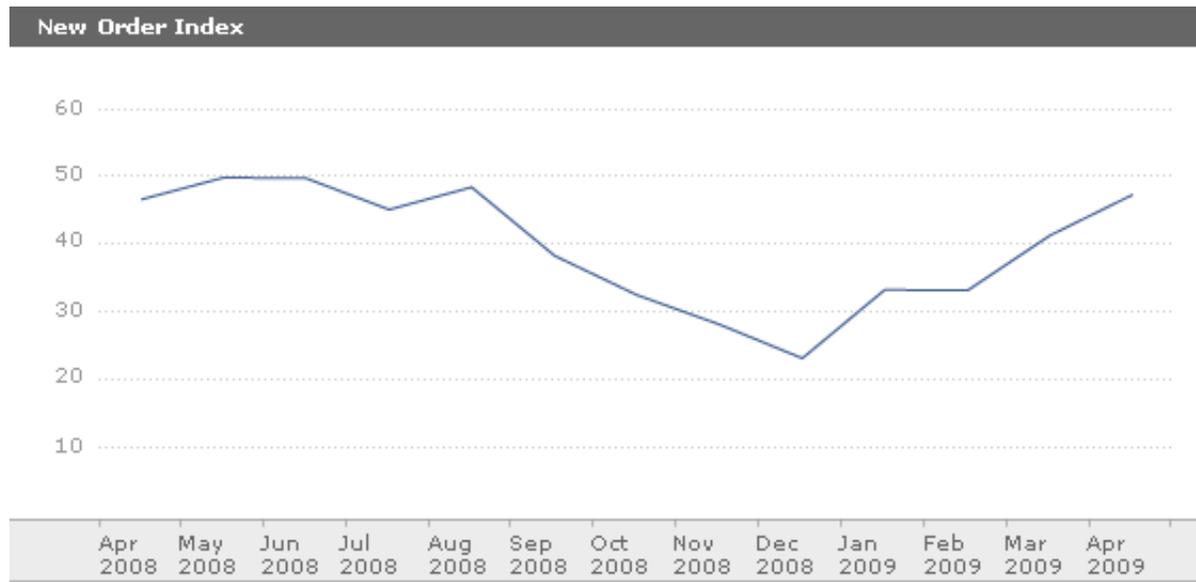
5/6/2009

Has the Economy Bottomed?

Number	Began	After Consumption Bottoms
1	1948	3 quarters
2	1953	2 quarters
3	1957	1 quarter
4	1960	1 quarter
5	1969	Same quarter
6	1973	2 quarters
7	1980	1 quarter
8	1981	4 quarters
9	1990	1 quarter
10	2001	2 quarters
11	2007	Unknown

Consumption this cycle may have bottomed Dec-2008

We are seeing some early signs that businesses are loosening their purse strings as well. The Institute of Supply Management's new order index has moved up nicely from a disastrous 23 in December to 47 for April (reported on May 1). This is our very favorite indicator, and its bottom has generally led the economy by about four months, which would put us at the bottom just about now. The data for this index is collected from purchasing managers in the field at the very front of the supply chain. This indicator represents one of the very first data points available each month and is not subject to many revisions.



Source: ISM

The four-week moving average of initial unemployment claims released last Thursday also appears to have peaked on April 4, as the average of initial claims have now dropped from 658,750 to 637,250, a healthy decrease. This is also a modestly leading indicator, though with only a month's worth of lead time. Again, that would imply the bottom in the economy just about here. Even though the direction here is positive, the [...morningstar.com/.../printArticle.htm](http://www.morningstar.com/.../printArticle.htm)

5/6/2009

Has the Economy Bottomed?

level of claims is still just about double the level of two years ago. We will breathe a bigger sigh of relief when this number drops below 600,000. A Watson Wyatt survey of layoff intentions and the employment section of the ISM manufacturing report give us some confidence that new claims should get better from here. Job growth and the unemployment rate are lagging indicators and will take longer to show improvement. Hopefully those numbers won't spook the market too badly when they are reported on Friday.

Overall, the numbers we saw this week were consistent with a bottoming in the economy. The one thing that did give us some modest concern was that the consumer side of the economy did appear to weaken during the quarter along with consumer incomes. We are hopeful that the lowered withholding rates that kicked in during April, the \$250 checks going out to Social Security recipients in May, and maybe some stimulus money in June will begin to arrest some of the consumer weakness.

At the bottom of an economy, we would typically begin to see consumer discretionary stocks and technology stocks do better while some of the more defensive stocks like health care, consumer staples, and maybe utilities lag a bit. We have seen some early signs that scenario is already beginning to play out. To help formulate your view of the economy you might want to keep your eye on these. Again, this is just a general pattern, and each recession has its own special character.

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