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Recovery Path: is there a double dip in our future?

Recession Etiology:

The **trigger** for this recession was clearly the **overextension of investment**. (Boom) That excess was manifested in sharp declines in private domestic fixed investment spending after the peak of Q2 2000. (Bust) Coupled to that decline, but greatly intensifying the economy's downward thrust, have been **massive cuts in inventories.** Beginning in Q1 2001, the annualized rate of inventory decline (in $Billions, SAAR) by quarters was –27.1B, -38.3B and –61.9B. Q4 is thought to have reached a level of some –110B. **That would represent more than a 1% reduction in Q4 GDP!**

It is fashionable to compare this recession with previous post war recessions as a method of calibrating the recovery path from this recession. What is clear is that without the massive intervention of the Fed, real GDP would have plunged, probably quite sharply! That would have intensified the slowing of consumption, exacerbated the inventory correction and, no doubt, depressed investment for a number of quarters longer than is likely in this cycle. This may make prior comparisons to prior recessions dangerous. While Q3 GDP fell 1.3%, after having risen at only modest rates in the prior four quarters, Q4 GDP is likely to reverse course and decline only modestly, if at all. Q1 2002 will be improved as the high rates of inventory reduction decline (boosting GDP directly). It will do that on the back of a huge lift in consumer spending in October. Consumption in Q4 will surely rise to 2.5 or 3% matching the average quarterly increases of LH 2000 and FH 2001.

The consumer was lured back into the game after the virtual stoppage in the last month of Q3, stimulated by lower interest rates, inventory clearing sales of durables and soft goods, tax rebates and rate rollbacks, sharply declining energy prices, and **the very process of deflation** that has been eroding corporate pricing power. **The deflation story has a double edge.** Price declines weaken corporate profits but they maintain real spending power of consumers, during a period of weakened employment. The key to recovery will be the consumer, as economic history shows.

The Consumer is King

The consumer has actually been at the centerpiece of the Fed's strategy. Lower interest rates (or more liquidity), depending upon how one wants to measure the impact of monetary policy, loosened the purse of consumers. A vigorous politico-military response to Terrorism also has helped to improve confidence, but declining prices of goods and energy as well as interest rates have helped. Ultimately, in order to restore a reasonable level of private domestic investment, however, the path of forward consumption has to become more certain. Businesses have to expect they can sell the goods and services that new machines and technologies can produce. While it is now fairly certain that Q12002 is likely to produce positive real GDP growth, the question now is can the positive path be sustained? Analysts are divided on this issue with some maintaining that the typical pattern of recovery in nearly all of the post war recessions has been a **double dip.**

A Double Dip in our future?

The growth rate of GDP (QonQ) in Q12002 seems to be in dispute with optimists now claiming as much as 3%

Real GDP Change During Recessions

(Annualized % change from preceding period)

Recession	Starting Date	1st Qtr	2nd Qtr	3rd Qtr	4th Qtr	5th Qtr	6th Qtr	7th Qtr
1957–58	2Q57	–0.9	**4.0**	–4.1	–10.3			
1960	2Q60	–2.0	**0.7**	–5.0				
1969–70	4Q69	–1.9	–0.6	**0.8**	**3.6**	–4.2		
1973–75	3Q73	–1.6	**3.4**	–3.0	**1.1**	–4.4	–2.2	–5.0
1981–82	2Q81	–2.8	**4.9**	–4.6	–6.5	**1.7**	–1.9	
1990–91	3Q90	–0.7	–3.2	–2.0				
2001–?	3Q01	–1.3						

Note: Figures in bold denote false-starts to subsequent economic recovery
Source: U.S. Department of Commerce, Bureau of Economic Analysis

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growth, while other see growth rates at 1% or less. The high side estimates are based upon a strong inventory rebound and slowing cuts in investment spending. In addition, government spending will increase with more of the budgeted increases flowing into the pipeline.

Stephen Roach, Chief Economist of Morgan Stanley, has recently made the case for a **double dip** ("DD") pattern of recovery and that case was amplified by an appeal to Austrian business cycle theory written by Barton Biggs.[1] What gives rise to the DD pattern is that while the 'inventory' recovery drives GDP up "statistically," there is a lack of follow through from consumption and later, investment spending. In order to regain true traction, the consumer has to come into the picture in a steady manner and that requires sufficient income maintenance and growth to allow for a normal expansion in consumer demand. Were consumer demand to fall into place quickly, it would be reasonable to expect the business sector to follow with increased needs for capital goods and inventory. What is 'reasonable' this time?

The traditional Austrian view of the Credit Cycle is that low interest rates (market rates below the 'natural rate') will induce an over-expansion in the capital stock and excessive consumer spending. To finance that boom, credit is expanded and the debt/equity ratio of the private economy rises to an unsupportable level. Once the Bust begins, a 'natural' process of debt liquidation wipes out over-extended firms and households until sustainable levels of debt are reached that allow spending to begin to rise again. In effect, along with the 'natural rate,' we have a 'natural' cycle. Without a 'cleanout,' the Austrian theorists claim there is insufficient tinder for the next boom and recovery is a start and stop affair.

The counterpart of this Boom/Bust cycle, in a modern equity market context, is rising earnings fueled by expansion, a period of euphoric stock prices and rising productivity. Extrapolated, it appears to be a Golden Age until the burden of debt and paltry returns to capital finally force retrenchment. Consumers slow down their buying; business begins to accumulate inventory; investment spending slows and then declines and the previous high valuation of assets collapses. What is different this time? The answer is a very activist Monetary Policy that has been used to bring the consumer back into the game at an earlier stage. Will it work?

A "V" in the "U"

In our view, the economy was in the process of making a bottom during the late summer, but the **9-11 Attack** first aborted the process, and then the political and economic response to the tragedy restored some sense of stability to consumer spending. The economy was already in recession although it generated a peculiar pattern of recession indicators.[2] In addition, the Fed jumped in with even more ease, adding to the incentives already supplied. So to speak, the economy got a V inserted into the U that was already evolving. The economy was accelerated downward, and now it is accelerating upward.

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[1] Stephen Roach, "Double Dip Alert," and Barton Biggs, "Greenspan's Recession," **Morgan Stanley Investment Perspectives**, January 7, 2002.

[2] The NBER designation did not rely on a negative GDP reading when it dated the recession beginning in March 2001. It relied instead on industrial production, capacity utilization and the fall in job creation.

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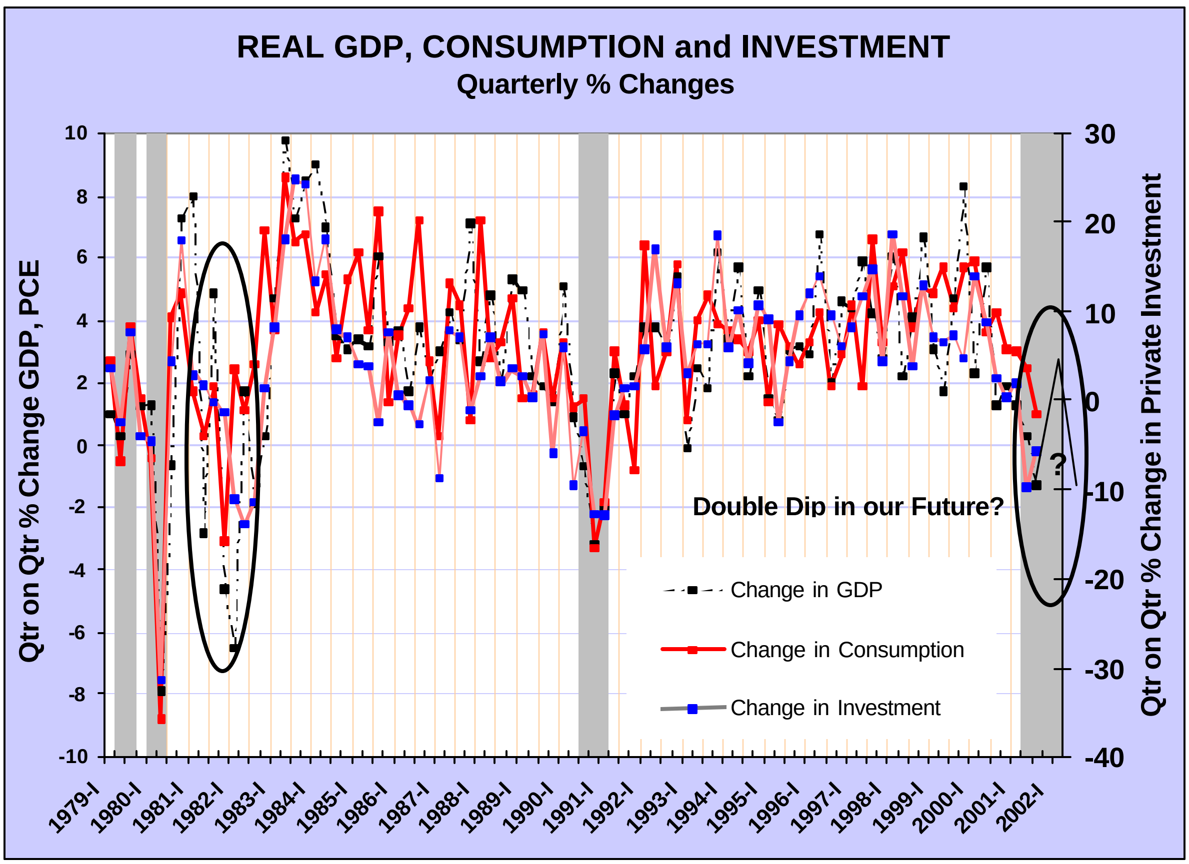
Stripped of the rhetoric surrounding the Greenspan halo and those who wish it removed, this cycle is different, if only by the speed and magnitude of the policy responses. Unfortunately, there is no way to be sure how much impact **extensive monetary ease, a sharp fiscal expansion, falling prices of consumer durables and non-durables and the sharp impact of falling energy prices** can have in altering a traditional cyclic process. At this stage, it appears to be working, although the quality of growth in QI2002, dominated as it is by inventory behavior, is suspect. There is also the fear that even if this policy response 'cures' the current ailments, insufficient 'clean out' will occur and new problems will emerge shortly. That is a different kind of 'double dip,' which we will not address now.



The equity market has had a very sharp V rally following the policy stimuli and the confidence that sprang from a vigorous foreign policy and determined military actions. Q12002 has already been discounted and perhaps the process of undoing excess is at work in the market as a patient search for realistic earnings capabilities takes place. The market must also digest a coming shift in Fed policy to neutral, and then assess how soon the Fed will begin to brake. We think that is quite a number of months in the future, although we believe easing will now stop. Double dip? Maybe, but much of that will be in the 'arithmetic of growth accounting.' The process of recovery has begun. It will get stronger over 2002. The consumer is the key to keeping the

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process smooth. If the consumer falls back, the economy could easily slip into further quarters of negative growth. Stabilized economic growth will require a reasonable rate of expansion in consumer expenditure that itself will induce better expectations for business to add to inventory and newer pieces of capital to remain competitive.

The Global Economy and the Japanese Endgame

The last element in the puzzle is the global economy. Europe is bottoming out and some of non-Japan Asia has already responded to the better performance in the U.S. during Q42001. That will reinforce positive growth measures in the U.S. Yet, one immense problem remains---Japan.

Japan may now be reaching the end of its ability to manage its tattered financial situation. The Yen has already begun to depreciate, causing ripples of concern throughout non-Japan Asia. The political economy of Japan has prevented a vigorous, rational attack on the financial problems of Japan, let alone other structural impediments to regaining growth. Japan, and ultimately the rest of the world, is waiting for the last shoe to drop.

It is often remarked that large cyclical disturbances create an environment in which a financial accident can more easily occur. Japan could be the accident waiting to happen. The Double Dip argument was based on purely domestic considerations, but a more globalized economy means that a financial accident in Japan could easily have serious repercussions in the U.S. Unfortunately, timing the Japanese Endgame has baffled traders for years.