ECONOMIC AND FINANCIAL DIGEST

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Is This Time Different?

John Maynard Keynes once said, "When the facts change, I change my mind." More than sixty years later, an increasing number of economists are taking that message to heart, changing their near-term outlook for the economy. Happily, the changes are for the better, as most are ratcheting up their growth estimates. The reason: the facts are changing. As the year began, the economy had just stumbled out of a nearly stagnant fourth quarter, when GDP registered virtually no increase. Things did not look promising in January, as job growth and consumer spending slowed sharply. With the growth-killing sequestration and higher payroll taxes on the books and gasoline prices spiking, the widespread view was that another quarter or two of tepid growth loomed ahead.

But a funny thing happened on the road to economic perdition. Suddenly the potholes filled up and the speed bumps got smoother, paving the way for a faster drive. Companies added far more workers to payrolls in February than expected. Consumers stepped up spending; and businesses started rebuilding inventories, which were drawn down sharply late last year in response to gloomy forecasts. Meanwhile, the nascent strength in some traditional cyclical catalysts gained momentum. The housing recovery continued to strengthen and auto sales remained in high gear. By late March, economists had upped their first-quarter forecast, with some putting the growth rate in the 2 ½ to 3 percent range.

That would be a rarified pace for the underperforming recovery. In the fourteen quarters since the recession ended, a 2-½ percent growth rate has been exceeded only four times. That's a dismal track record compared to the 4.9 percent average growth rate of previous postwar upturns; it does not even rise to the 3 percent average for all years since 1960, including recessions. Worse, many skeptics doubt that the faster pace, even if it materializes, can be maintained, recalling the previous brief episodes of strength that melted away during the recovery. Indeed, the full drag from the sequester and higher taxes may not be felt until later in spring and summer. It would be foolhardy to deny that past patterns won't be repeated, but there are reasons to believe that this time, things may really be different.

Joy On Wall Street

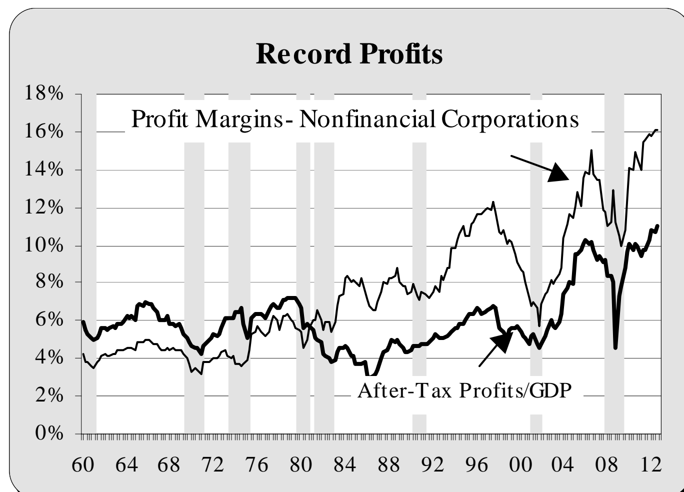
Just as scores of pundits claimed the economy would be in for another sub-par year in 2013, so too did they deride prospects for the stock market as the year began. After all, a languishing economy suggests that profits would suffer, depriving stock prices of its lifeblood. Of course, the same was said prior to last year, when the stock market registered a sturdy 15 percent gain even as the economy did indeed languish, growing by a tepid 2.2 percent. Stock prices, in fact, have surged by more than 120 percent since early 2009 – with the Dow Jones Industrial Average hitting a record high in March – despite the economy's lackluster performance over the period. It is no coincidence that the exuberance on Wall Street is not shared by the denizens on Main Street.

But while the disconnect between Main Street and Wall Street has been strikingly evident, the link between stock prices and profits has remained firmly intact. True, the growth in profits has slowed, and even turned down slightly late last year for nonfinancial corporations. But margins, the gauge that analysts and investors watch closely as a measure of profitability and valuations, remained at their all-time highs. In the third quarter, nonfinancial corporations generated 16.1 cents of profit for each dollar of revenue, dwarfing previous cyclical peaks by a considerable margin.

What this highlights is an even more astonishing disconnect – that between profits and the economy's performance. Just as margins have hit an all-time high, so too have profits as a share of GDP or, for that matter, any other measure of national income. Simply put, corporations have been eating the economy's lunch, feasting off of the time-honored benefits that the early stages of a recovery provide – stronger productivity, cheap labor, low borrowing costs and, until recently, a weaker dollar that promotes exports. The difference this time is the extreme amount of benefits that businesses have gobbled up.

Waning Productivity

To be sure, this is not a disconnect that can be sustained



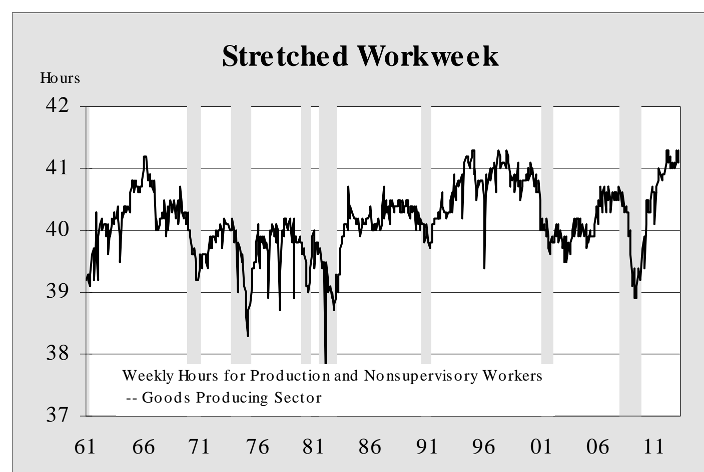
forever. The forces that underpin the relatively faster rise in profits eventually recede as a recovery matures, taking some of the air out of bloated margins. The deflation may be particularly acute this time, if only because of the extreme amount of air that has been sucked out of labor. Because the plunge in employment far exceeded the fall in output during the Great Recession, companies entered the recovery with a lean and mean workforce. As the recovery got underway, they were able to squeeze an enormous amount of additional output from existing workers. The result: more of the revenues flowed to the bottom line, and less to labor.

This pattern is typical of business cycles. Companies are understandably cautious at the start of a recovery, reluctant to expand payrolls until they are confident the upturn in sustained. Over time, however, there is just so much productivity that can be squeezed out of labor and it becomes necessary to hire additional workers. As the pool of unemployed workers is whittled down, the less skilled and experienced ones are taken on, resulting in slowing productivity gains. This, together with the enhanced ability of workers to bargain for higher wages, leads to increased unit labor costs that eventually cut into profit margins.

By all accounts, the record-setting profit margins achieved during the recovery have been accomplished more through controlling costs – particularly labor costs – than through revenue growth. Put another way, the bottom line has increased much faster than the top line. But in time-honored cyclical fashion, that dynamic may be in the process of changing. Nonfarm productivity fell by a 2 percent annual rate in last year's fourth quarter, and unit labor costs jumped by 4.6 percent. The first quarter of this year is not yet available, but there is one telltale sign that companies are reaching the limit of what can be squeezed out of the existing workforce: the workload is piling up. In the goods producing sector, the average workweek at 41.3 hours equaled a postwar high in February.

Workers Should Benefit

So why is this good for the economy? In the long run, of course, weaker productivity is not a positive development, as it results in lower living standards for Americans and reduced U.S. competitiveness. As a short-term engine of growth, however, there is much to be said for it. Just as stronger productivity enables companies to use less labor, the flip side is also true: weaker productivity means that companies need more workers to generate a unit of output. Put another way, with cost cutting no longer as easy to come by, workers may now start to get a bigger slice of the economic pie.



And this is exactly what is needed to jump-start the recovery into a speedier gear. The reason for the disconnect between Main Street and Wall Street is simply that hiring and household incomes have languished even as profits thrived, driving up stock prices. But having gotten as much as possible out of labor productivity, companies have started to accelerate hiring. That, in turn, portends fatter paychecks and stronger consumption, which begets even stronger demand for labor.

The good news is that better times on Main Street need not detract from the fortunes of Wall Street – or its lifeblood, business profits. True, higher labor costs should cut into margins, which is probably already happening. But stronger income gains and consumption imply that the top line, or revenues, will also be growing faster. How Wall Street evaluates the trade-off between margin compression and stronger growth in gross profits remains to be seen. But increased revenues means that companies will have the resources to expand investment outlays as well as payrolls – a win-win for the economy

More Firepower

What's more, companies have built up an enormous pile of cash – a record $1.8 trillion in liquid assets at the end of last year — to cushion the effects of a margin compression. If the recent increase in job growth is sustained and jump-starts consumer demand, that might just be the catalyst that spurs businesses to unlock their cash hoard and go on a long awaited spending spree. Another incentive: virtually all of the excess slack in industrial companies has been used up. After plunging to a postwar low of 66.8 percent during the Great Recession, capacity utilization has climbed all the way back to within a percentage point of its 80.7 percent historical average.

Unlike past signs of strengths that have fizzled out, the economy has more going for it this time. Not only is the steady improvement in the job market underpinning the surprising resilience of consumer spending, households have made great strides towards repairing damaged balance sheets. Thanks to the muscular stock market along with the revival in home prices and debt liquidations, all but $1.4 trillion of the $16 trillion plunge in net worth caused by the financial crisis and housing bust was recovered by the end of last year. The housing revival – which is gaining momentum – is a particularly significant growth driver, providing critical support that had been missing earlier in the recovery.

So is this time really different? While there are compelling reasons to be optimistic, some things never seem to change. The persistent threat of another euro-zone conflagration – highlighted by the recent Cyprus-related debacle – still poses risks to the global economy and financial markets. Meanwhile, Washington continues to lurch from one fiscal crisis to another, and each ends with more growth-dampening austerity. No doubt, the sequestration will create another speedbump for the economy to navigate in the second quarter, so a setback could very well be in the cards. But there is more firepower underpinning the economy than earlier in the recovery. That's a big change in facts, which lends credibility to the recent batch of stronger forecasts.

KEY ECONOMIC AND FINANCIAL INDICATORS

FINANCIAL INDICATORS*

	February	January	December	Novembe	October	September	August	12-Month Range High	Low
Prime Rate	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25
3-Month CD Rate	0.22	0.23	0.24	0.23	0.23	0.24	0.26	0.32	0.22
3-Month Treasury Bill Rate	0.10	0.07	0.07	0.09	0.10	0.11	0.10	0.11	0.07
5-Year Treasury Note Rate	0.85	0.81	0.70	0.67	0.71	0.67	0.71	1.02	0.62
10-Year Treasury Note Rate	1.98	1.91	1.72	1.65	1.75	1.72	1.68	2.17	1.53
20-Year Treasury Bond Rate	2.78	2.68	2.47	2.39	2.51	2.49	2.40	2.94	2.22
Tax-Exempt Bond Yield	3.72	3.60	3.48	3.46	3.65	3.73	3.74	3.95	3.46
Corporate Bond Yield (AAA)	3.90	3.80	3.65	3.50	3.47	3.49	3.48	3.99	3.40
Dow Jones Industrial average	13967	13615	13144	12896	13380	13419	13134	13967	12555
S&P 500 Index	1512	1480	1422	1395	1438	1443	1403	1512	1323
Dividend Yield (S&P)	2.21	2.20	2.27	2.28	2.27	2.22	2.25	2.37	2.14
P/E Ratio (S&P)	15.0	14.8	14.2	14.3	14.3	14.6	14.3	15.0	13.2
Dollar Exchange Rate (vs. Major Currencies)	74.6	73.5	73.1	73.6	72.7	72.6	74.2	75.2	72.6

* Monthly Averages

ECONOMIC INDICATORS

	February	January	December	Novembe	October	September	August	12-Month Range High	Low
Housing Starts (In Thousands)	917	910	982	841	889	843	750	982	706
New Home Sales (Thousands of Units)		437	378	393	364	379	367	437	352
New Home Prices (Thousands of Dollars)		226	250	245	247	255	253	255	226
Retail Sales (% Change Year Ago)	4.6	4.2	4.8	4.2	3.9	5.4	4.9	6.3	3.5
Industrial Production (% Change Year Ago)	2.5	2.3	2.9	3.5	2.2	3.0	3.0	5.0	2.2
Operating Rate (% of Capacity)	79.6	79.2	79.3	79.2	78.1	78.4	78.3	79.6	78.1
Inventory Sales Ratio (Months)		1.29	1.28	1.28	1.28	1.28	1.29	1.29	1.26
Real Gross Domestic Product (Annual % Change)			0.1			3.1		3.1	0.1
Unemployment Rate (Percent)	7.7	7.9	7.9	7.8	7.9	7.8	8.1	8.2	7.7
Payroll Employment (Change in Thousands)	236	119	219	247	160	138	165	247	87
Personal Income (% Change Year Ago)		2.2	7.0	4.6	3.3	3.6	3.3	7.0	2.2
Savings Rate (Percent of Disposable Income)		2.4	6.4	4	3.4	3.3	3.6	6.4	2.4
Hourly Earnings (% Change Year Ago)	2.1	2.1	2.1	1.9	1.6	1.9	1.7	2.1	1.6
Consumer Credit (Change in Mil. Of Dollars)		16151	15099	16103	14221	11388	18672	19682	-1983
Consumer Prices (% Change Year Ago)	2.0	1.6	1.8	1.8	2.2	2.0	1.7	2.7	1.4
CPI Less Food & Energy (% Change Year Ago)	2.0	1.9	1.9	1.9	2.0	2.0	1.9	2.3	1.9
Wholesale Prices (% Change Year Ago)	1.7	1.4	1.3	1.5	2.3	2.1	2.0	2.8	0.5