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Economic Outlook 2007

A Deloitte Research Brief

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Economic Outlook 2007

The Case for a Soft Landing

“The dog barks but the caravan moves on” is an old Iranian proverb that in many ways characterizes the economy over the past five years of economic expansion. Over that period of time, packs of dogs have barked and yet the economy has moved on, continuing to grow despite many challenges. Beginning with market crashes, fears of pandemics and terrorism, to war, accounting scandals and Wall Street malfeasance, nothing has kept the economy from growing since the post-9/11 recovery began in late 2001. And that growth was not confined to the United States; the past five years showed more aggregate global economic growth than any other five-year period since World War II.

The scenario today is no different. The latest worries center around the collapse of the housing market, the inversion of the yield curve in the Treasury market, the size of the trade deficits and the health of consumer finances. Are these enough to bring down the economy, or will the caravan once again move on?

Can the Housing Market Take Down the Economy?

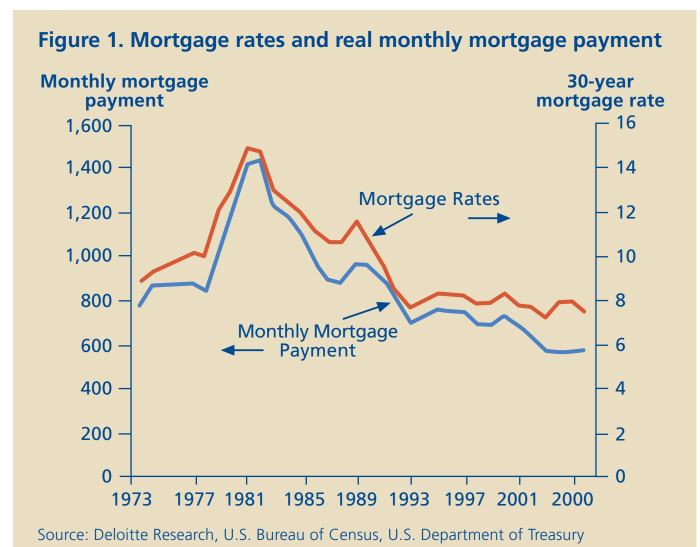
There is no question that the housing market has been suffering. Starts are down, prices have fallen, inventories are high and home sales are soft. But is the downturn in housing the breaking of a price bubble, or just the normal workings of the market? And given the downturn in housing, how much is the rest of the economy at risk?

In 2006, housing construction steadily declined and the conventional wisdom has it continuing to do so in 2007. Whether housing continues to decline depends on several factors, including interest rates and future home price movements. More than any single segment of the economy, housing is very sensitive to interest rate changes. A small rise in interest rates can significantly reduce the purchasing power of buyers. While much has been made about the rise in housing prices, from the consumer’s cash flow perspective, housing in real terms is as cheap now as it was over 30 years ago.

What figure 1 shows is the inflation-adjusted mortgage payment made on the median priced home with a 20 percent down payment on a 30-year mortgage. As mortgage rates rise, the payment rises with them, reducing consumer home buying purchasing power. The steady decline in mortgage rates over the past 25 years has greatly reduced the cost of carrying a mortgage to the average household. As a result, the share of households owning homes has risen from 64.5 percent in 1973 to 69 percent in 2006. Far from being a bubble, the rise in home prices over the past decade reflects the positive effects of falling mortgage rates on consumer purchasing power and a steady growth in the number of households that are homeowners.

With mortgage rates up in 2006, it should not be surprising that we are seeing a correction in the housing market. For the year, housing has shaved a full percentage point off of real GDP growth. With mortgage rates stable and in some cases actually easing, housing sales rebounded modestly as 2006 came to an end. With housing starts down sharply over the past year and inventories of unsold houses stabilizing, we could see a tightening of the housing market this spring and an unexpected rise in home prices as stable demand begins to take down the excess supply. Rising home prices give consumers a source of future refinance money and have a positive impact on consumer spending. While housing may not add to GDP growth in 2007 the way it did in the first half of this decade, it will not be the drag on the economy it was in 2006.

Figure 1. Mortgage rates and real monthly mortgage payment



Source: Deloitte Research, U.S. Bureau of Census, U.S. Department of Treasury

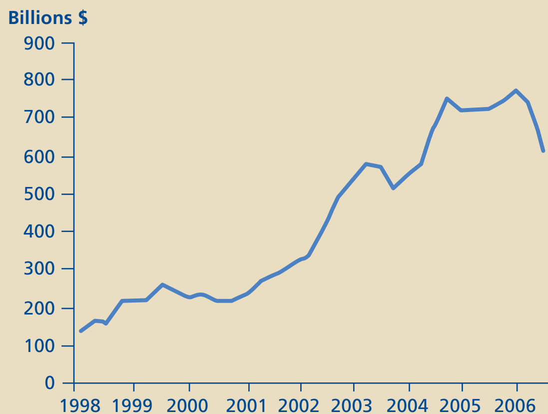
Weak housing bleeds out into the rest of the economy through loss of employment in the construction and real estate sectors and, most importantly, through reduced consumer spending. The loss of construction jobs alone in 2007 is likely to push up the jobless rate. While housing will stabilize in 2007, can the consumer continue to spend?

Can The Consumer Keep on Spending?

For the past five years, consumers have been the bulwark of the economy, spending in the face of declining confidence, terrorist attacks, financial market meltdowns and pandemic scares. They were able to do this by taking on record levels of debt, much of it coming from past appreciation in the values of their homes.

At its peak, home mortgage refinancing produced a windfall of more than $750 billion in household cash flow, nearly 14 percent of disposable personal income. With housing prices coming down, the level of mortgage refinancing has dropped sharply. The loss of refinancing money has led to all kinds of dire warnings about the impending collapse of consumer spending. If the consumer is going to continue on the merry spending way, what will take up the slack?

Figure 2. Mortgage equity withdrawal: four quarter moving totals

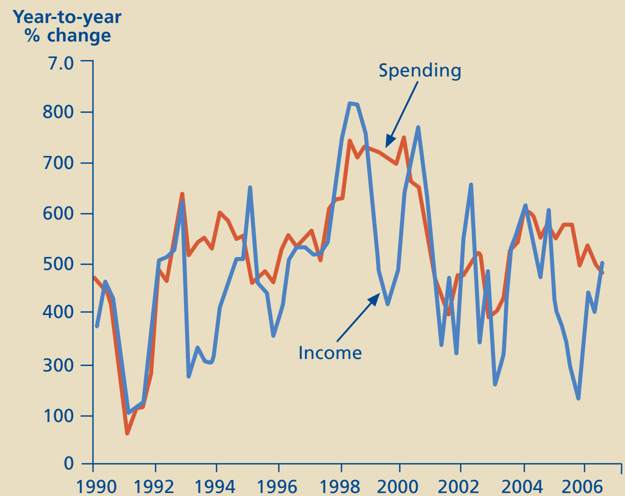


Source: U.S. Federal Reserve Board

One way could be from a rebound in refinance activity. As the year came to a close, the Mortgage Banker's Association refinance index rebounded from its summer lows. But what is a more certain source of future cash flow for the consumer is income from employment. As the economy entered the last recession late 2000, consumers were feeling some distress; real disposable income was slowing as job opportunities evaporated. Today, real disposable income is accelerating, having grown more than 3 percent from a year ago.

The rebound in real incomes has been driven by several factors. First, energy prices have fallen sharply from their mid-summer highs, giving a boost to consumer purchasing power. Second, solid job growth over the balance of 2006 added 2 million new jobs to the economy. And finally, as the labor market tightened, wages growth began to pick up. Spending tends to track income growth, except in times when income growth drops sharply, as it did in 1993, 1999 and in 2005 (see figure 3). During those periods, consumers fall back on savings and debt creation to maintain their pace of spending. With the rebound in income growth, the consumer need for additional debt will wane.

Figure 3. Inflation-adjusted consumer spending and income growth



Source: U.S. Bureau of Economic Analysis

Will Oil Prices Limit Growth?

Over the past six years, oil prices have steadily risen. Stronger demand from China and India has finally caught up with years of limited investment in drilling and new exploration. However, unlike past oil price hikes, this one has had only a modest impact on either real economic activity or inflation. The reason for this is simple: As a share of the economy, energy is less important today than at any time in the past 40 years. Rising energy productivity has limited the ability of rising oil prices to rock the economy.

What the recent rise in oil prices has done is to set off another round of investment in energy production, while dampening demand. This market response to higher oil prices will act to bring prices down in 2007. Already, the decline in oil prices since their peak last summer has given a boost to real consumer incomes. Further declines in oil prices going forward will provide additional lift to consumer purchasing power.

Will The Trade Deficit Sink the Economy?

"Nothing, however, can be more absurd than this whole doctrine of the balance of trade."

— Adam Smith

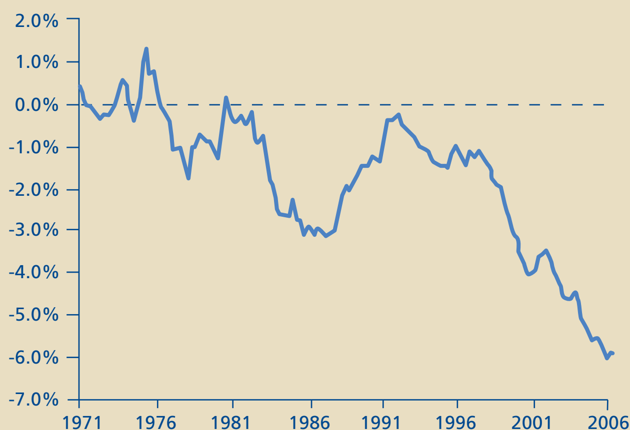
From the protectionists and the illiberal populists in the media we hear cries of despair over the trade deficit. It is either selling out American workers, leaving the next generation heavily indebted to foreigners, or the result of rapacious excess consumption on the part of Americans. Actually, neither is the case.

At the end of the day, trade and capital flows have to balance. If some foreign government is buying US Treasuries to bolster their currency reserves, then the United States has to offset that purchase by either similar asset purchases overseas or by running a trade deficit.

The steep decline in the trade deficit goes back to late 1998 (see figure 4). The Asian currency crisis was a bracing experience for countries like Thailand and South Korea. With limited currency reserves, they were forced to depreciate their currencies in the face of rampant speculation. For businesses that had liabilities in dollars but assets in the local currency, the result was catastrophic.

Since the Asian crisis, countries around the world have aggressively rebuilt their currency reserves through the purchase of dollar-denominated assets, usually US Treasury notes. The result has been a more stable global trading system, the strongest global growth in the post-World War II era and a large US trade deficit. As foreign demand for US assets begins to wane over the next couple of years, the US trade deficit will recede with it.

Figure 4. U.S. trade deficit as a share of GDP



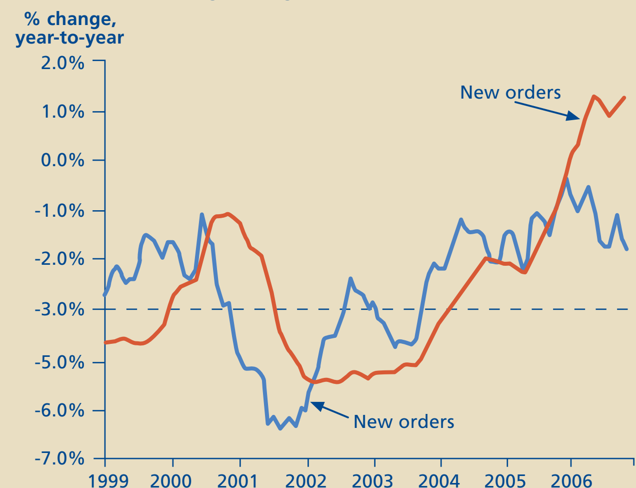
Source: U.S. Bureau of Economic Analysis

What will moderate the pace of transition to a lower trade deficit will be continued large purchases of US assets by China and by oil exporters like Saudi Arabia and Kuwait. China will continue to buy US Treasuries to slow the appreciation of its currency in order to sustain its large trade surpluses. And the oil exporters will continue to buy dollar-denominated assets as well. They simply do not have the ability to absorb the massive inflow of dollars into their own economies that is being generated by high oil prices. A reduction in oil prices will accelerate this process by reducing both the US trade deficit and the oil surpluses that need to be recycled.

Is Manufacturing in a Recession?

The news out of the auto sector is a steady stream of bleakness. Inventories are rising; sales growth has been sluggish, while rising gasoline prices makes it more difficult to sell larger, higher-margin vehicles. Construction-related manufacturing is also having its problems. With housing starts down sharply, there is simply less demand for all of the manufactured products that go into a new home. And yet, despite the problems in housing and autos, the US manufacturing sector continues to expand at a modest pace.

Figure 5. Durable goods manufacturing orders and backlogs: three-month moving average



Source: U.S. Bureau of Census

While the pace of new orders slowed toward the end of 2006, backlog for durable goods manufacturers remains robust, up more than 20 percent from a year ago (see figure 5). Orders have been particularly strong for new aircraft, and to a lesser degree, business equipment. Much of the information technology equipment put in place at the turn of the millennium is beginning to show its age. A new technology investment cycle over the next several years will provide support for business investment in 2007.

When the Bond Market Speaks, Should We Listen?

A number of years ago, one of the major brokerage houses had an ad campaign that went something like "when so-and-so speaks, people listen." It featured well–turned-out folks talking stocks over lunch in a busy restaurant, who suddenly went quiet when the sage words of investment advice were about to be revealed. Today, the bond market is speaking rather loudly but no one seems to be listening. Should we?

Over the course of the past two years, the Federal Reserve has steadily increased short-term interest rates. At the same time, long-term interest rates have fallen, resulting in a deeply inverted yield curve, the likes of which we have not seen since late 2000, just before the beginning of the last recession.

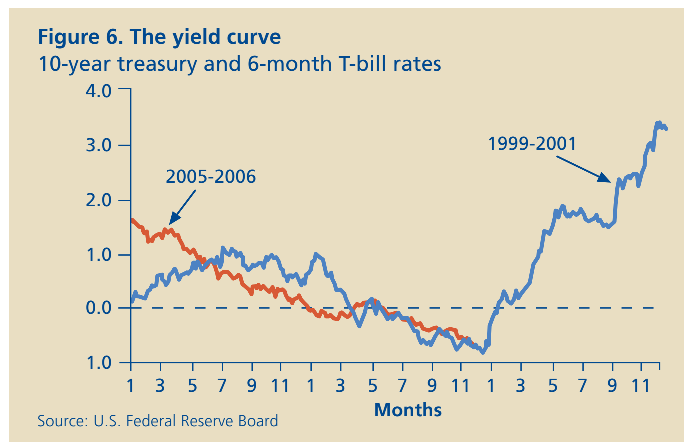


Figure 6. The yield curve
10-year treasury and 6-month T-bill rates

The yield curve is the difference between long and short term interest rates. Traditionally, the yield curve has a positive slope with long rates higher than short ones. Long rates are generally higher than short rates because, the longer the term of the loan, the bigger the risk lenders are taking on both inflation and the future health of the borrower. Banks have taken advantage of the difference in long and short rates to borrow short and lend long. When that difference goes away or turns negative, banks become less willing to lend and, at the very least, the economy slows.

Inverted Yield Curves and Recessions

The bond market has the best recession forecasting record of any single financial indicator. An inverted yield curve has preceded every post–World War II recession. There have, however, been two false alarms in 1966 and again in 1998 when the yield curve inverted but no recession followed. Over the past year, the yield curve has moved along a path that is very similar to the one it followed leading up to the 2001 recession. The current inverted position of the yield curve is comparable to where the bond market was in December 2000, just prior to the onset of the last recession.

Famed investor Sir John Templeton is supposed to have said that the four most dangerous words in investing are, "This time is different." In 2000, there were many forecasters who were insisting that this time was different. The tech boom, the federal government surpluses and the disconnect of the stock market, particularly NASDAQ, from the reality of earnings were all given as reasons why the economy had entered a new phase of unlimited growth and prosperity with forecasts of Dow 36,000 and even Dow 100,000 being commonplace.

Is This Time Different?

So is this time different? And if so, how is the economy different this time from 2000? As it turns out, quite a lot.

In 2000, the signature feature of the economy was a vastly overvalued stock market in the grip of irrational exuberance. The NASDAQ was a true financial bubble driven by excessive monetary liquidity and pure speculative behavior. Today, some would argue that the housing market has been in the grip of a similar speculative exuberance. The housing market has been in decline. But housing is a very different asset than technology stocks. You can always live in your home investment, something you cannot do with a tech stock. In the third quarter, housing took 1.2 percent off GDP growth. And yet, the economy still managed to post a growth rate of 2.2 percent.

The housing market may get worse but it is beginning to show some signs of stability. Mortgage applications are rising, home prices are stabilizing, and sales volume for new and existing homes were up in the closing months of 2006. The bust in housing has not had the ripple effects on the economy that the bursting of the NASDAQ bubble did.

In 2000, China played a small role in the Treasury market. Today it is a major player who needs to buy US Treasuries in order to maintain its currency peg. In the municipal bond market and high yield markets where China plays no roll, bond yields are not forecasting a recession as they did in 2000.

In 2000, the Federal Reserve, concerned about possible ill effects of the Y2K meltdown, flooded the markets with cash to provide liquidity; money was then aggressively drained by the Fed from the banking system in 2001. In 2005, money supply growth has been modest: there is no need for a draining of liquidity.

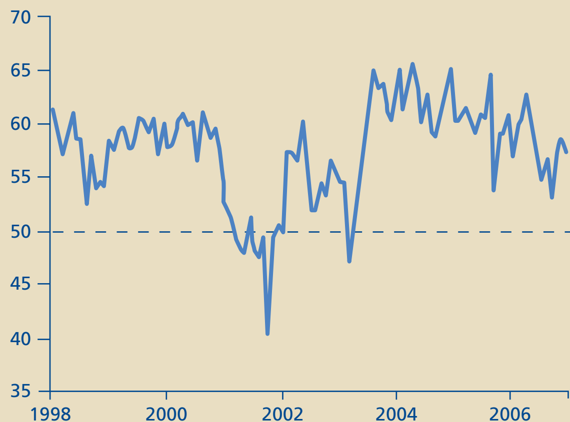
In 2000, business investment was hurt by the previous year's rush to implement Y2K solutions. Today, there is no comparable problem. In 2000, business investment was also hurt by growing business scandals, particularly in the areas of energy and telecommunications. No such scandals exist today.

In 2000, the stock market fell as the yield curve inverted. Today, the stock market has continued to rise in spite of the Treasury inversion. While the stock market does not have the forecasting record of the bond market, it is clearly anticipating future growth ahead. The reason the stock market is rising is that corporate profits are soaring, whereas in 2000, corporate profits had been falling for two years.

So What Keeps the Economy Going?

Service Industries Are Booming: While the challenges facing the manufacturing sector get a lot of financial press attention, the service sector is booming. Over the past 30 years, the share of the economy produced by services has grown precipitously.

Figure 7. Purchasing manager's index: service industries
Above 50=Growth; Below 50=Contraction



Source: Institute for Supply Management

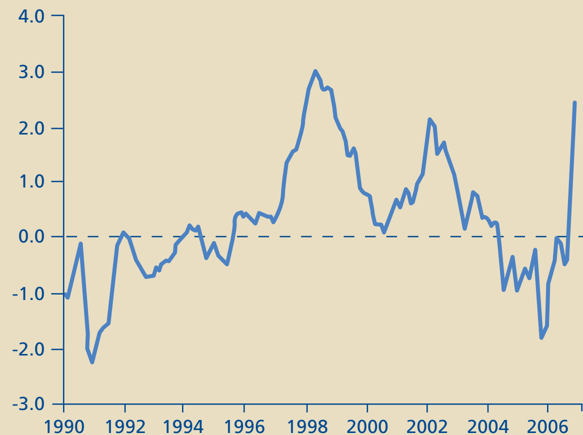
Services include everything from utilities and retail to financial services and health care. As the economy has become more information-driven and skills-based, services have grown. While growth has slowed from the torrid pace of 2004-5, it still remains robust.

Real Hourly Earnings Are Soaring: After taking a beating for the past three years, real hourly earnings are soaring. Up nearly 3 percent from a year ago as 2006 came to a close, real earnings are rising at a pace not seen since late 1998 (see figure 8).

The rise is being driven by a collapse in energy prices and a steady tightening of the labor market. While declining real earnings force consumers to reduce savings and increase debt in order to sustain the standard of living, a rise in real earnings allows them to boost savings and cut back on debt even as they continue to spend.

While weakness in top-line growth in 2000 led to layoffs, slower revenue growth today is not likely to produce layoffs as in the past. Companies have learned that rebuilding their labor force in a tight labor market can be a costly and difficult task. The desire to hold onto increasingly scarce talent is one of the factors that have produced record low rates of layoffs, as measured by initial unemployment claims and rising real earnings growth.

Figure 8. Real hourly earnings for non-supervisory workers
% change, year-to-year

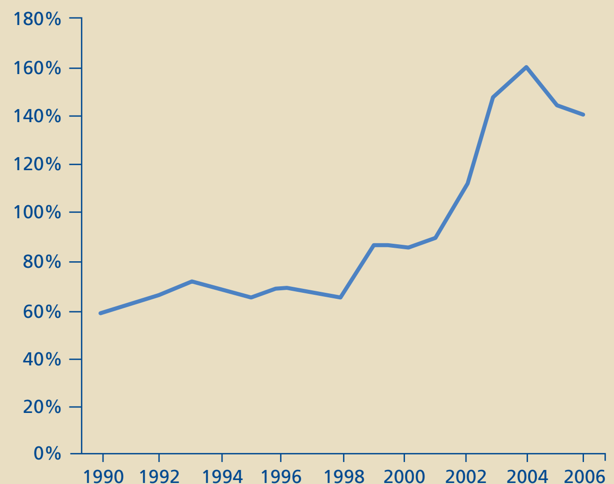


Source: U.S. Department of Labor

With record warm temperatures on the east coast and in Europe, energy prices have continued to tumble. At the same time, an unemployment rate of 4.5 percent points to an ever-tighter labor market and higher wages and benefits. And finally, an increase in the minimum wage will push the entire wage structure up as businesses recalibrate their pay scales to comply with the new law. These three economic fundamentals will combine to keep upward pressure on real hourly earnings this year.

Corporate Cash: In the same way that countries have built currency reserves to prevent speculation against their currencies, the US economy has also seen a substantial rise in corporate cash levels. As a share of corporate assets, cash is near a record high. The rise in corporate cash represents a significant increase in corporate risk aversion. It also represents a significant reduction in the volatility in the economy. Businesses are better positioned today to deal with instability than at any time in the post-World War II era.

Figure 9. Corporate cash as a share investment

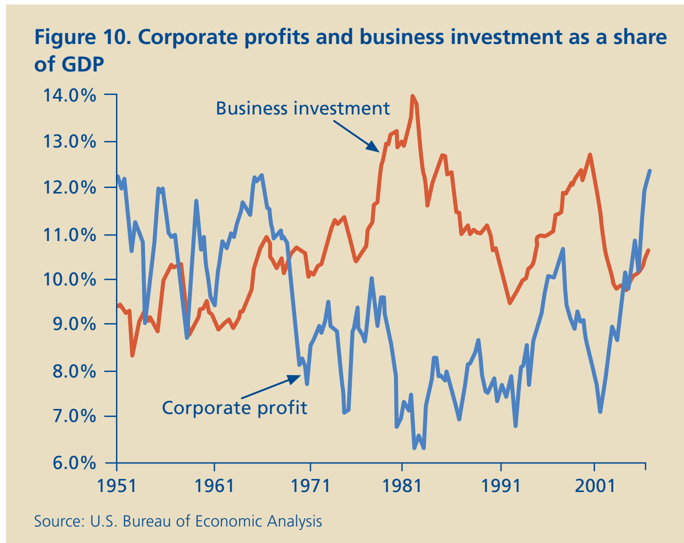


Source: Standard & Poor's

With cash levels high and stock valuations modest, corporations are also in a better position to engage in merger and acquisition activity.

Profit Growth and Business Investment: As a share of GDP, corporate profits have never been higher. The boom in corporate profits has not produced the kind of growth in corporate investment that we have seen in the past. Businesses have taken a much more conservative approach to expansion, similar to what we saw in the 1950s and early 1960s. As a result, corporate balance sheets are getting much stronger even as expansion opportunities are being limited.

Figure 10. Corporate profits and business investment as a share of GDP



Source: U.S. Bureau of Economic Analysis

Productivity Growth: For much of this recovery, employment growth has been mediocre. The primary reason for weak job growth has been a combination of factors, including robust productivity growth and weak growth in the labor force. With fewer people looking for work, as reflected in the low unemployment rate, employers have had to invest in improvements in productivity. In that regard, they have been very successful. Productivity growth in this recovery has been very strong.

While productivity does not get much attention in the business press, few measures of economic activity better capture the performance of the economy or the effectiveness of management. Higher productivity growth is the key to raising the standard of living and keeping inflation in check. One hundred years ago, 40 percent of the American consumer spending went to food; today the food share is 12 percent. The decline is due entirely to rising productivity, increased incomes and the decline in the relative price of food.

What has been unusual about the current recovery is that the rise in productivity growth has produced a significant rise in profitability but only a modest rise in worker income. Some of the "missing" gains in income have come in the form of increased tax-free benefits. But even taking that into account, the return on capital has done much better in this recovery than the return on labor. This imbalance between capital and labor is not likely to persist for long. As the labor market continues to tighten, real wages will get pushed up.

Over the past two years, the pace of productivity growth has slowed, a common characteristic of an aging business cycle. However, even with the slowdown, productivity growth remains above growth levels achieved during most of the past 25 years.

Figure 11. Non-farm productivity growth: two-year moving average

Source: Bureau of Economic Analysis

Conclusions and Observations

In the mid-1980s and again in the mid-1990s, the Federal Reserve tightened credit policy in the face of rising inflation. In both cases, the economy slowed but did not fall into recession. Once again, the economy has slowed in the face of Fed tightening aimed at dampening inflation. Business cycles do not last forever. Eventually we will have a recession.

The last two recoveries lasted 96 and 108 months respectively. By comparison, the current recovery is middle-aged at 61 months. While growth will slow in 2007, there is no reason to think, notwithstanding what the bond market is saying, that the economy will fall into recession. Expect real GDP growth to average better than 2.5 percent, with real consumer spending doing slightly better.

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As chief economist for Deloitte Research, Carl Steidtmann is a writer, lecturer and consultant on a wide range of issues including technology, culture and economics. He has been a student, a teacher, a systems engineer, a management consultant and a Wall Street economist. His research has been quoted extensively in the Wall Street Journal, The New York Times, Business Week and USA Today. He was on the ten-year plan at the University of Colorado where he earned four different degrees in three different subjects: history, statistics and economics.

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