

THE ECONOMIC OUTLOOK: HALF-SPEED AHEAD

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April 27, 2012

The Pace Of The Recovery Has Improved

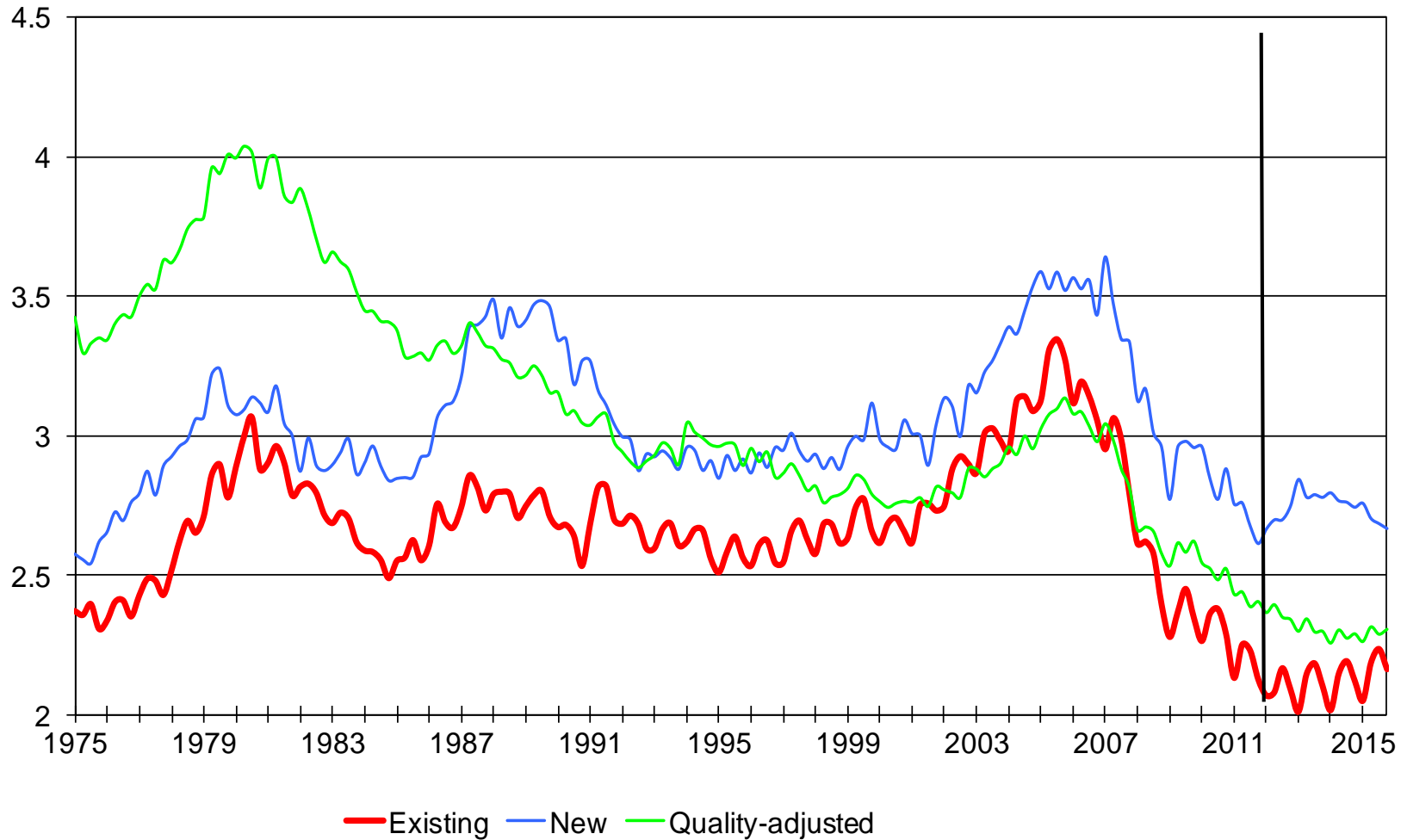
- A recovery has begun, but is likely to remain weak.
- Housing now appears to be stabilizing, although prices are still falling. Sales are up, but still very weak by normal standards.
- Overseas partners are recovering, helping exports, but developed economies remain slow. The financial problems in Europe add to risks from overseas.
- Signs of a slowdown in China add to fears of weaker exports.
- The fiscal stimulus helped boost the economy, but is being withdrawn. The 2013 budget is very uncertain, as is any extension of the Bush tax cuts.
- Private nonresidential construction is still weak
- Consumers aren't bouncing back as quickly as usual, because of still-high debt levels.
- Another recession is possible if the European debt crisis spreads to the U.S., there's sharp near-term austerity at home, if financial markets lock up again, or oil prices spike on Middle East turmoil.
- The risk of another recession is now 20%, down from 25% in February

The Housing Bubble

- **Housing was too affordable, thanks to low mortgage rates**
- **Ratio of home price to income hit a record high in 2007.**
- **We built too many houses at too high prices**
- **Starts and sales dropped sharply**
- **Defaults have soared, cutting back on willingness to lend**
- **Prices are down 34.5% from their peak, a new record low. The price/income ratio remains below its historical average**
- **Starts and sales are recovering**
- **But prices are likely to drop back through spring.**

Home Prices Were Too High

(Ratio of average home price to average household disposable income)

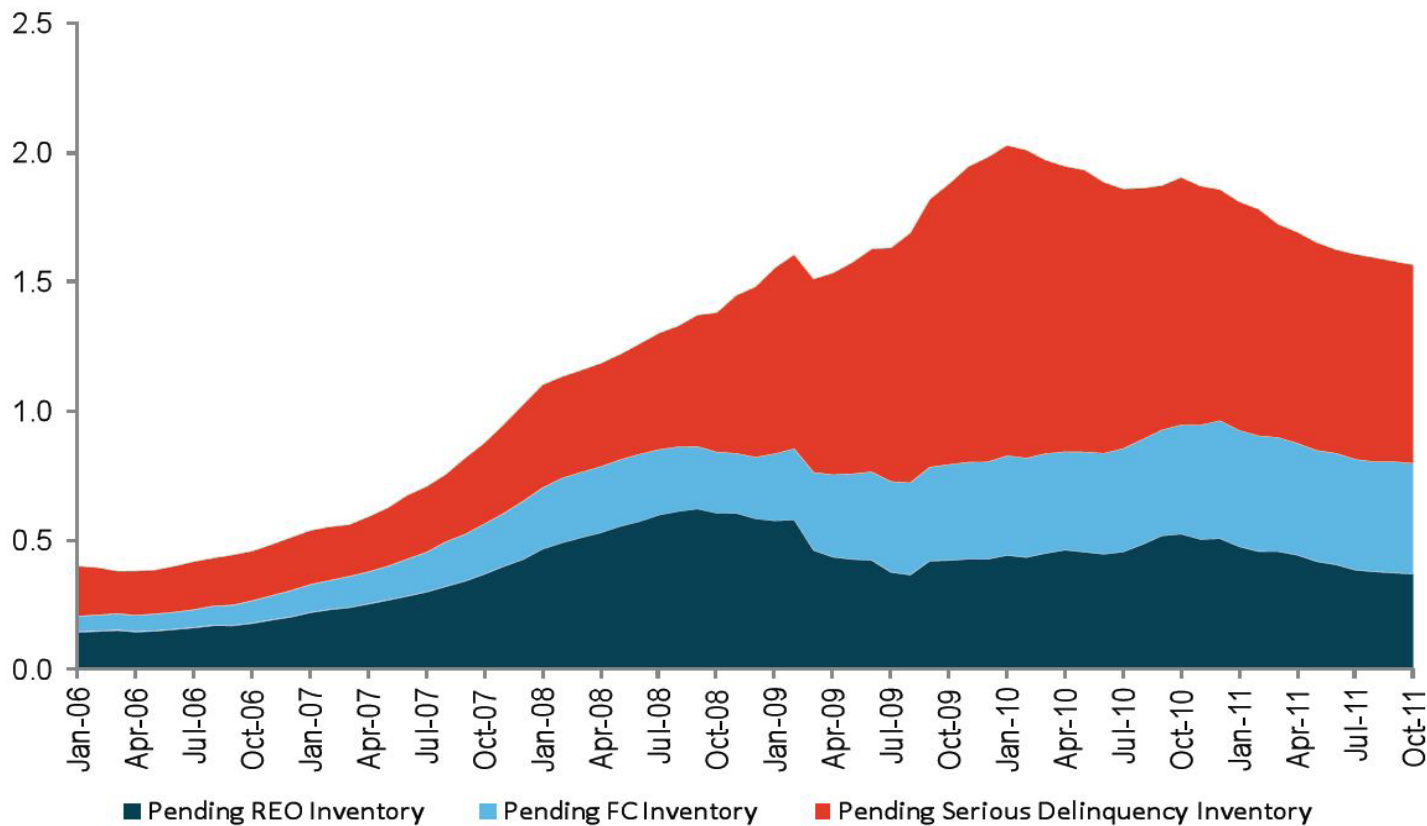


Source: Bureau of Economic Analysis and Census Bureau

And Shadow Inventory Is High

Figure 1: Shadow Inventory Detail

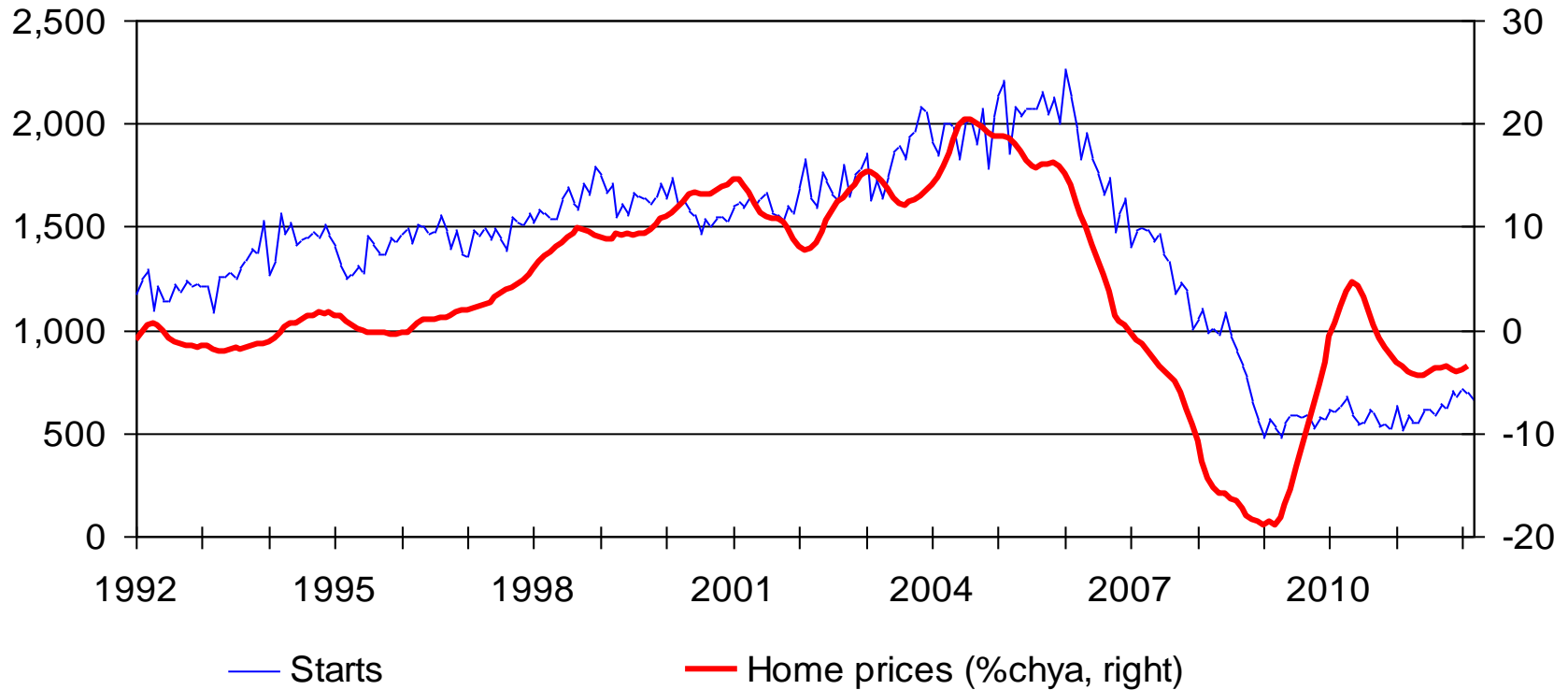
Count in Millions, Not Seasonally Adjusted



Source: CoreLogic October 2011

The Housing Market Cycle

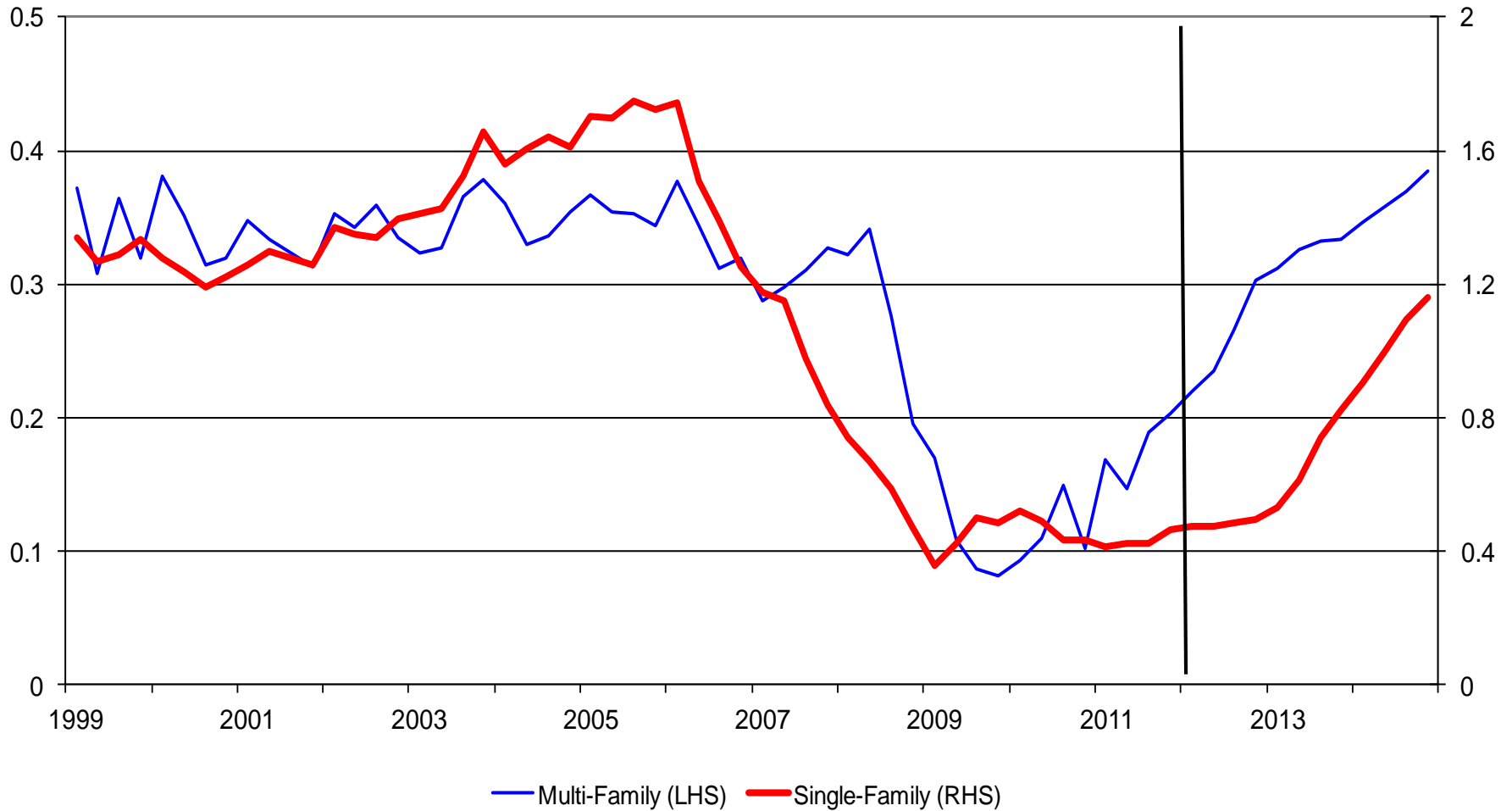
(Housing starts (1000) and 12-month % change in home prices (S&P/Case-Shiller, Fed 2012))



Source: Standard & Poor's and Census Bureau

Multi-Family Starts Outpace Single-Family Starts

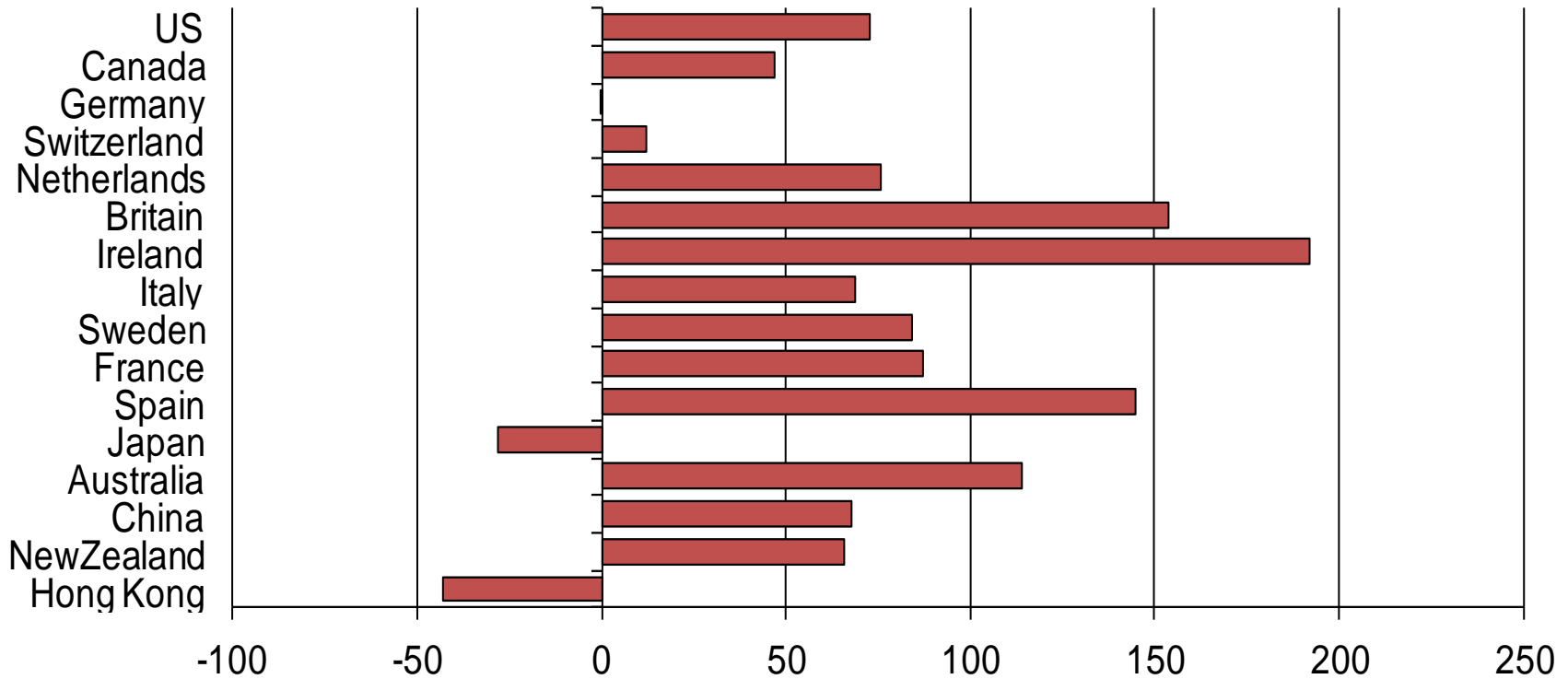
(Housing starts (millions))



Source: Standard & Poor's and Census Bureau

Bubbles Were Almost Everywhere

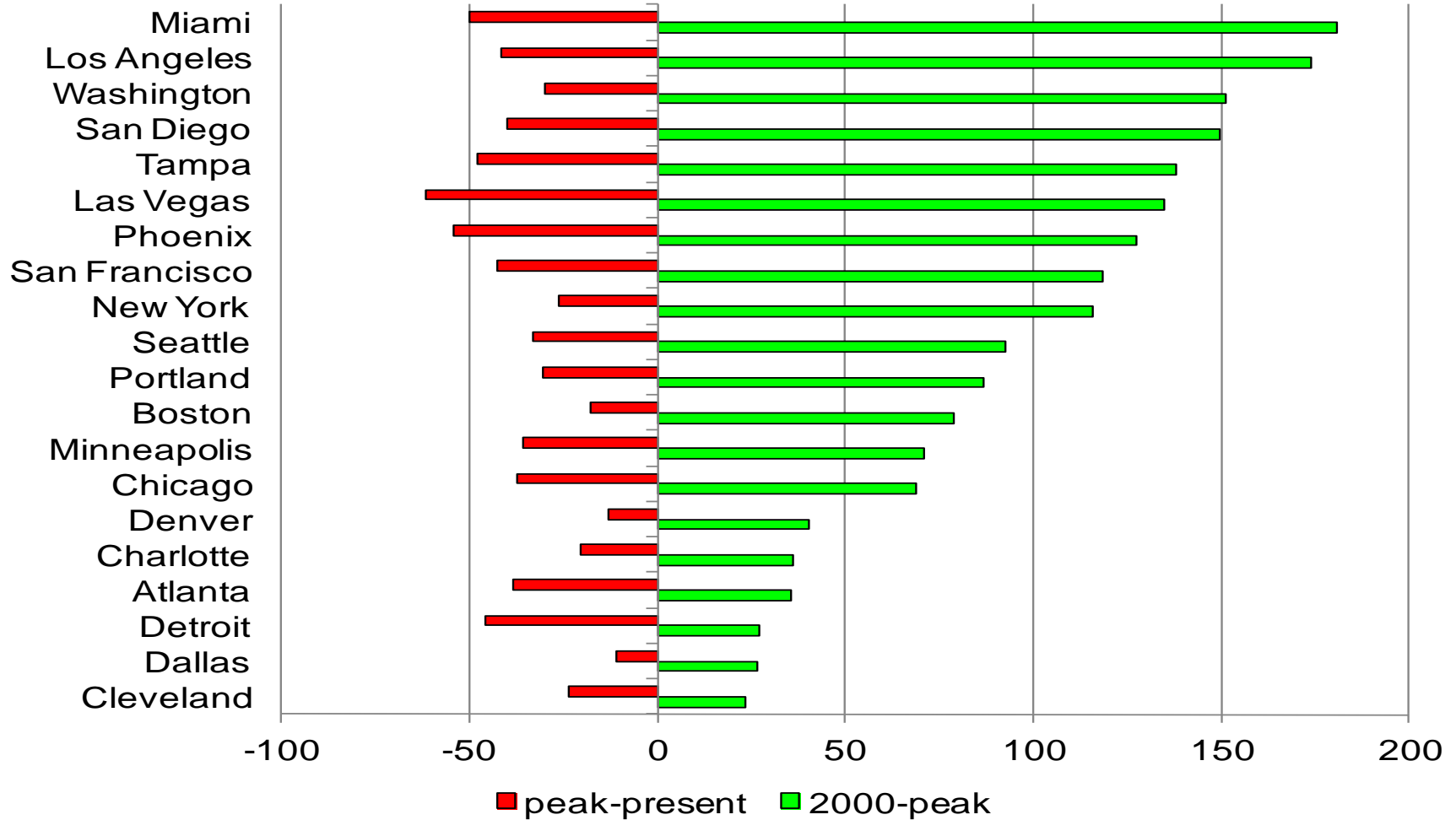
(Percent increase in home prices, 1997-2005)



Source: Mortgage Bankers' Association and Standard & Poor's

Those Who Bubbled Highest Burst Loudest

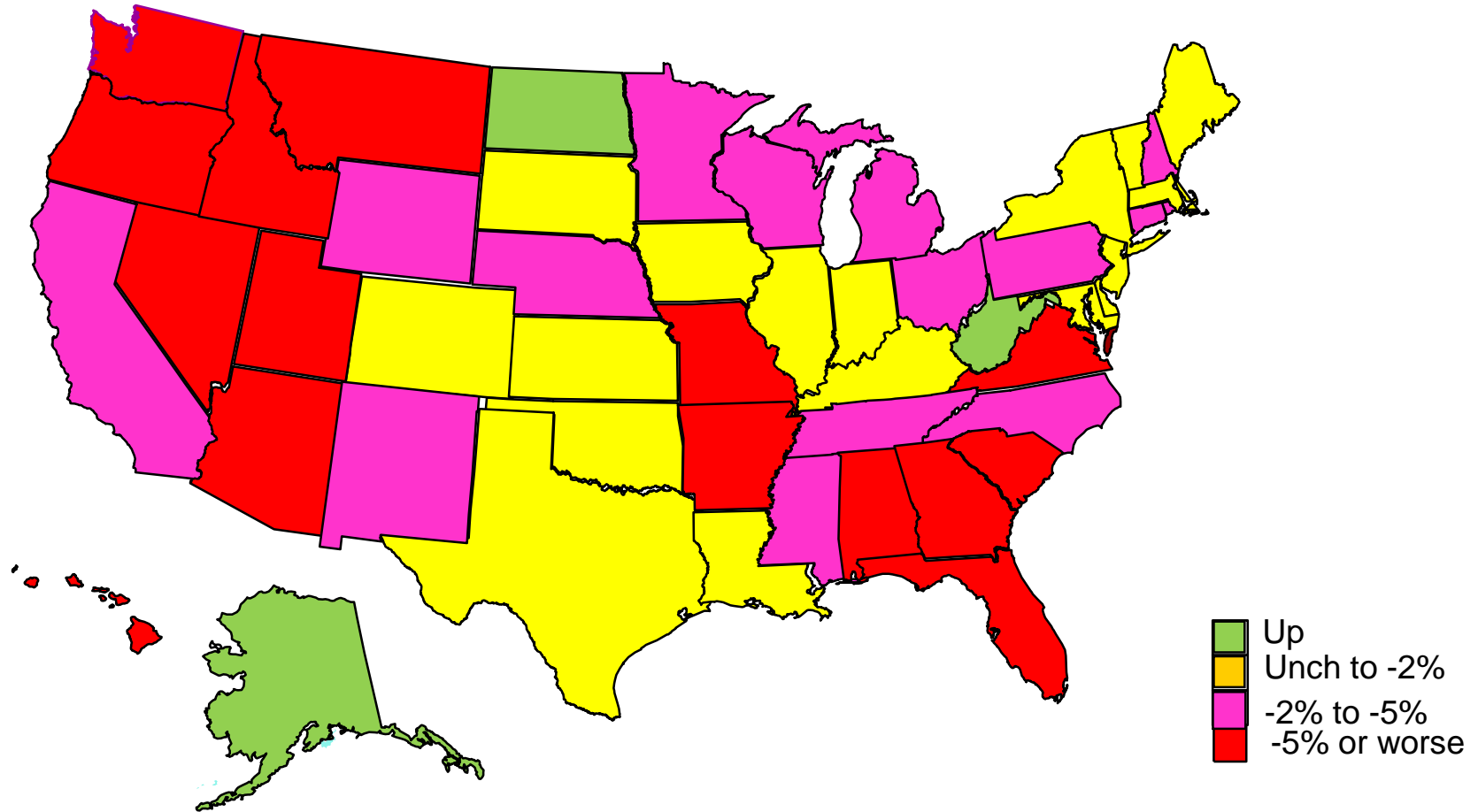
(Percent increase in S&P/Case-Shiller home price index, Feb. 2012)



Source: Standard & Poor's

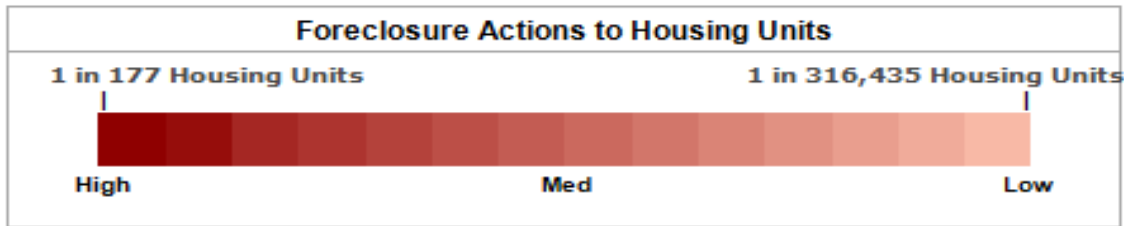
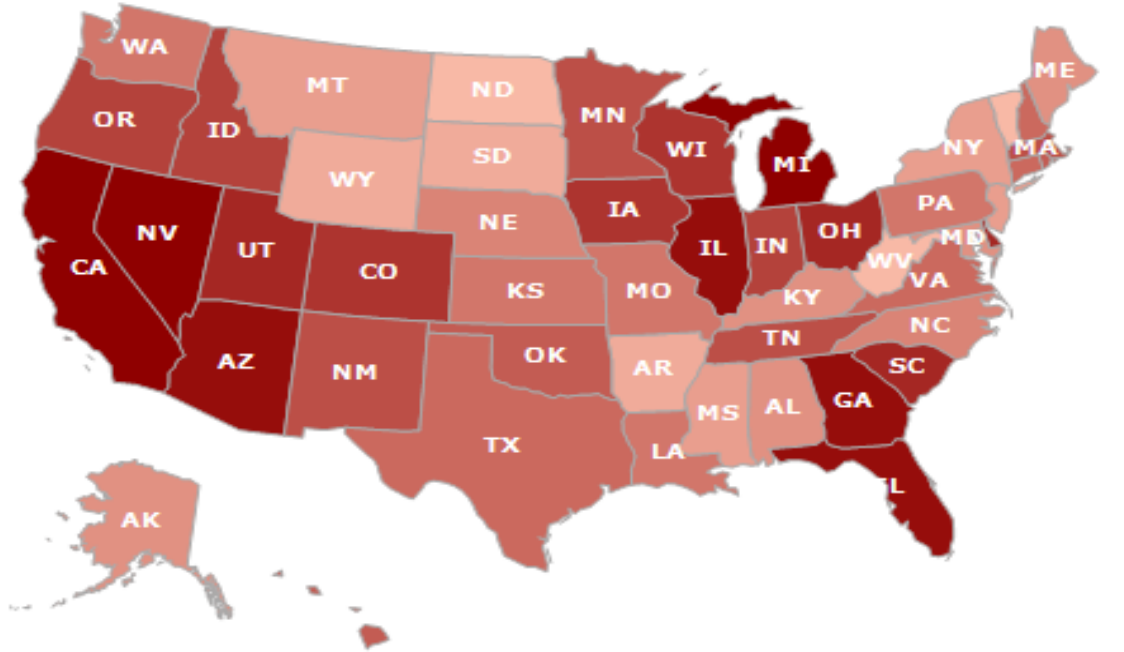
Home Price Declines

(4-quarter change in home prices, fourth quarter 2010)



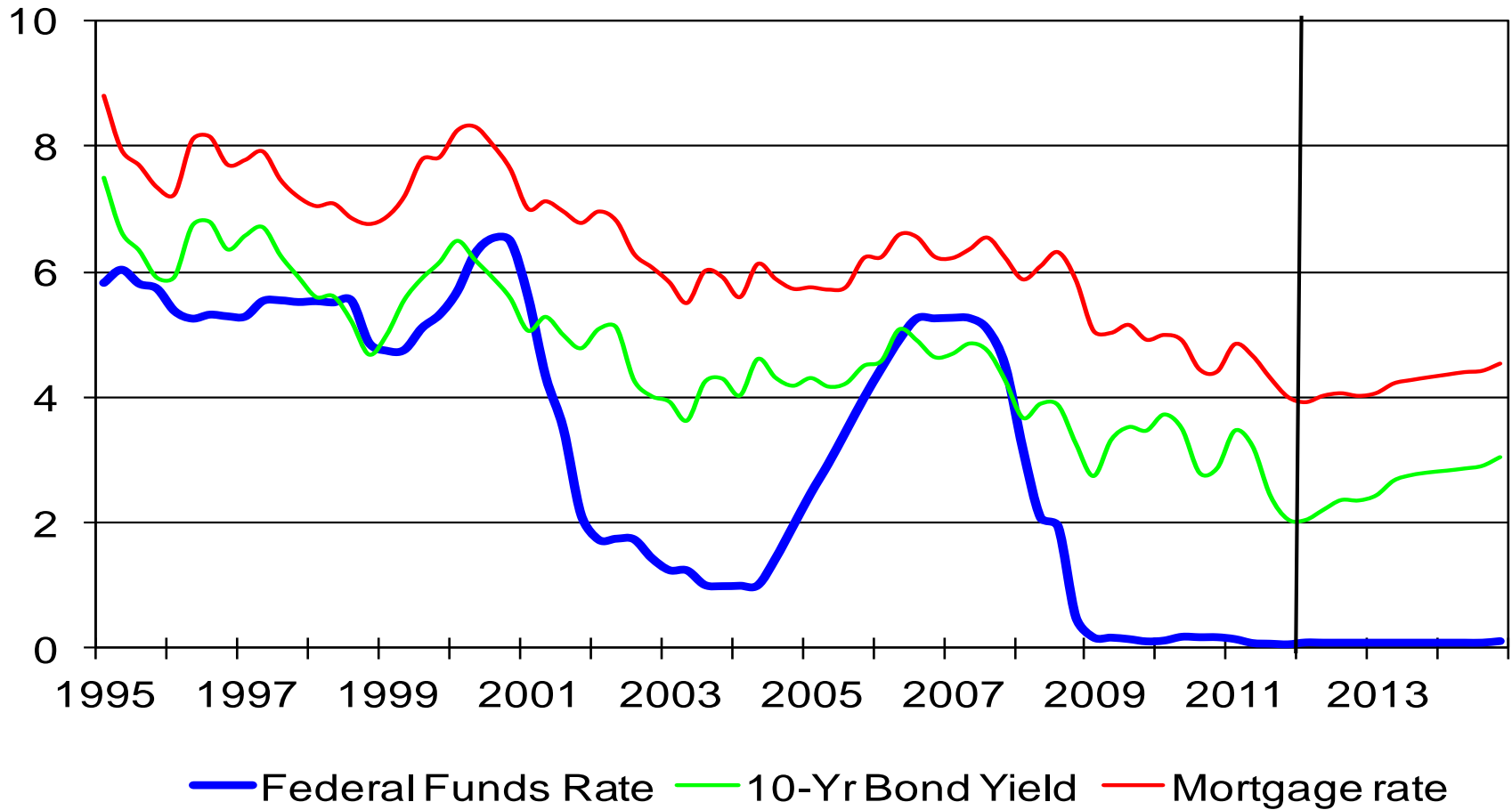
Source: Federal Housing Finance Agency

December 2011 Foreclosure Rate Heat Map



The Fed Didn't Stop At Nothing

(Percent)



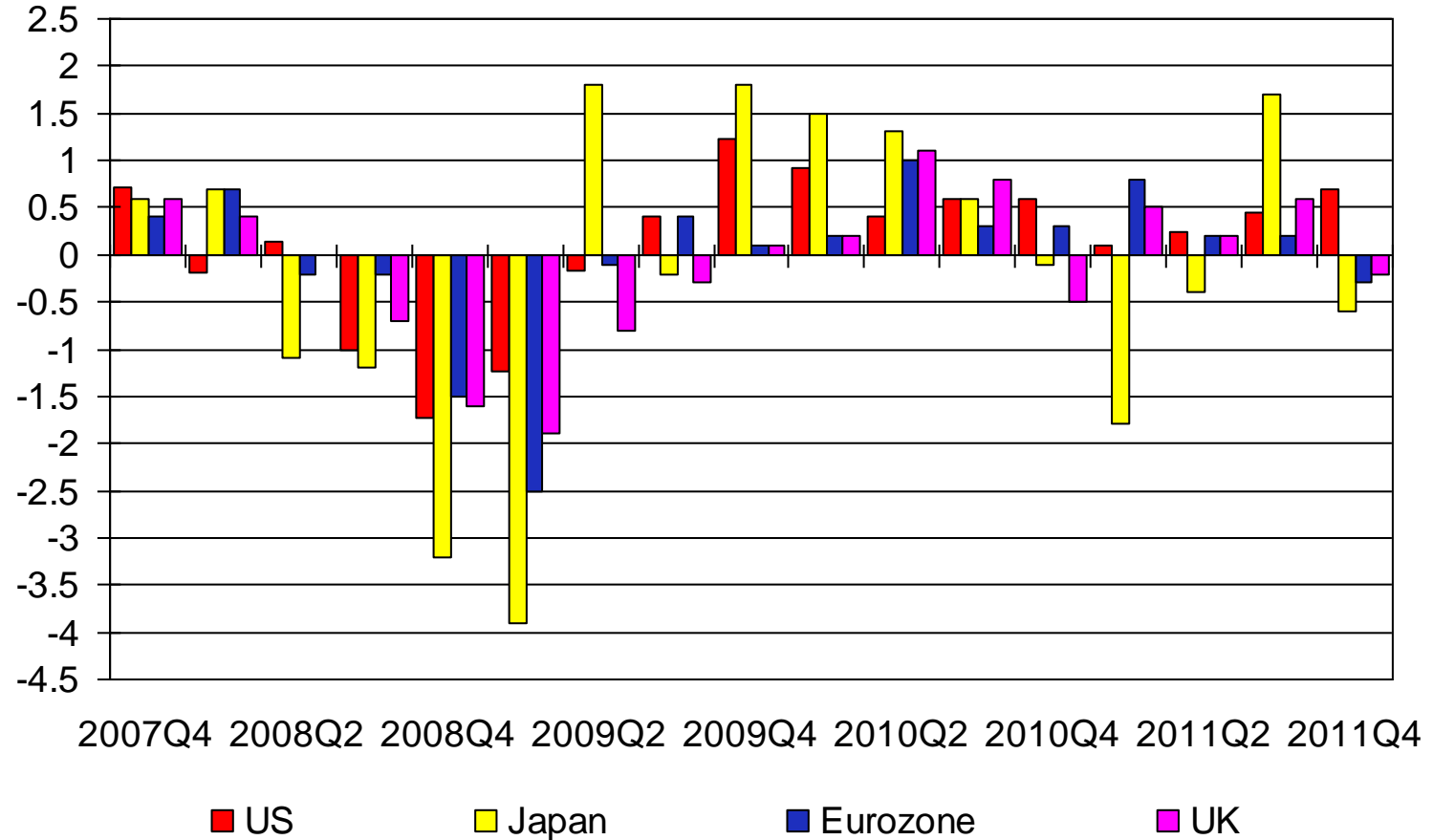
Source: Federal Reserve

Synchronized Sinking

- **Industrial countries went into recession in 2008, and into a plunge in the fourth quarter of 2008**
- **Real GDP fell in the U.S., Japan, and Europe**
- **Developing countries looked like they might escape**
- **Until commodity prices plunged in Q4 2008**
- **World GDP slowed, likely up 3.25% in 2012 from 3.8% in 2011.**
- **The most synchronized world recession in history is being followed by a slow, less synchronized recovery**
- **Problems in Europe and Japan will further cut developed country growth, with Japan likely to fall back into recession.**
- **But Asia continues to grow strongly**

All Fall Down

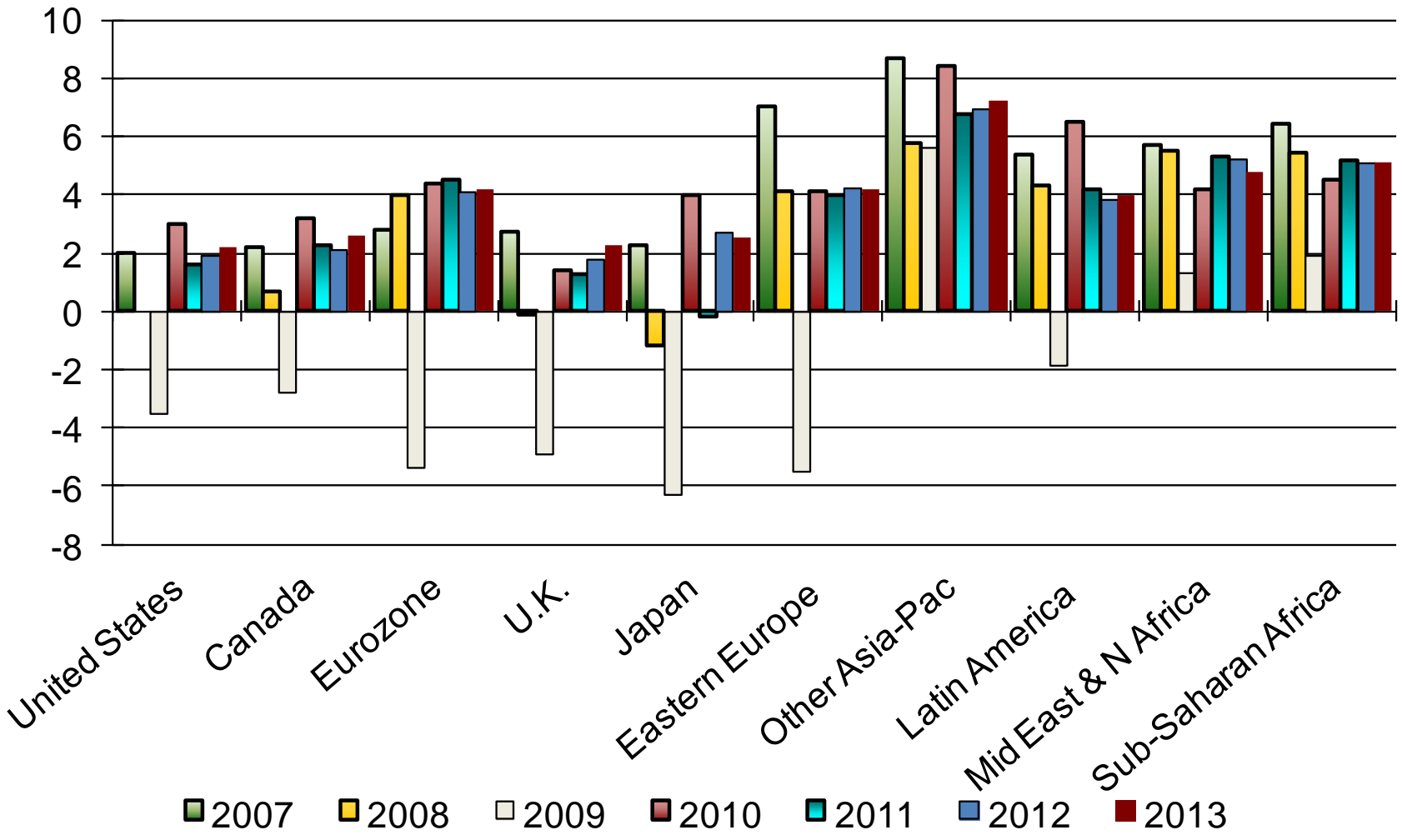
(Percent change in real GDP, quarterly rate)



Source: Global Insight

Synchronized Sinking

(Real GDP, % change)

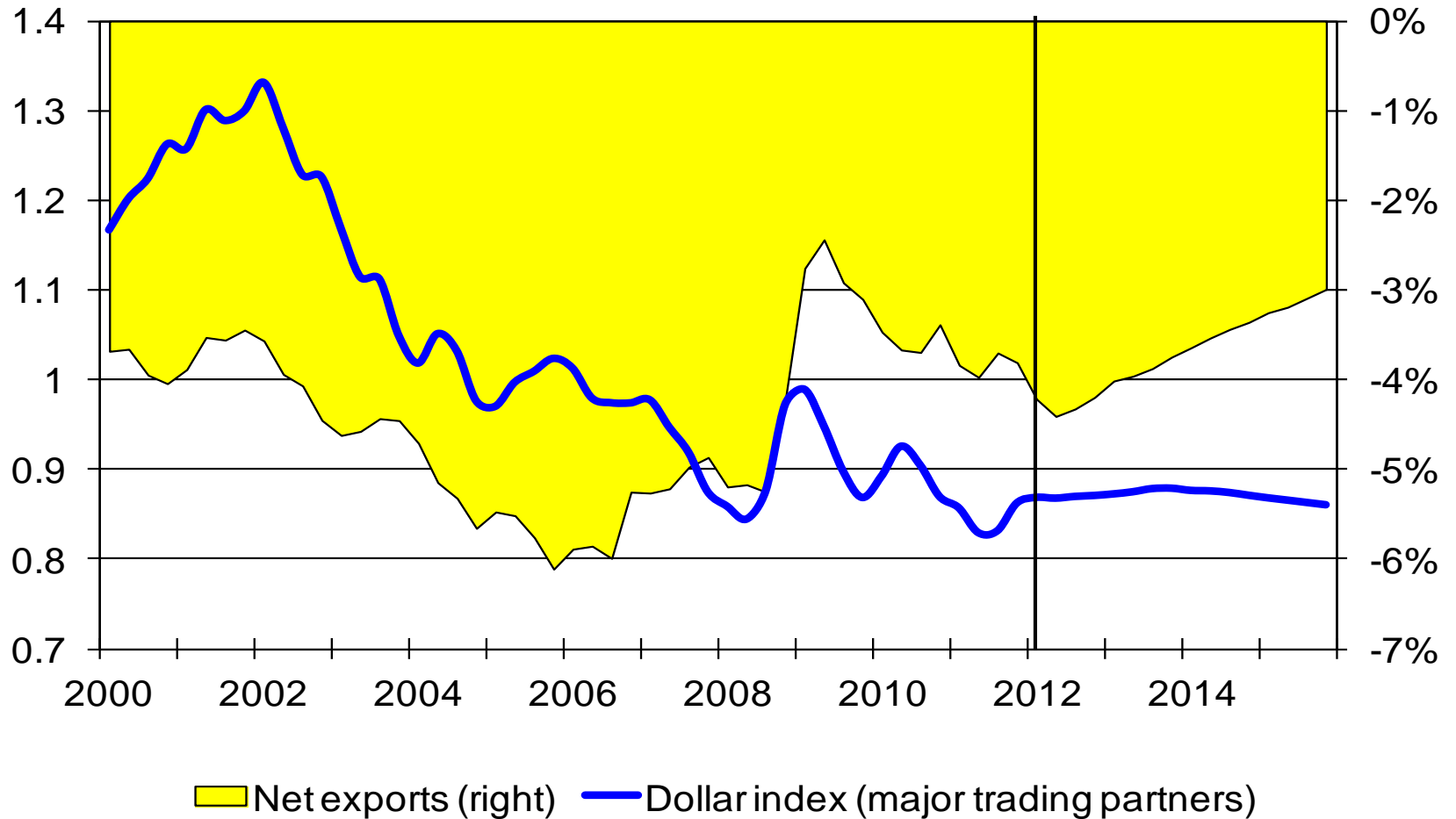


Source: Global Insight and Standard & Poor's

Trade Gap And Reserve Diversification Will Send Dollar Lower

(Index)

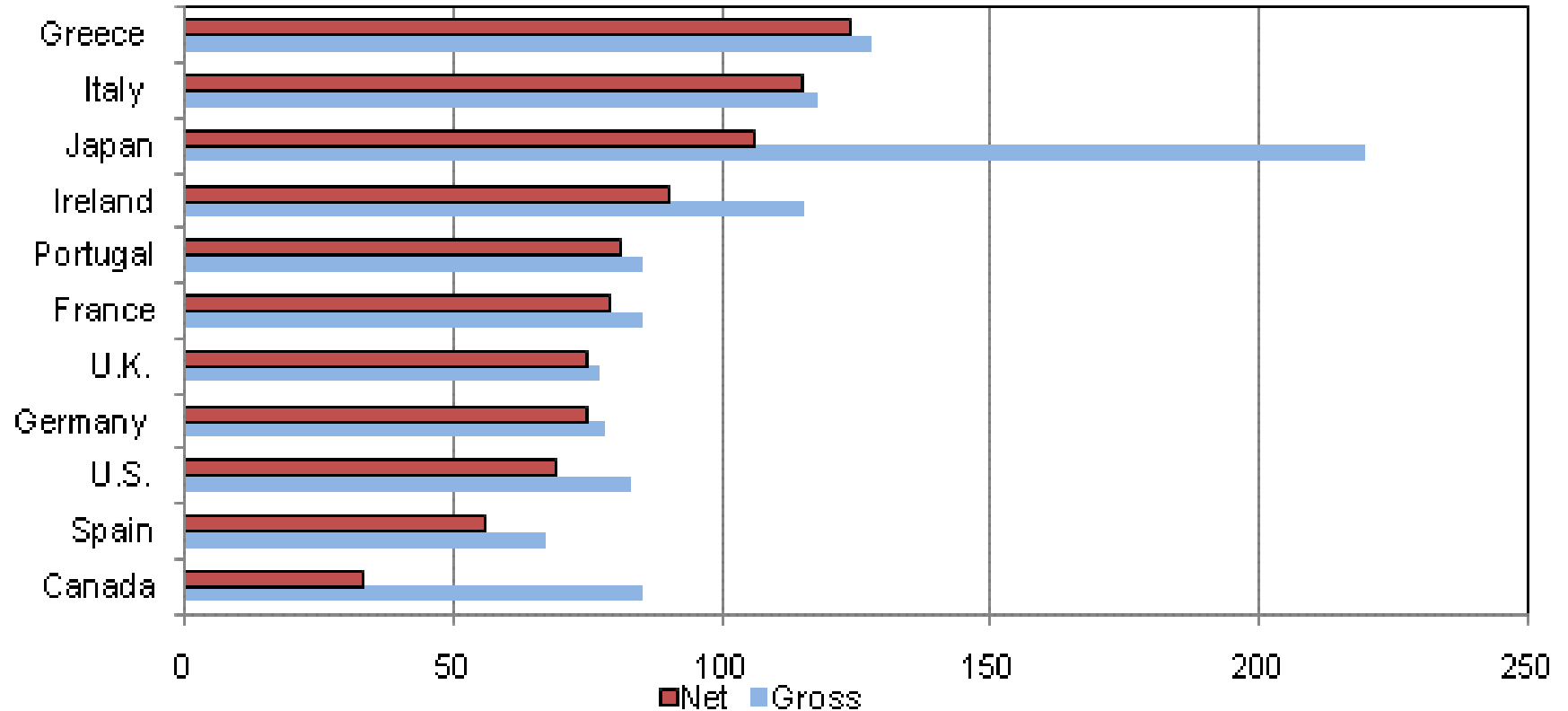
(Percent of GDP)



Source: Bureau of Economic Analysis and Federal Reserve, S&P Economics projections

Timeo Danaos Et Debitum Ferentes

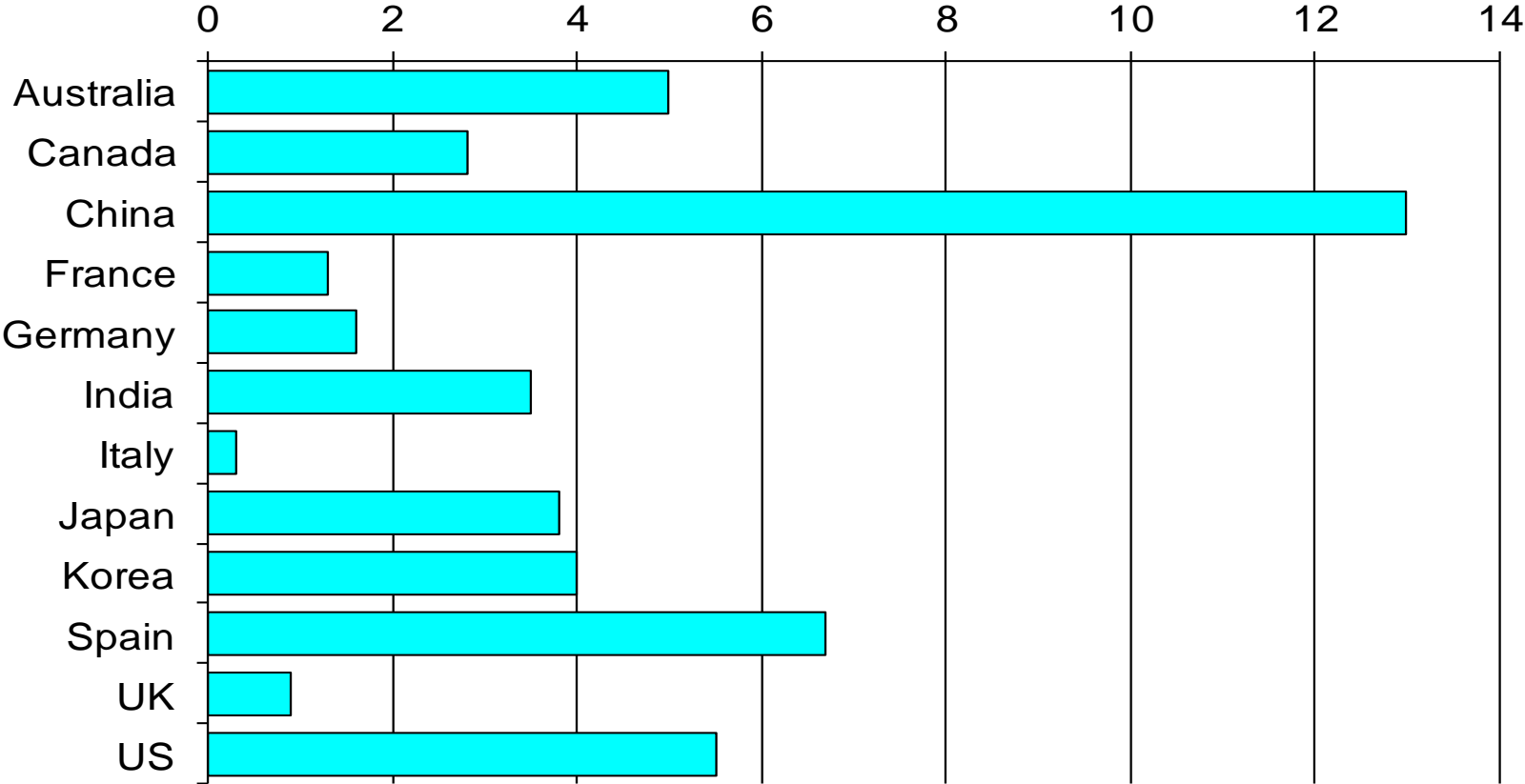
(Central government debt as percent of GDP, 2010)



Source: Standard & Poor's Economics from national sources

Fiscal Stimulus Packages Varied Widely

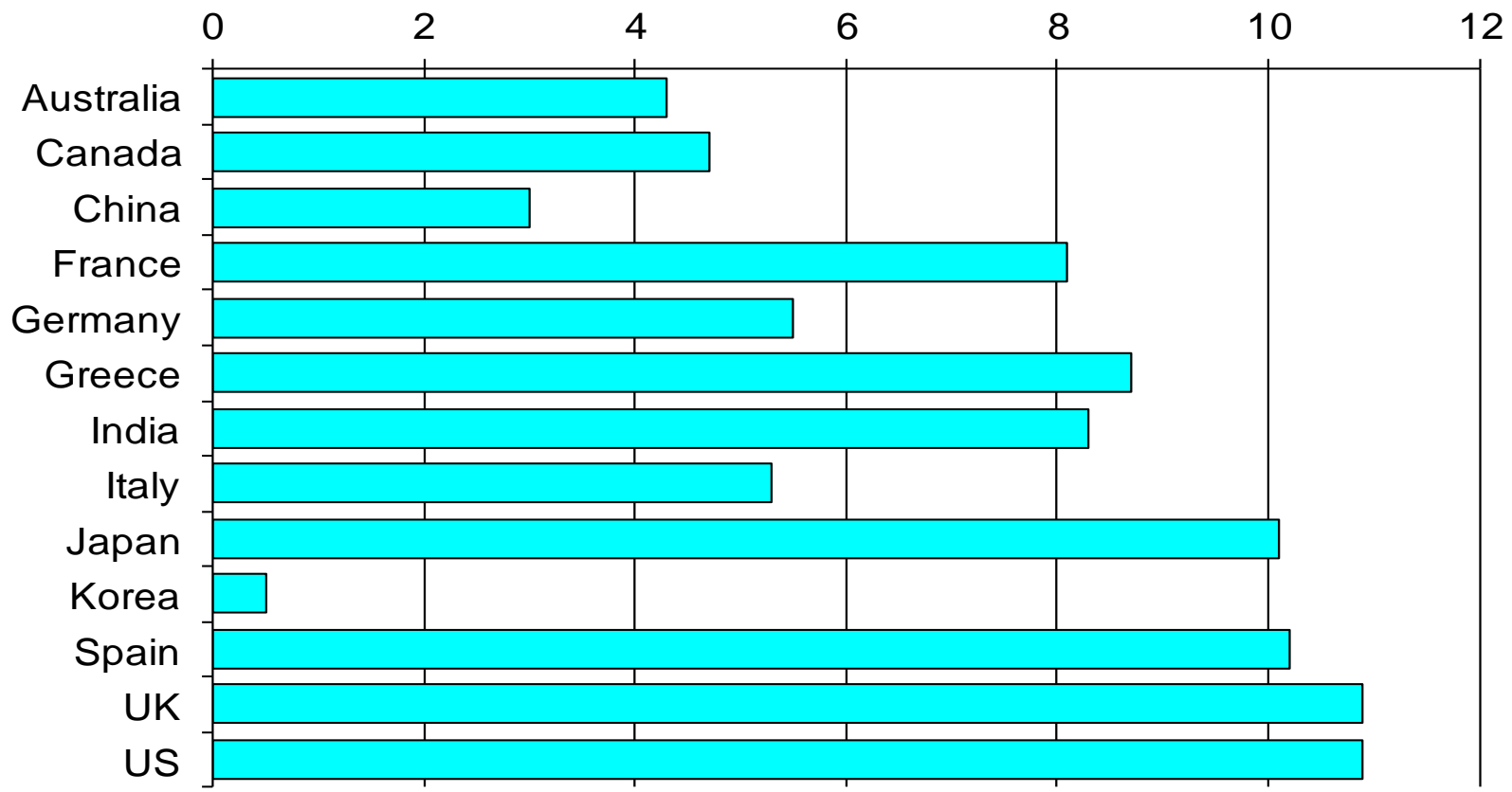
(Packages passed in Q4 2008- Q1 2009, percent of GDP)



Source: Standard & Poor's CRISIL

Budget Deficits Depend On Economy

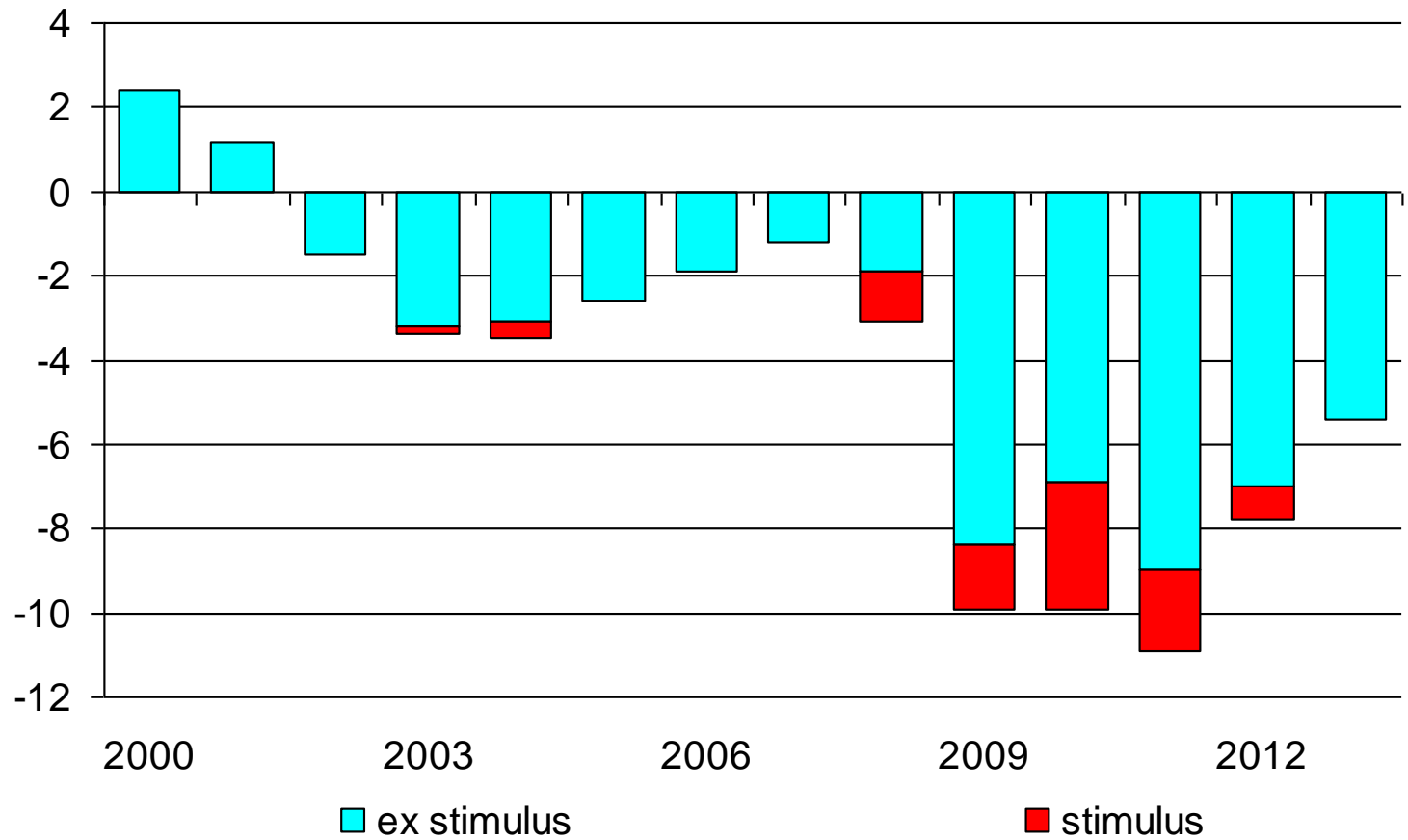
(Budget gap as percent of GDP, 2010)



Source: Standard & Poor's CRISIL

Deficits Are Mostly Cyclical

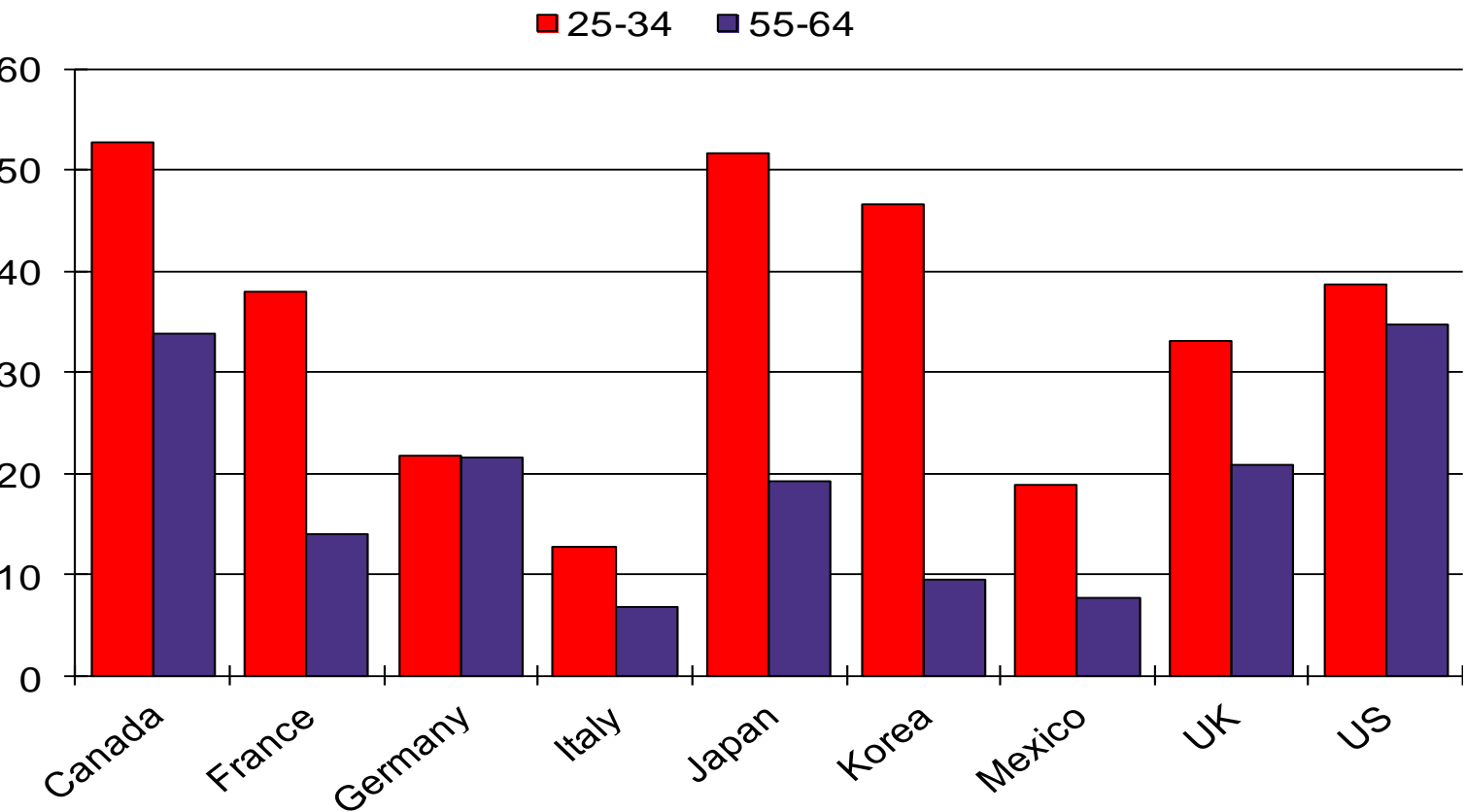
(Government deficit as % of GDP, fiscal years)



Source: Standard & Poor's

Other Countries Are Catching Up

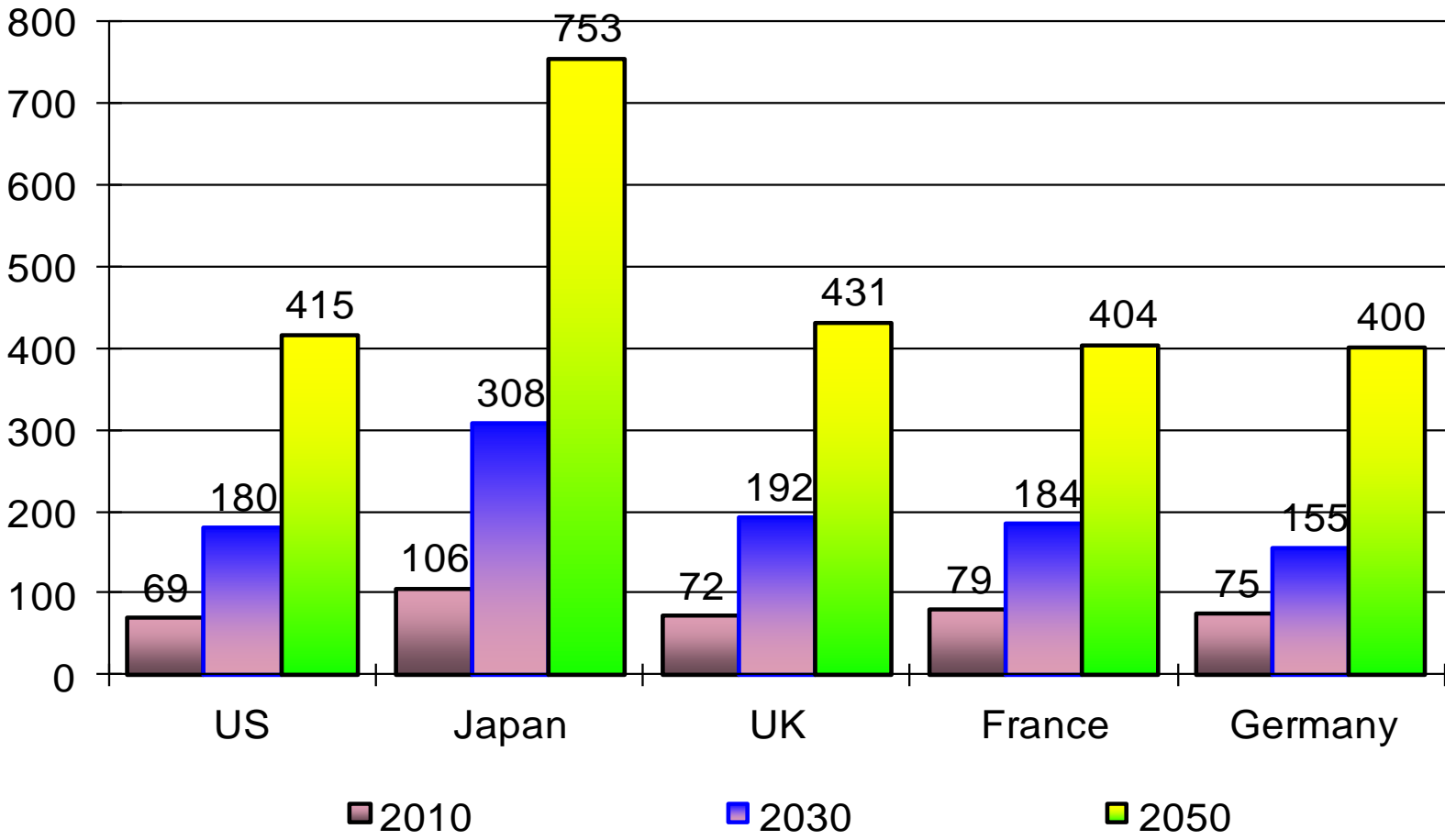
(Percentage of tertiary degrees by age group, 2003)



Source: Organization for Economic Cooperation and Development

The Future Looks Bleak

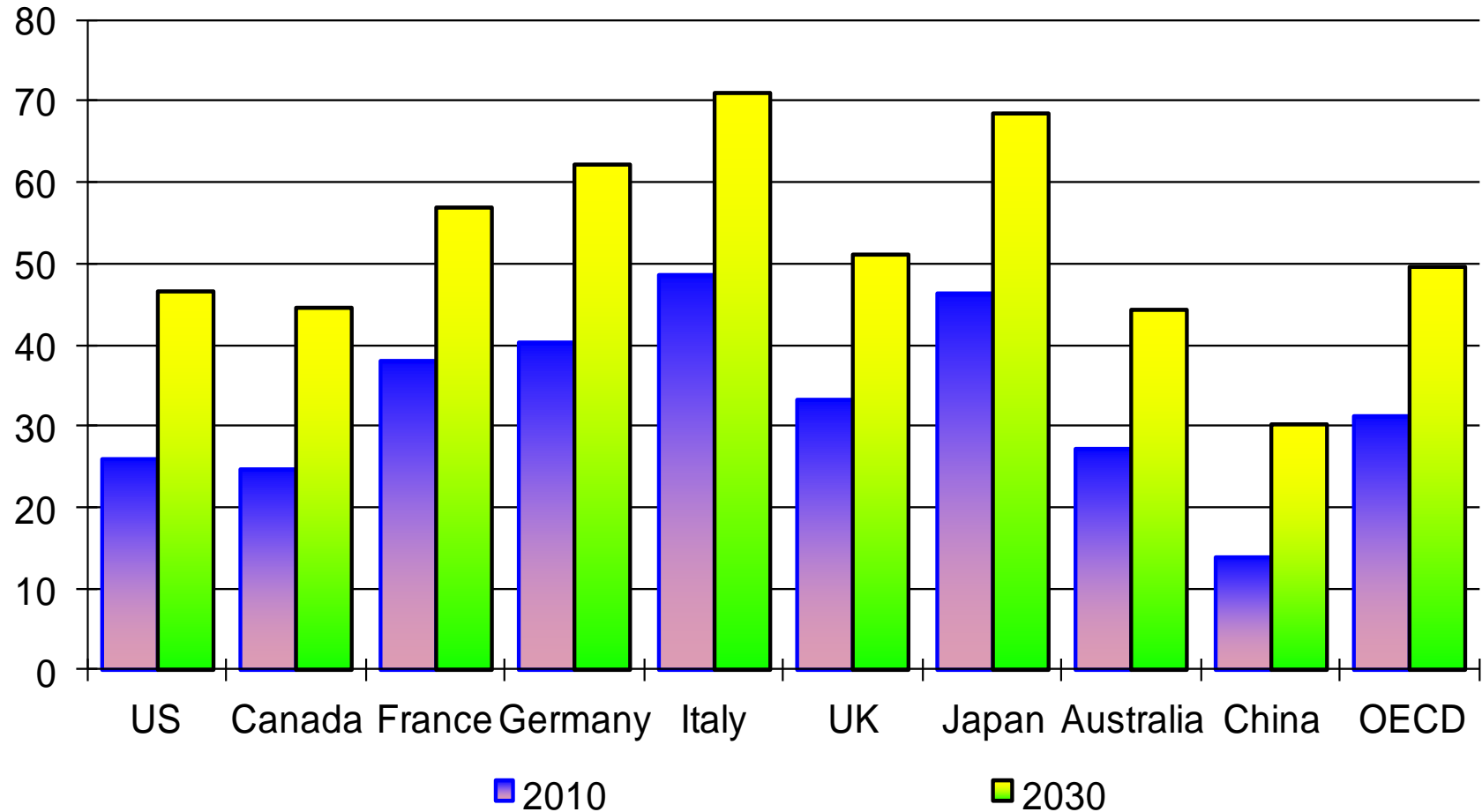
(Government debt as % of GDP)



Source: Standard & Poor's, 2010

Aging Populations Will Boost Government Spending

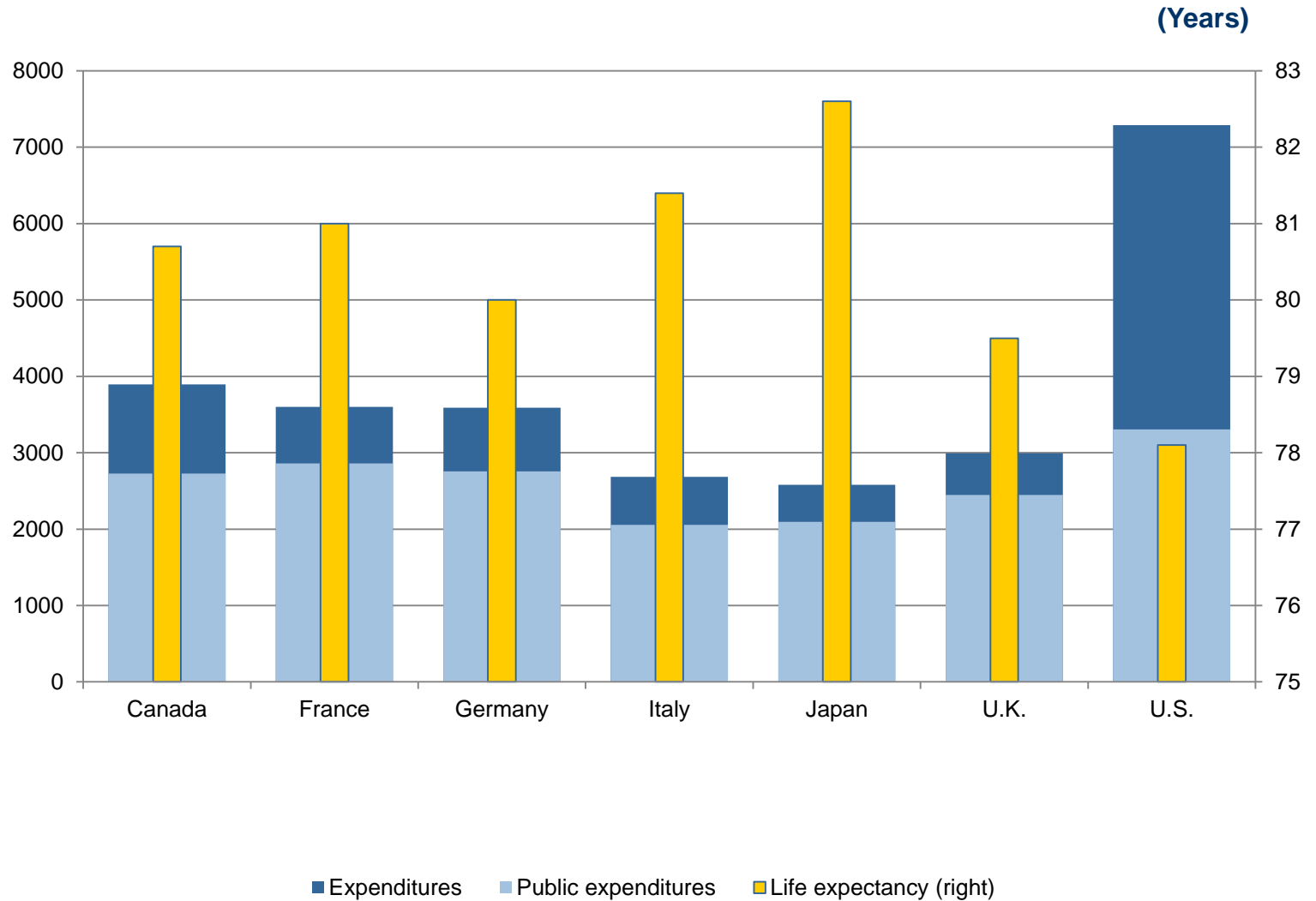
(Retirees as percentage of labor force)



Source: Organization for Economic Cooperation and Development

U.S. Has Highest Health Costs And Lowest Life Expectancy

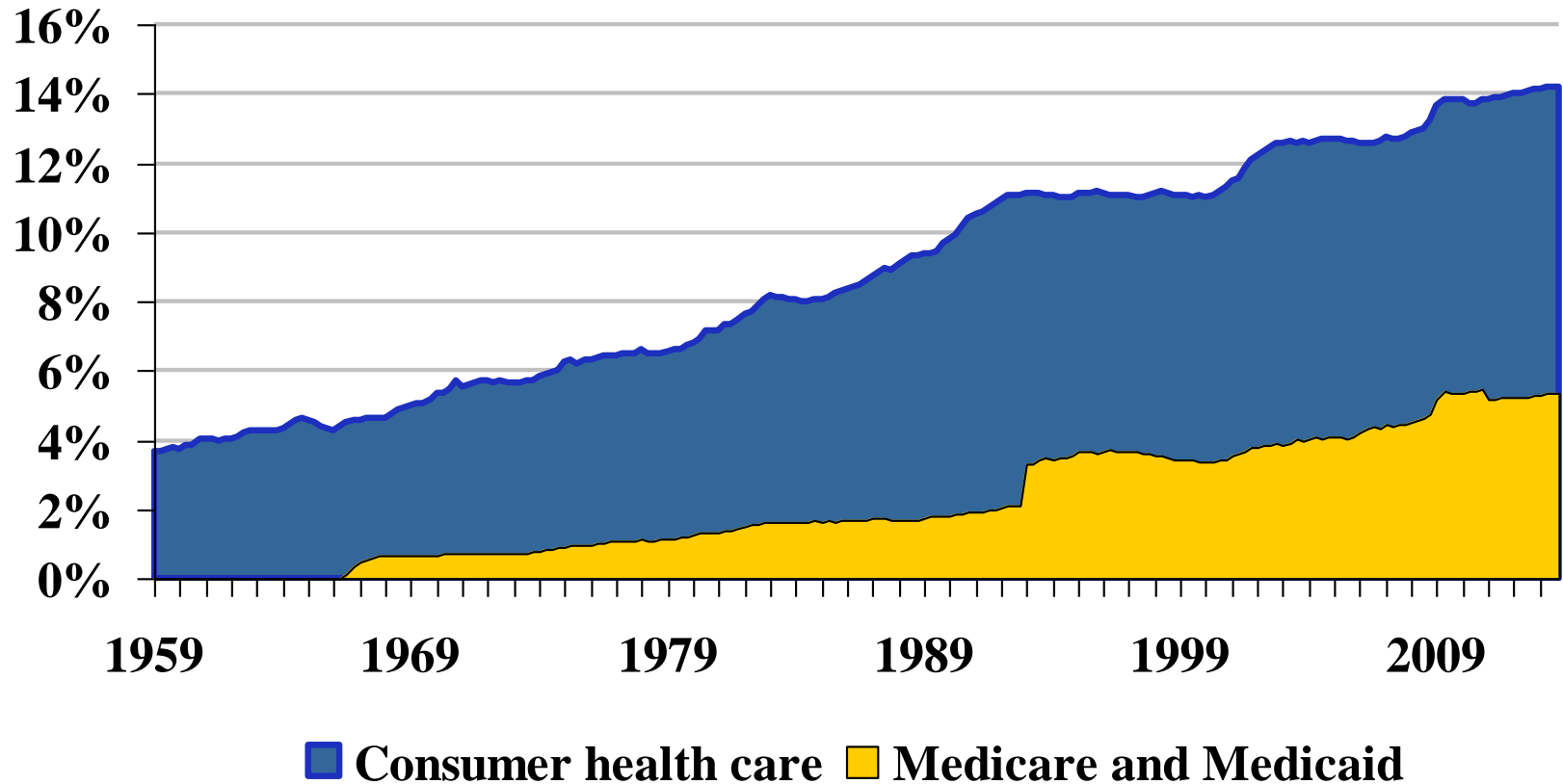
(Health care expenditures per capita, purchasing power)



Source: OECD.

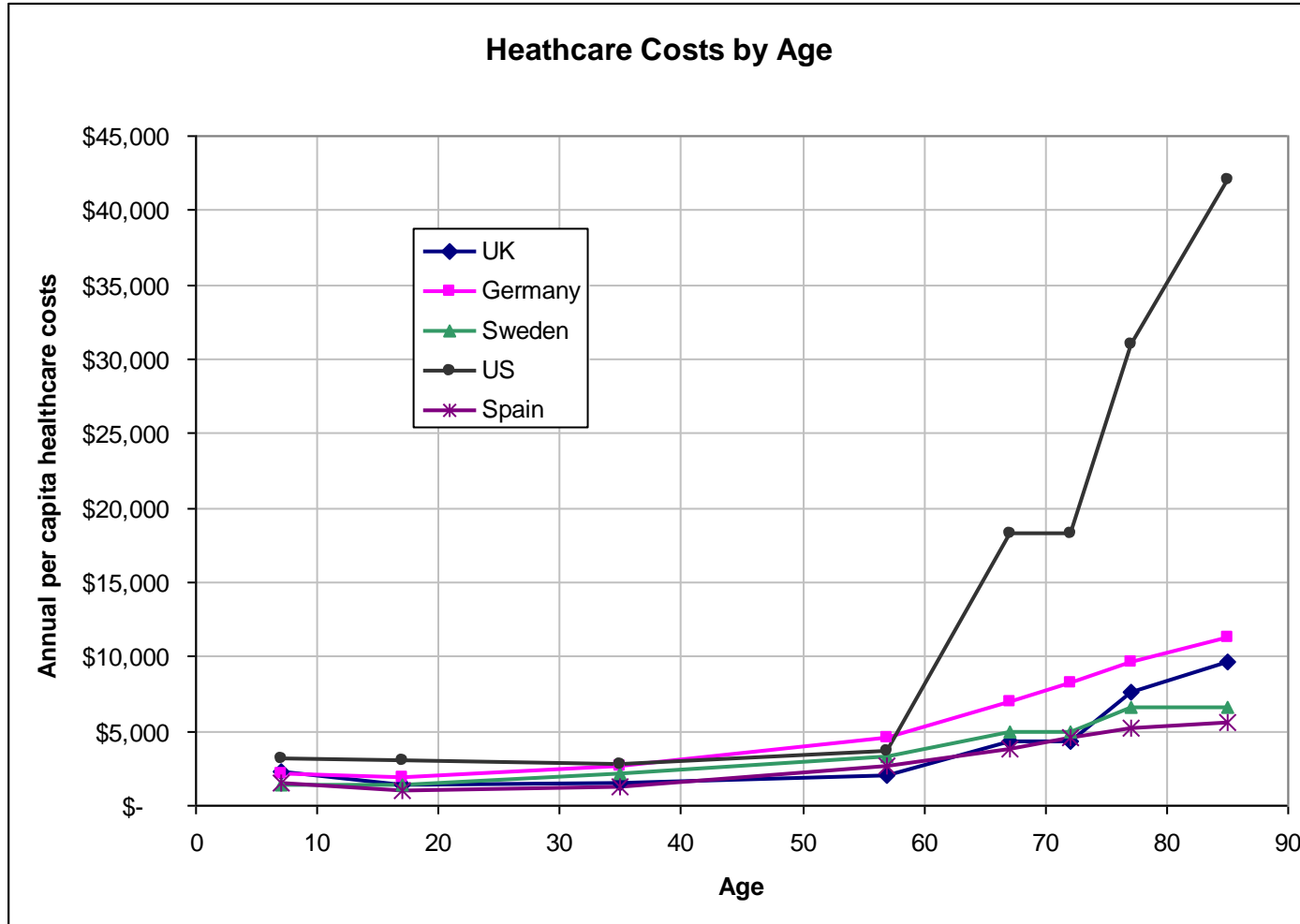
Health Care Expenditures Climb Rapidly

(Percent of GDP)



Sources: Bureau of Economic Analysis, S&P projections.

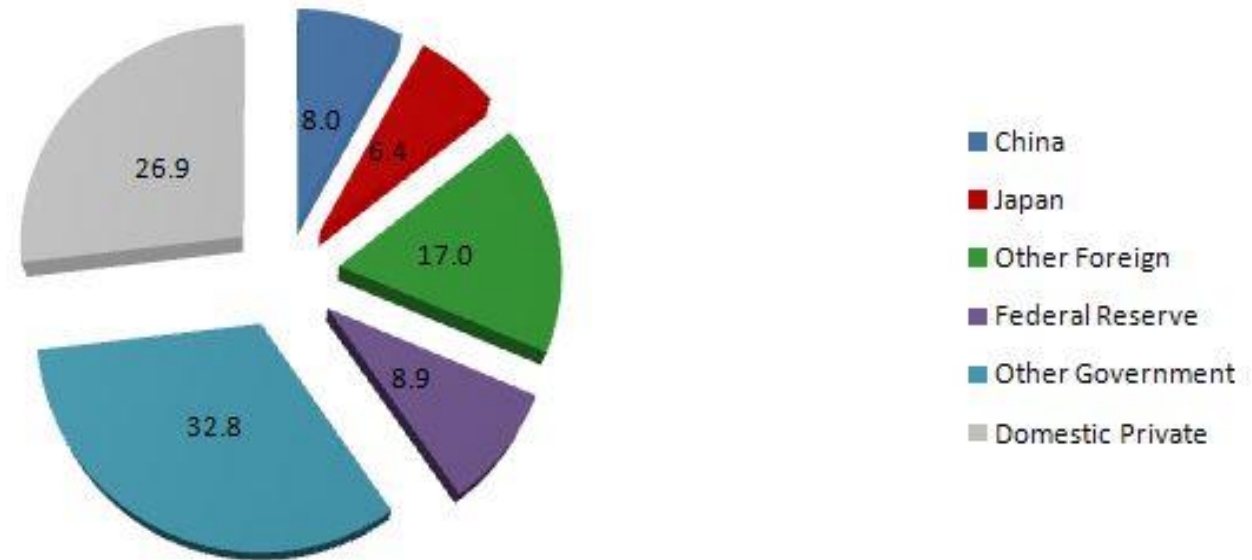
Costs by Age By Country



Sources: Paul Fischbeck, Carnegie Mellon University

Who's Picked Up the Bill? {chk source}

Proportion of US Public Debt Holdings (%) - March 2011



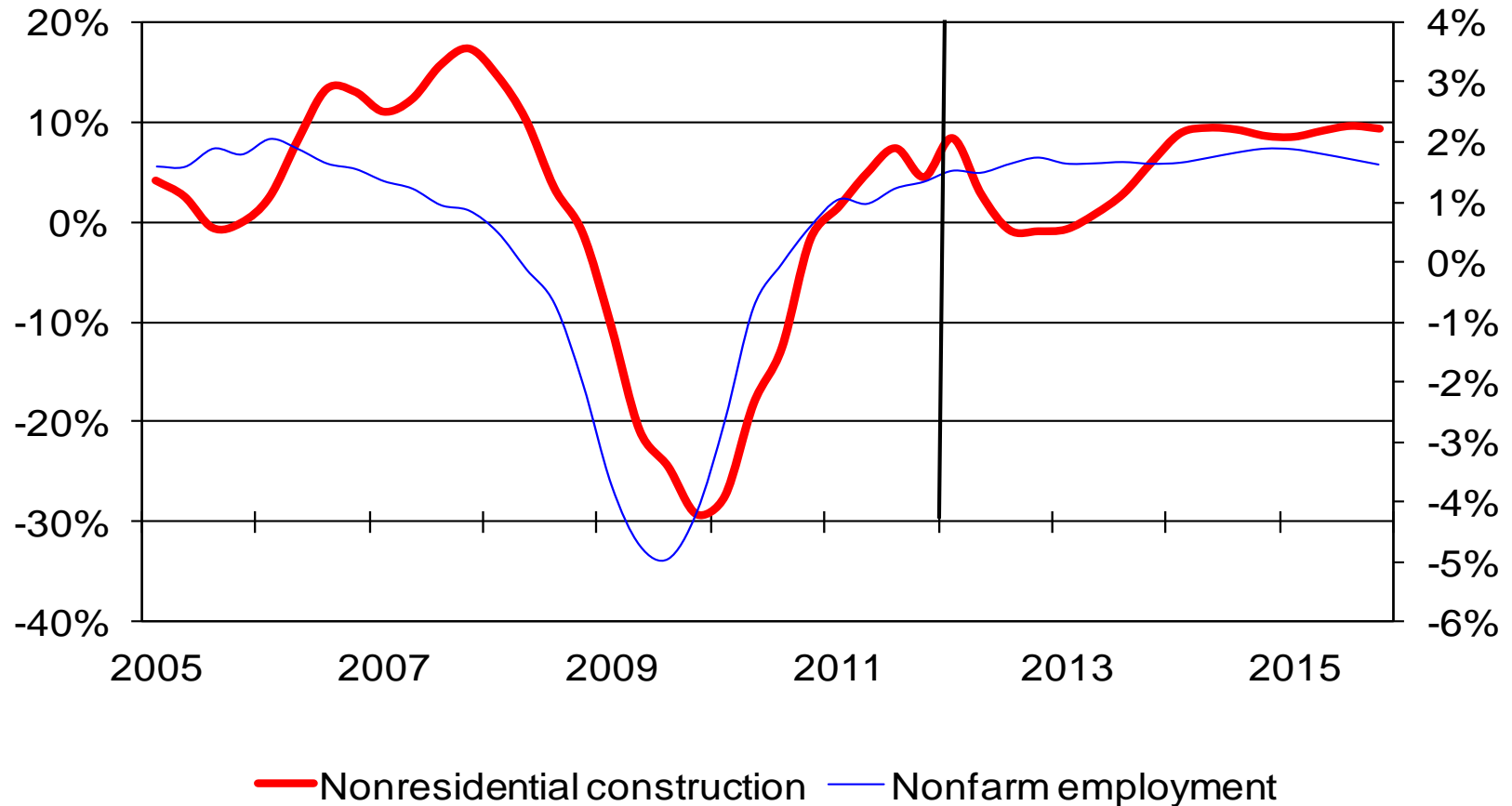
2 major holders:

- **U.S. Federal Reserve**
- **China**

Source: <http://bilbo.economicoutlook.net/blog/?p=15591>
The US Treasury - Foreign breakdown.
The US Federal Reserve - Consolidated Balance Sheet data.

Weaker Employment Is Hurting Construction

(4-quarter percent change)



Source: Bureau of Labor Statistics, Bureau of Economic Analysis, S&P Economics projections

Commercial Real Estate Price Declines Are Bottoming

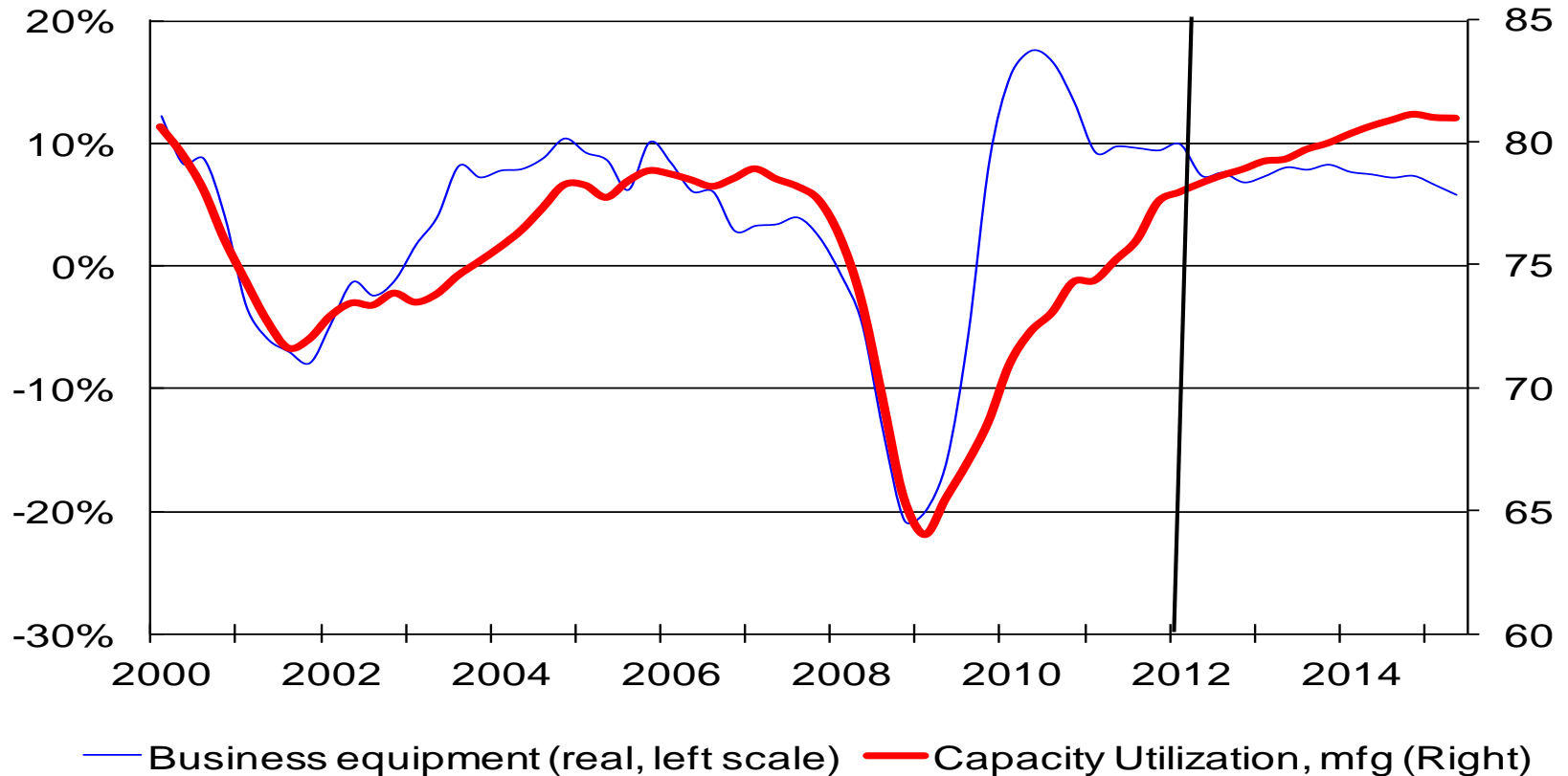


Source: M.I.T. Center for Real Estate.

Equipment Spending Follows Capacity Needs

(4-quarter percent change, and production as % of capacity)

(Percent)



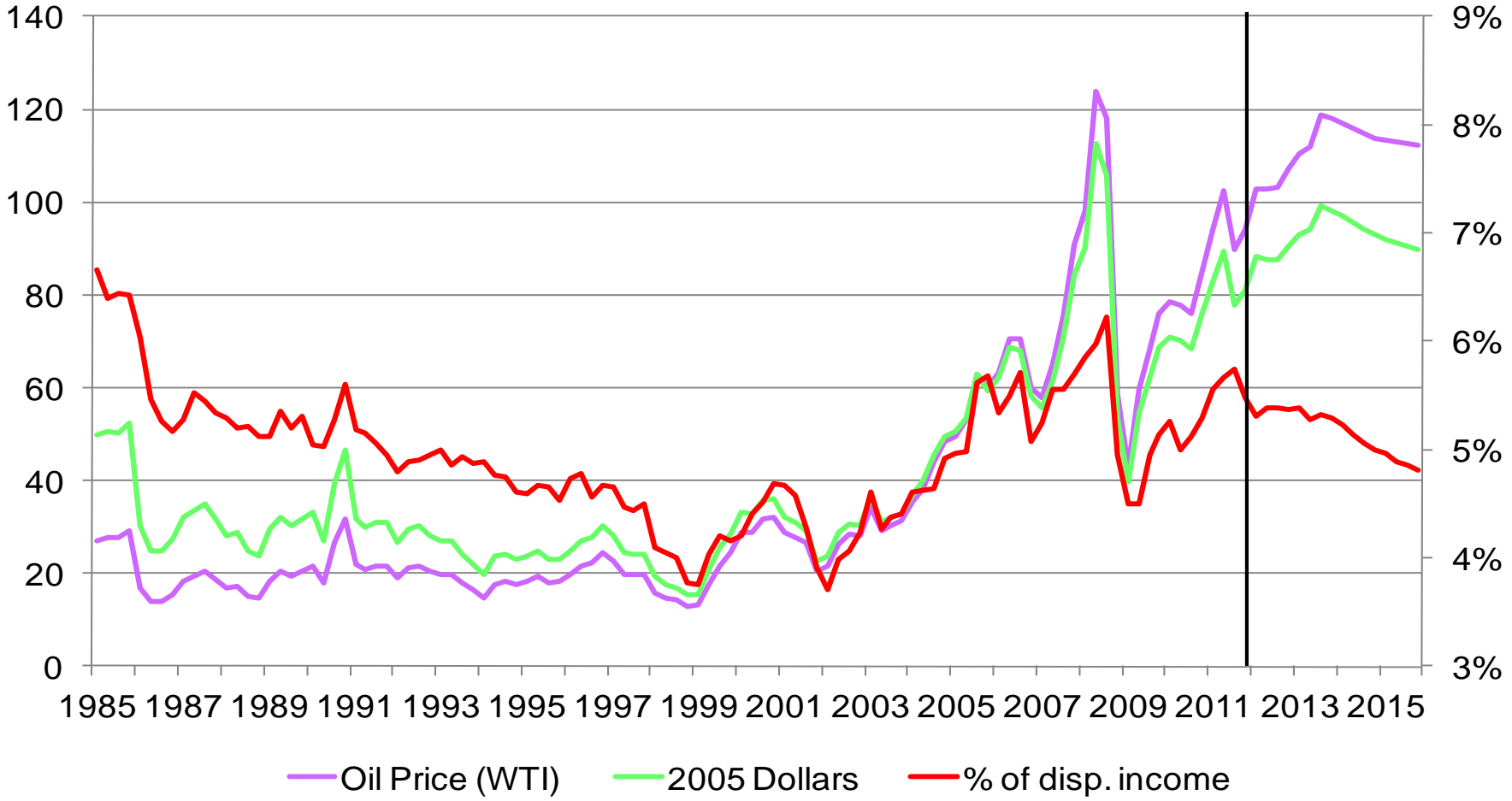
Source: Federal Reserve, Bureau of Economic Analysis, S&P Economics

Can the Consumer Keep Spending?

- **Consumer spending led recent expansions**
- **But wealth is down because home prices have dropped and**
- **Stocks are still below their 2007 peak**
- **Borrowing is more difficult, and home equity loans much less available**
- **Confidence has dropped and unemployment risen**
- **Consumers are likely to continue to save more and borrow less**
- **High oil prices hurt purchasing power and confidence**
- **Stimulus package provided some income boost**

Oil Prices Remain Down From Peak

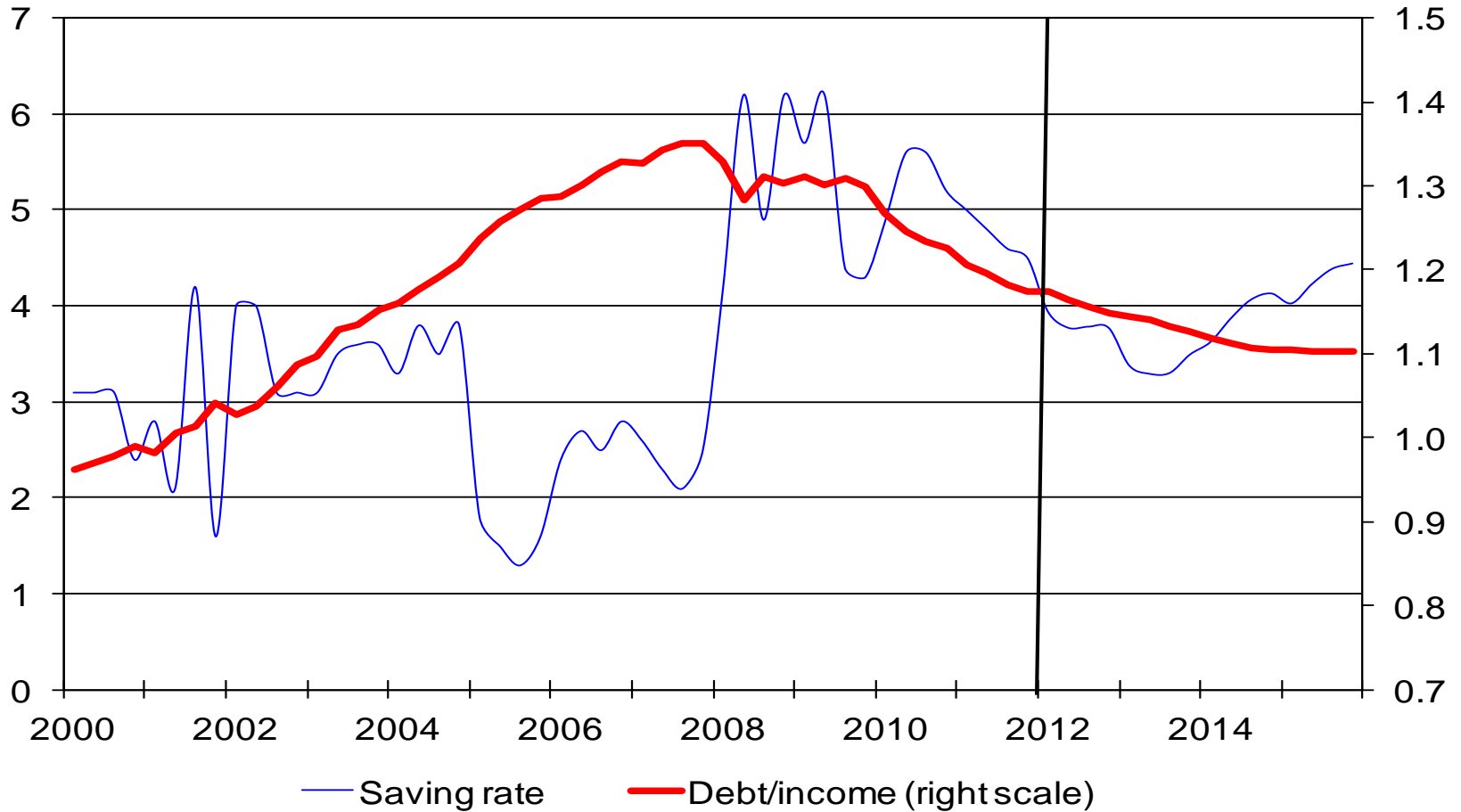
(\$/barrel, WTI and deflated by CPI; household energy purchases as percent of disposable income)



Source: Bureau of Economic Analysis

Debt Is Dropping From Record Highs

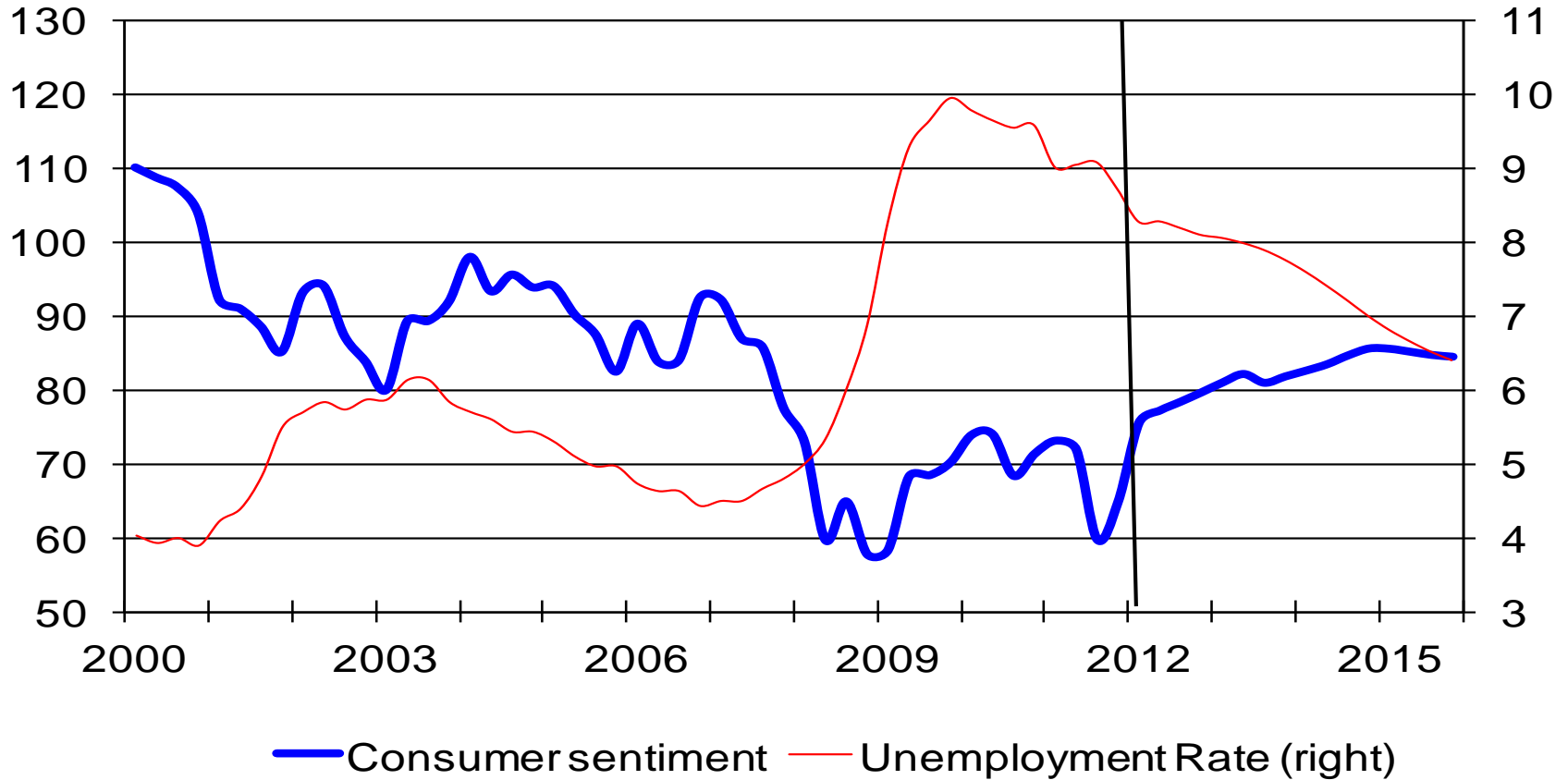
(Percent of after-tax income)



Source: Bureau of Economic Analysis and Federal Reserve

High Unemployment Scares Consumers

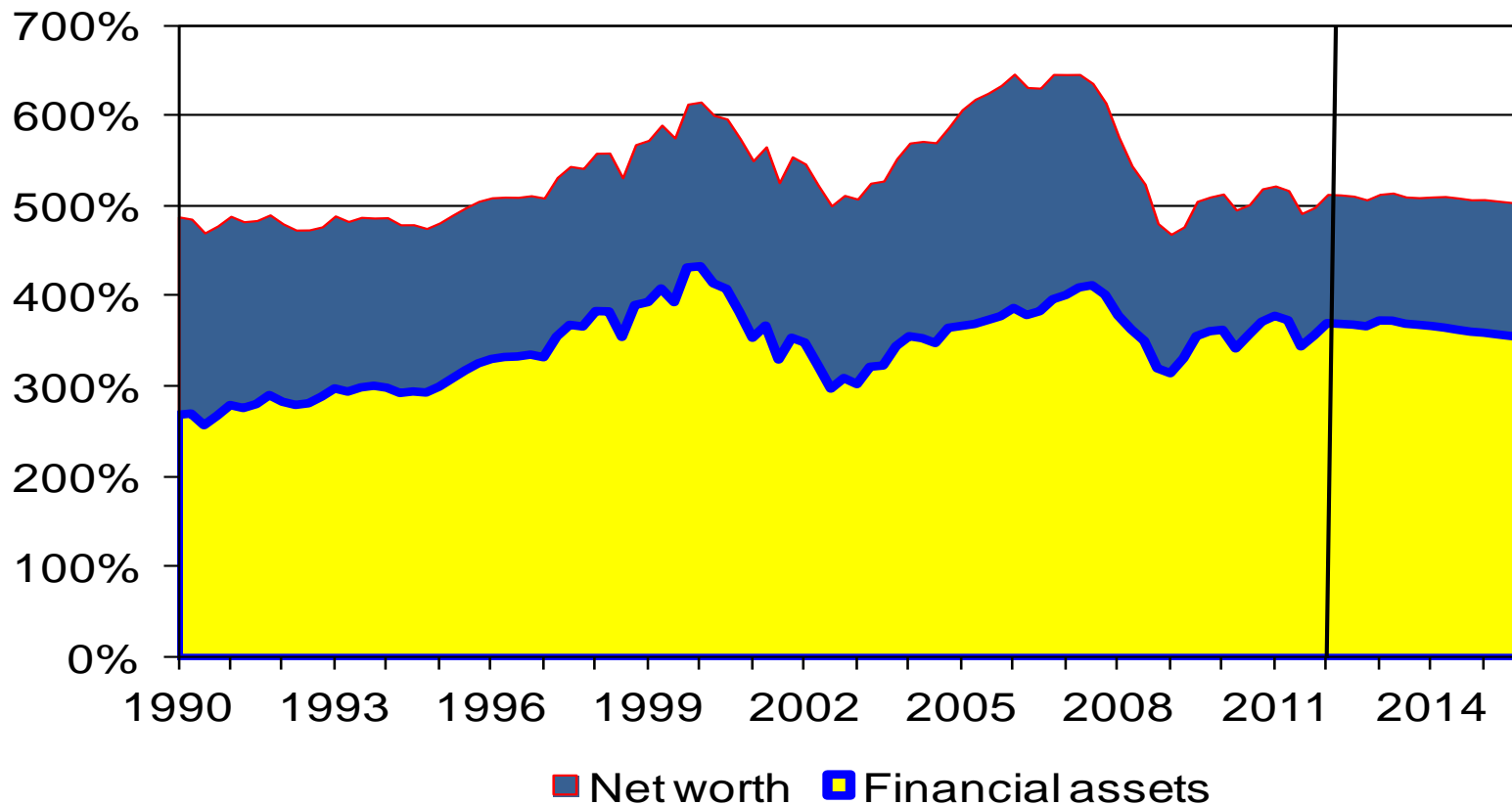
(Percent)



Source: Bureau of Labor Statistics and University of Michigan Survey Research Center

Wealth Slides With Home and Stock Prices

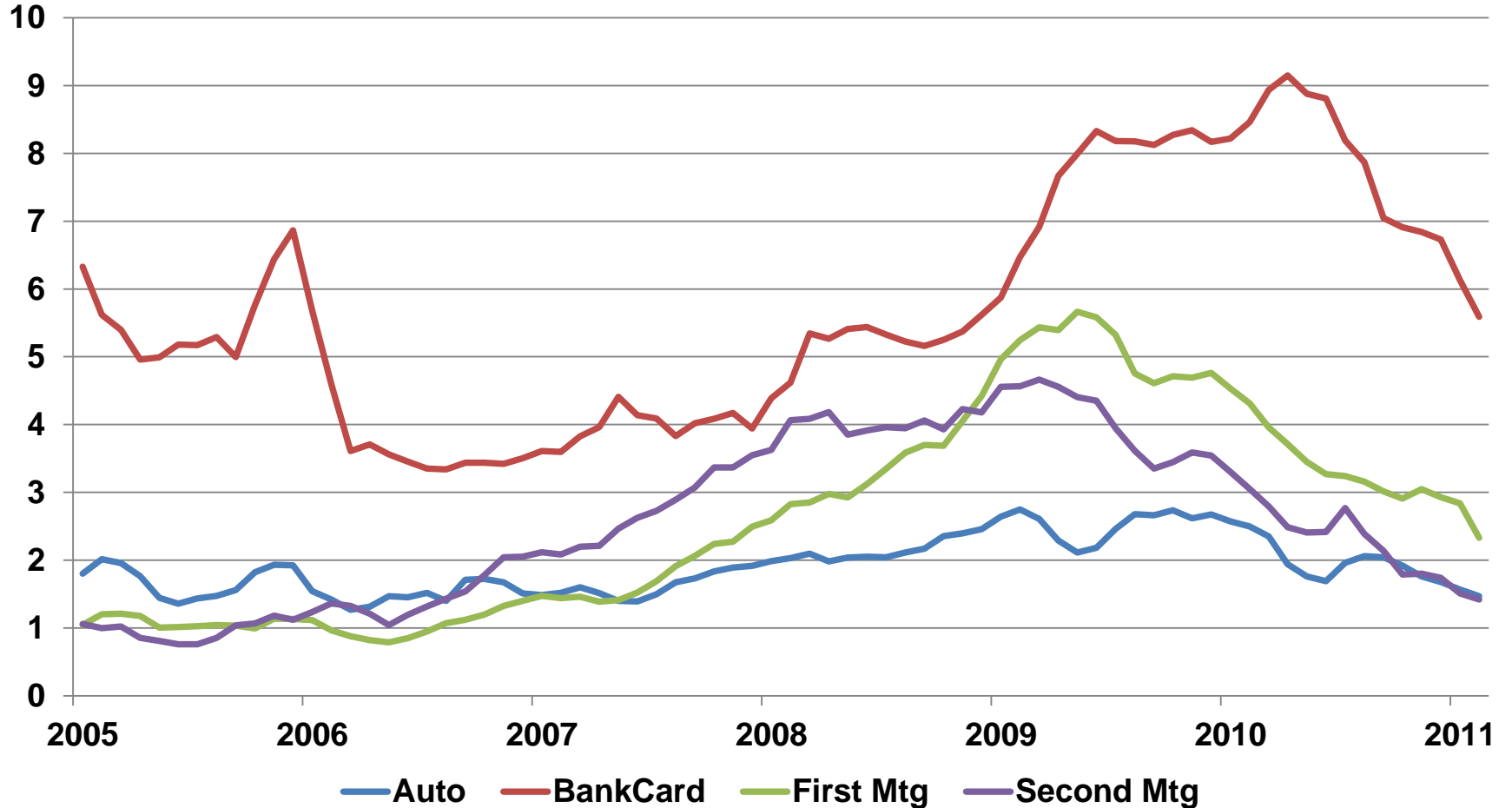
(Percent of after-tax income)



Source: Federal Reserve, S&P Economics projections

Default Rates Begin To Drop

(Percent)



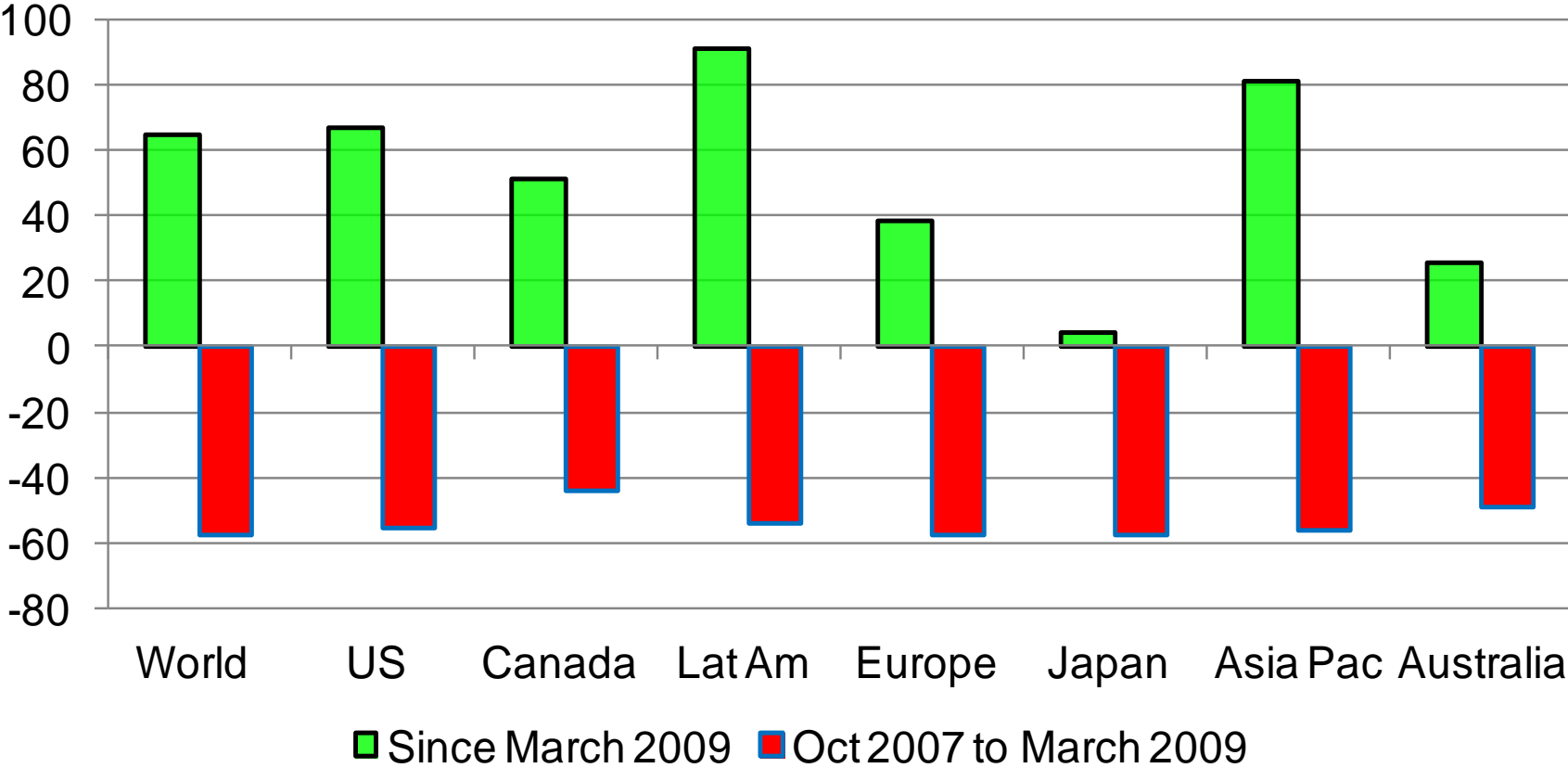
Source: S&P/Experian

Bigger Than The Average Bear

- **A great run from 1982 to 2000**
- **But the secular bear began in 2000**
- **Two largest bear markets since the depression**
- **Earnings were negative in 2008 Q4 for first time in history**
- **We think the rally will continue**
- **But the long-term cycle probably has another bear in it.**
- **World stock markets have generally become synchronized**
- **As money flows between markets in search of yield**

Everybody's Down

(Percent change in stock prices, Aug. 18)



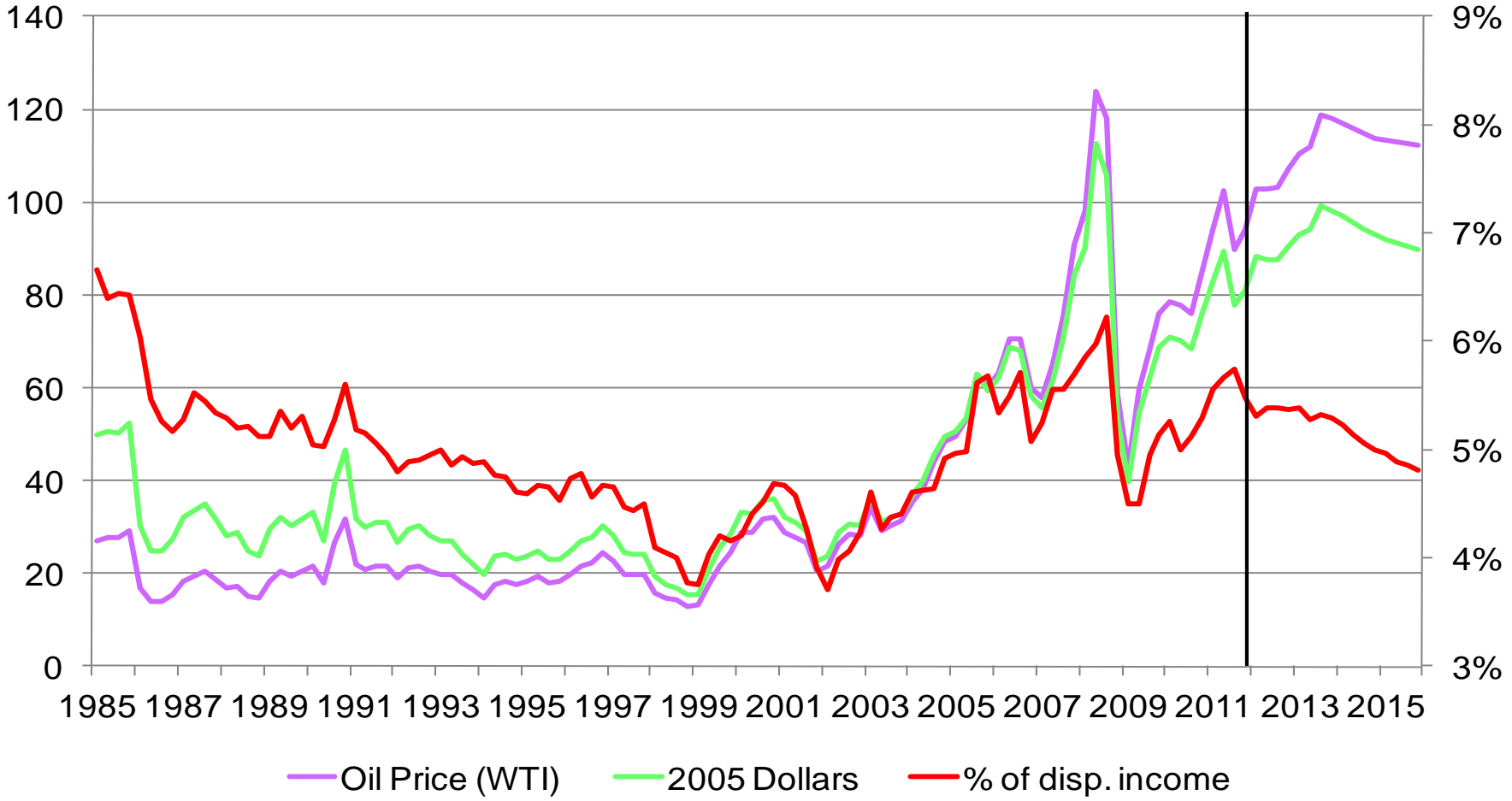
Source: Standard & Poor's

Bottom Line: The Economy Will Recover Slowly

- **The recession was the longest and deepest since the 1930s**
- **Fiscal stimulus has supported the recovery**
- **But recovery is likely to be slow because of financial markets and switch to higher savings**
- **If financial markets lock up again**
- **Fiscal stimulus ends abruptly**
- **Home prices continue to fall**
- **And oil prices continue to rise**
- **The recession could be longer and deeper**
- **With the risk of a “lost decade” similar to Japan in the 1990s**

Oil Prices Remain Down From Peak

(\$/barrel, WTI and deflated by CPI; household energy purchases as percent of disposable income)

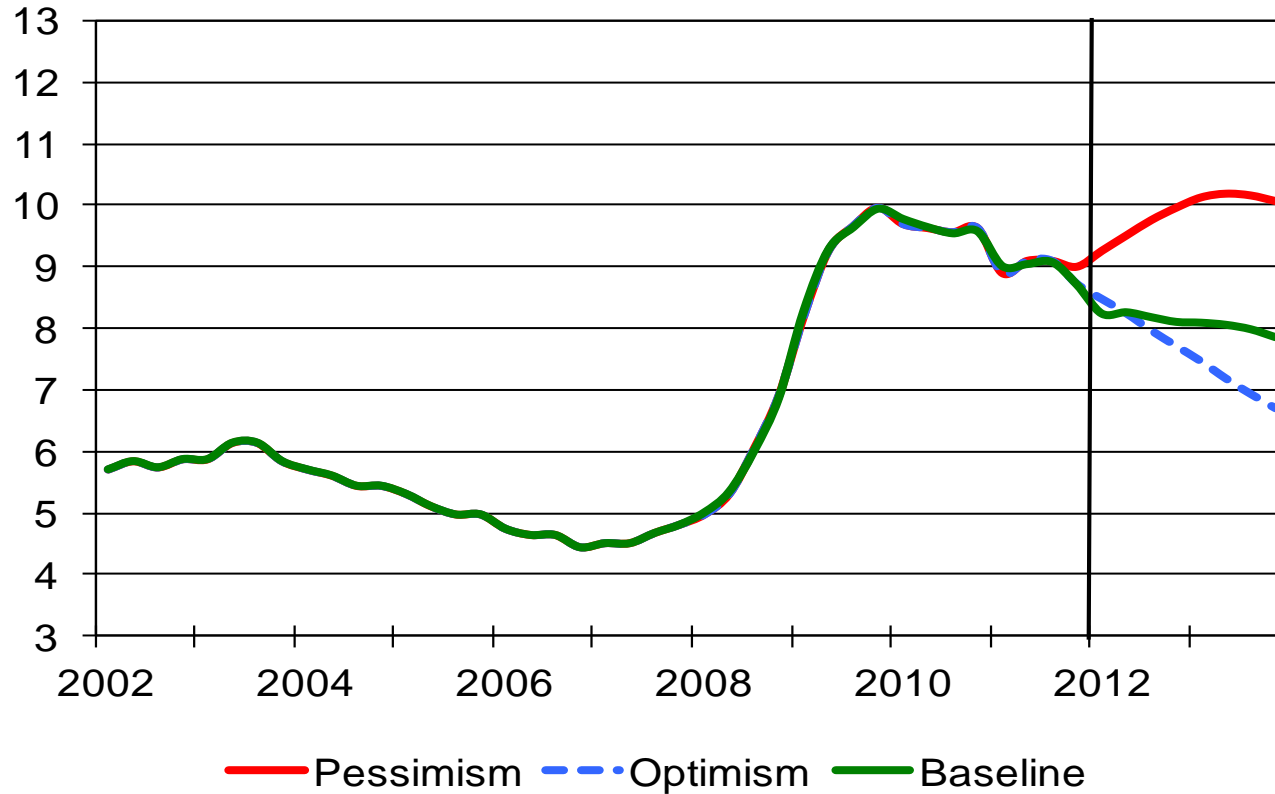


Source: Bureau of Economic Analysis

Risks to the U.S. Economy

The Unemployment Rate

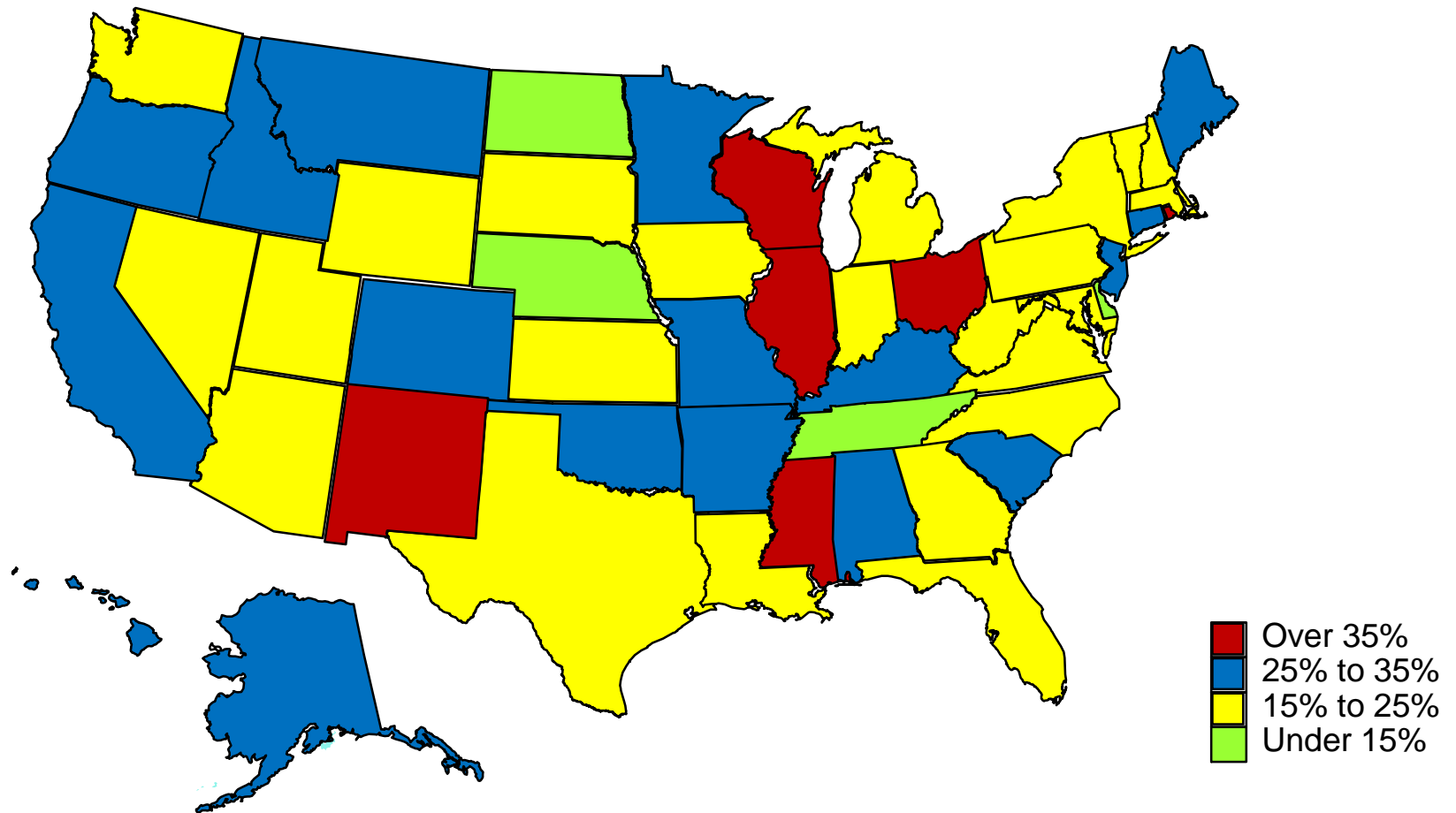
%



Source: U.S. Bureau of Labor Statistics (BLS), Standard & Poor's Economics projections begin 2011Q1

State Pension Underfunding

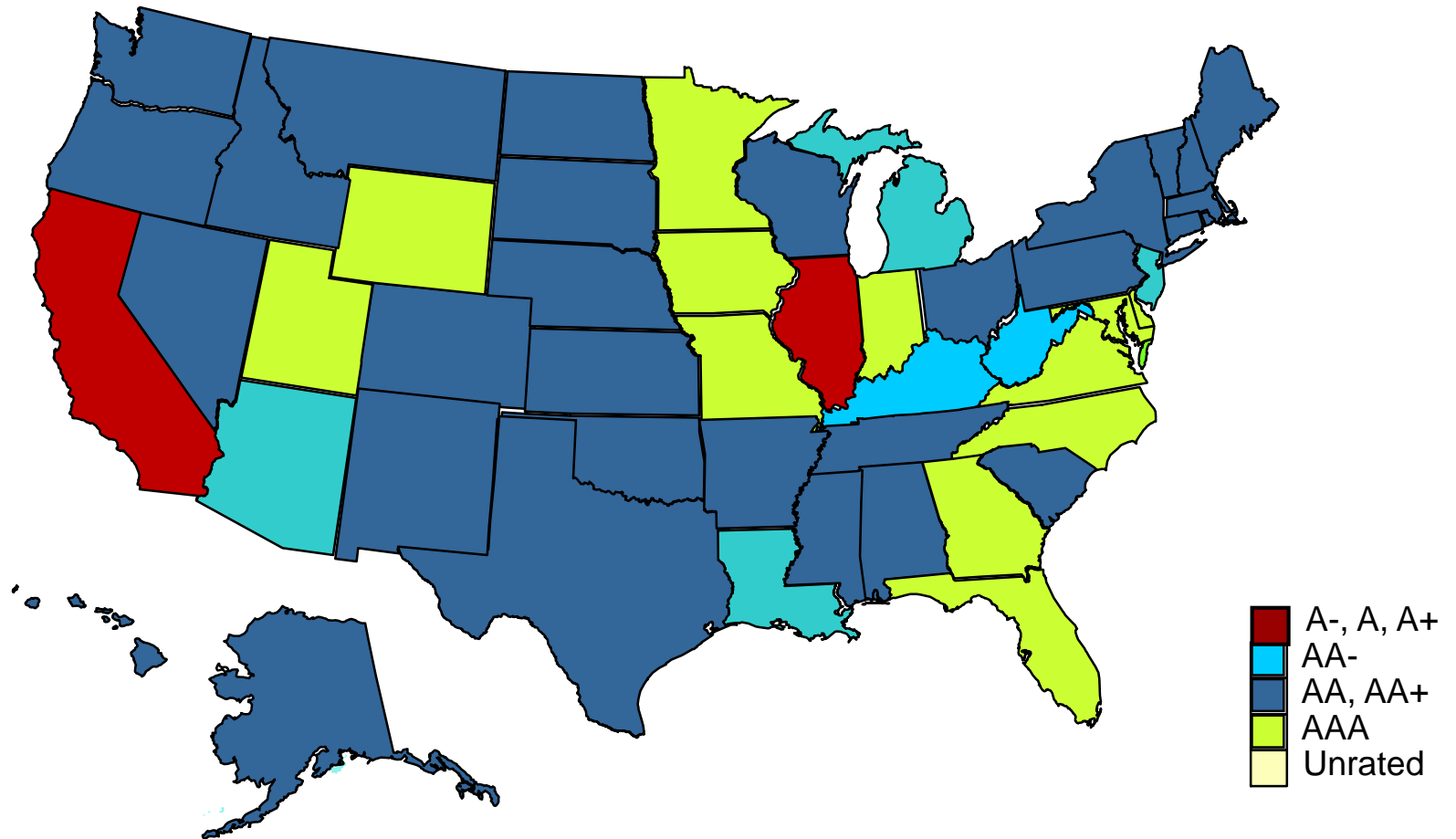
(Percent of gross state product, 2008)



Source: Robert Novy-Marx and Joshua Rauh, Journal of Economic Literature, Fall 2009

State Ratings Remain Strong

(S&P rating, April 2011)



Note: for states that don't have a GO rating from S&P, the chart assumes an equivalent from the short-term ratings