

# Economic Insights

## Double Dip? Seven Reasons Why Not

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It seems these days that half the headlines in the financial media fear a double-dip recession, as do half the conversations on Wall Street. There certainly are risks, not least in Europe's financial difficulties. But still, there are reasons to question such widespread concerns. History, after all, offers only one true double-dip experience, and that grew out of a policy error. More, the actual data on the economy fly in the face of such an outlook. Following are seven reasons to doubt the double-dip outlook.

### 1. The Consumer Seems Firm Enough

At some 70% of the economy, the American consumer almost always calls the general tune, and here, the picture is one of relative strength. To be sure, the market took it to heart when reports some weeks ago showed that retail sales in May dipped by 1.4%. But that sales decline followed a powerful 10% advance in retail sales during the prior 12 months. Had the consumer not paused, it would have been worrying. Meanwhile, broader-based measures of personal outlays have expanded moderately throughout. The 2.4% annual rate of expansion registered for overall outlays in May was slightly slower than the 4.2% annual rate of expansion recorded for the prior six months, but still, that was a slowdown not a decline.

More telling fundamentally, household income has risen sufficiently enough to support future spending. Overall personal income rose at an annual rate of 5.4% annual last May (the most recent month for which data are available), actually accelerating from the 4.4% annualized rate of advance during the prior six months. Meanwhile, the personal savings rate, at 4.0% of aftertax income, generates a \$454 billion annual flow of new money from which households can pay down debt even as they maintain existing levels of spending. If income continues to expand, as is likely, households will have the wherewithal to continue that "de-leveraging," even as they increase spending. All they need do is keep outlays from growing faster than income—a circumstance that should easily support at least moderate spending growth.

### 2. Housing Data Are Misleading on Two Sides

The \$8,000 first-time homebuyer's tax credit has played hob with monthly housing statistics and investor perceptions of the sector's fundamental strength. Of course, it was always ridiculous to suggest, as Washington did, that the credit would prompt someone to purchase a house. Even those with the most backward approach to financial matters would resist taking on a \$200,000 debt to save \$8,000 on taxes. But for those who otherwise would have bought a house, the homebuyer credit could and did affect the timing of purchases.

Thus, as the first expiration of the credit approached last November 2009, many who were otherwise looking for a new home crowded their purchases into the eligible period. Not surprisingly, home buying surged in October and November. But since many of these hurried sales would have otherwise occurred in December, January, and February, new purchases in those months dropped by more than 12%. Something even more extreme occurred as this latest expiration date approached in April 2010. People who were looking crowded their purchases into March and April in order to qualify for the credit, driving up home sales by almost 30%. Then, because so many of those sales would have occurred after April, recorded sales fell suddenly by about 30% in May. Housing starts and residential construction put in place followed this same up-and-down pattern.

But none of this says anything fundamental about the housing market. There, the more significant consideration is the drop in the inventory of unsold homes by 27%; in fact, during the last 12 months, from the equivalent of 13 months' supply during the 2008–2009 crisis to about eight months' supply more recently. This development fundamentally has lifted previous downward pressure on new construction, sales, and pricing. According to the National Association of

Realtors, for instance, the median sales price of homes sold in the United States has risen 5.3% so far this year, and prices continued to rise in May. It will be a long while before residential real estate becomes a good investment, but the price pattern nonetheless suggests that the market has easily compensated for the gyrations surrounding the tax credit.

### **3. Business Spending and Exports Are Awfully Strong for a Dip**

If business is anticipating a second dip in the economy, it has chosen a strange way to show it. To be sure, firms have held back on new construction, hardly surprising given the low level of capacity utilization. So far this year, nonresidential construction spending has dropped by 2.1%, or at an annual rate of 5.0%. But business managers cannot be too frightened, for they are spending heavily on new equipment. Shipments of capital goods (excluding defense materials) rose at a 3.0% annual rate during April and May—the same pace they have maintained during the past 12 months. More telling of expectations than actual shipments, new orders for such capital goods exploded at a remarkable 48.3% annual rate during this supposedly weak April–May period—a tremendous acceleration from the already rapid 25% rate of expansion during the prior 12 months.

Meanwhile, business also has begun to rebuild inventories, presumably in anticipation of future sales growth. Stocks of finished goods on hand rose at a 6.0% annual rate between March and May (the latest month for which data are available), and work in progress increased at a 4.3% annual rate.

Exports also showed strength. So far this year, through April (the latest month for which data are available), total U.S. exports to the rest of the world have expanded at an impressive annual rate of almost 17%. In April, they jumped at a 12.7% annual rate. That kind of growth will not only help spur the overall U.S. economy but it also argues that the world economy is far more robust than double-dip arguments suggest. As a take on domestic U.S. demand, it is noteworthy that imports have expanded at a 23.5% annual rate so far this year, a pace they held in April. Clearly, someone in this economy is buying.

### **4. Overall Production Levels Look Fairly Good, Too**

More general measures of economic activity also cast doubt on the double-dip outlook. Industrial production, for instance, continues to rise at impressive rates. The year-to-date rate through May (the most recent month for which data are available) has seen this measure of output in factories, mines, and utilities rise at an annual rate of more than 8%, and in May, the pace actually accelerated to an annual rate of more than 15%—clearly unsustainable, but quite the opposite of weakness, much less a double-dip. Similarly, the Purchasing Managers Index (PMI)<sup>1</sup> of the Institute of Supply Management shows continued growth. To be sure, the index fell in May and June (the most recent months for which data are available), to a level of 56.2 from an April level of 60.4. But since any reading above 50.0 speaks to economic expansion, even the lower figure records continued growth and not another dip. The fact is that the April figure was unsustainably high.

### **5. Employment Does Not Look Threatening, Either**

Indicators on hours, temporary employment, and even full-time employment have begun to edge up. And even though the unemployment rate has failed to fall in a concerted way, such a move would be premature at this stage in the recovery, at least given the lags averaged in past cycles. Actually, the jobs market is slightly ahead of schedule, according to these historical benchmarks. (For more detail, see the *Economic Insights* of July 6, 2010, “Late for Work?”)

### **6. Financial Markets Are Healthier Than the Headlines Imply**

Though Europe’s sovereign debt problems present a huge financial and, consequently, economic risk, financial markets have nonetheless demonstrated an impressive resilience. Indeed, their behavior under this strain speaks to a significant, fundamental healing. Contrary to the tone of the headlines, markets have avoided the much-looked-for relapse into the mess of 2008–2009. For example, the TED spread<sup>2</sup> (the gap between Treasury bill and interbank lending rates, and a good indicator of liquidity) has only widened in this crisis, from 20 basis points (bps) to about 40 bps. Some widening was to be expected in the face of European uncertainties, but matters are still a long, long way from the 460 basis-point spread recorded during the 2008–2009 crisis. Similarly, junk bond spreads have widened, from some 600 bps over Treasuries earlier this year, to 700–750 bps, as the European problems have become evident. Though an unsurprising reaction to the European credit scare, these spreads are a far cry from the 2,100 bps they reached in 2008–2009. Meanwhile, issues continue to get sold on bond and money markets, and even bank lending has shown some tentative signs of flowing again.

### **7. China Continues to Grow**

A slowdown in China is not only consensus but it also is a reasonable expectation. A housing bubble of sorts is deflating in China's major cities. The government in Beijing has taken monetary and fiscal steps to slow the pace of growth. Beijing's recent decision to allow the yuan to appreciate against the dollar on foreign exchange markets has raised questions about the future growth of Chinese exports, both to the United States and to Europe.

But though all these factors are real and will slow China's general economic growth rate, it would be a mistake to exaggerate them. China's decline in residential real estate prices hardly risks the financial collapse that occurred in the United States about a year and a half to two years ago. For one, debt levels in China are much lower than they were or are here. While Chinese households on average are carrying debt equal to about 40% of income, American debt levels approach 120–130% of income. For another, Chinese typically put 50% down for a home purchase and almost never less than 20%. Neither will the yuan's increase impact exports very much. The currency appreciation is so slight and so carefully managed that it is more cosmetic than real. It is certainly insufficient to threaten Chinese exports. Broad economic indicators also show a slowdown, not a decline. The PMI, for instance, dropped from 53.9% in April to 52.1% in May, but still anything above 50% is expansion. If, as expected, China's overall growth slows for an 11.9% annual rate in the first quarter, to 9.5%, it will still remain faster than the rest of the world—and hardly the stuff of which double dips are made.

<sup>1</sup>The Purchasing Managers Index (PMI) is a composite index that is based on five major indicators including: new orders, inventory levels, production, supplier deliveries, and the employment environment. Each indicator has a different weight and the data is adjusted for seasonal factors.

<sup>2</sup>The TED spread is the difference between the interest rates on interbank three-month eurodollar contracts as represented by the London Interbank Offered Rate (LIBOR) and short-term U.S. government debt (T-bills). TED is an acronym formed from T-bill and ED, the ticker symbol for the eurodollar futures contracts.

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