

RGE's Wednesday Note - No Chance of a V-Shaped Recovery

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1 message

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WEDNESDAY NOTE

Greetings from RGE!

The curtain has opened on Act Two of our [“Year of Two Halves”](#)—RGE’s theme since the end of 2009—with the slowdown forecast for H2 2010 getting here a bit earlier than expected. Growth in Q2 2010 registered a very weak 1.6%, revised down from an original estimate of 2.4%—a sharp slowdown from the 3.7% of Q1. This implies much weaker growth in H1 than even bearish forecasters had expected. Moreover, most of the growth was driven by a temporary inventory adjustment; final sales grew a mediocre 1.1% in Q1 and 1.0% in Q2.

All the tailwinds of H1 will become headwinds in H2, a shift we examine in a new [RGE Analysis](#), available exclusively to clients. As state and local governments keep retrenching and even the federal stimulus diminishes, the fiscal stimulus will turn into a fiscal drag that will be much more pronounced in 2011 and after some of the 2001-03 tax cuts expire. The base effects from the lousy economic activity figures of 2009 are gone, temporary census hiring is finished and tax incentives—cash for clunkers, the investment tax credit, the first-time homebuyer tax credit and cash for green appliances—have all expired after “stealing” demand and growth from the future.

As we argued in our [North America Focus](#) last week, a succession of data releases has induced a race to the bottom as other forecasters revise their estimates down to figures closer to ours. Personal consumption—70% of aggregate demand—seems off to a rocky start this quarter: Core retail sales for July showed the third decline in the last four months. In the week ending on August 21, same-store sales data released by ICSC-Goldman Sachs showed a fourth straight decline. With inventory restocking over, the investment outlook is equally bleak. Corporate sector capital expenditure, the only component of aggregate demand that grew robustly in H1, appears set to slow: The shipments and new orders indicators of the July durable goods report showed a decline across categories. Meanwhile, despite the return to marginally positive growth in Q2, investment in non-residential structures will remain anemic at best through H2, given the record-high vacancy rates in commercial real estate. [As we expected](#), the housing sector is already in a [double dip](#): Single-family starts fell by 4.2% m/m in July, the third consecutive month of decline, and both existing and new home sales touched their all-time lows. In summary, every component of aggregate demand—with the exception of net exports, which weighed on growth in Q2—appears set to offer a worse contribution to growth in Q3 than the previous quarter.

The truth is that we have not had much of a recovery in the first place, which might prevent the economy from falling enough to display what many would label a double dip—although we are now assigning a 40% probability to such an outcome. Weak [economic growth](#) and [labor market conditions](#) imply that the U.S. output gap keeps widening and the employment to population ratio will continue to fall. The anemic recovery and downward trend of inflation and inflation expectations are raising concerns that the economy could not only surprise to the downside but eventually stall. A growth rate of 1% or lower (now likely for H2 2010) is a severe growth recession, as potential growth is closer to 3%.

With growth nearly stalled, an unstable disequilibrium arises that is likely to tip the economy into a double-dip recession. The unemployment rate climbs, the budget deficit widens because of automatic stabilizers, home prices keep falling, bank losses are much larger and protectionist pressures come to a boil. Stock markets could sharply correct, and credit and interbank spreads could widen as risk aversion increases. A negative feedback loop between the real economy and the financial system could easily tip the economy into a formal double dip: The real economy reaches

a near-stall speed and risky asset prices correct downward, leading to a negative wealth effect, a higher cost of capital and reduced business, consumer and investor confidence.

Given political and fiscal constraints and banks' unwillingness to lend, we remain doubtful of the potential for policy to prevent a double dip. Even a new round of [monetary and quantitative easing](#) can provide limited stimulus. The real issue facing the U.S. is the need for balance sheet deleveraging and repair, and that will be a multi-year process. The U.S. must brace itself for a long period of below-potential growth.

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