Special Report


## US Economic Recovery:

# What's There To Cheer About?

Despite many analysts predicting a complete turnaround in the US economy, this cannot be possible what with the high count of the unemployed and the squeeze in domestic demand brought on by the debt trap of most people who bought new homes and lifestyle goods during the days of the boom, says **Kunal Kumar Kundu**

A recent Bloomberg survey indicated a majority of the analysts being of the opinion that the worst of the global economic crisis is over. Many are, in fact, waxing eloquent about a 'V' shaped recovery. To me, this seems to be more of a tendency on their part to extrapolate historical data rather than look at the ground reality. I feel that while the pace of decline is indeed slowing down and the worst recession in memory may possibly be behind us, any data pointing toward recovery might be illusionary. Further, signs of recovery do not mean that the good times are back and that global worries are over. It is quite likely that the actual recovery will be very slow and might not actually look like a recovery. But that's for later.

The scope of this article is to analyse why the worst might not be fully behind us and for which I am willing to stick my neck out. For the US economy to experience sustainable recovery, it is important that the labour market stabilises and then improves. At this point in time, there is no indication to that effect. The recently released unemployment number seemed to be cause for much rejoicing. The US apparently lost 'only' 2,47,000 jobs. More importantly, despite this loss, the unemployment percentage actually reduced from 9.5 to 9.4 per cent. Clearly, the improvement in the unemployment rate has more to do with a statistical phenomenon than any real recovery.

### In Search Of Jobs

As a result, despite a job loss to the tune of 2,47,000, there were nearly 5,00,000 people who were not counted as unemployed since they were not looking for a job during the month prior to the survey. They form a part of the 2.3 million discouraged workers. In reality, things are still dismal. The very fact that a huge 2,47,000 job loss cheers the market indicates the extent of the problem. During this recession, the US has lost 6.9 million private non-farm jobs starting from December 2007, when the employment number peaked. Even an annual destruction of 5.8 million jobs (as compared to July 2008) is the highest ever annual decline recorded.

In effect, not only have all the private sector jobs created after the last recession vanished, the total private sector employment number is currently back to what it was ten years ago. And, during this ten-year period, a little more than 15 million people have entered the work force. Things turn even scarier when one looks at long-term unemployment numbers, i.e. a person who has been unemployed for 27 weeks or more. This number has increased drastically to nearly 5 million with every third [33.8 per cent as per Bureau of Labor Statistics (BLS)] unemployed person being unemployed for a long time.

In this context, it is important to remember that a person who is unemployed for 26 continuous months will cease to get allowance. Hence, they fall out of the statistics after completing the period. As per a press release issued by BLS, on an average, every month since March 2009, 4,00,000 plus people have become ineligible for the allowance. Naturally, the statistics show improvement. Add to this the fact that there are nearly 8,00,000 workers who are considered 'discouraged' (i.e. they are not looking for job because they believe no jobs are available for them), and the final trace of euphoria would vanish.

Also, as of now, there are more than 8.6 million people (in totality) who have been forced to take up a part-time job because of economic reason i.e. while they want a full-time job they are not getting one. Of this, more than 4 million people were additions to the list during the current recession only, the highest ever in history. So, even after the economy turns around, most of the employers would first prefer to increase the working hours of these employees, so as to make them full-time workers. This would not only take some time, but also the conversion of these employees from part-time to full-time would mean no new jobs would be created for some more time to come. Hence, a high level of unemployment would persist.

### Hard To Recover

Recently, Fed Chairman Ben Bernanke said, "It takes GDP growth of about 2.5 per cent to keep the jobless rate constant. But the Fed expects growth of only about 1 per cent in the last six months of the year. So that's not enough to bring down the unemployment rate." The US is in a very difficult terrain currently what with their consumers being highly indebted. Despite some correction, the current US household debt to disposable income ratio is as high as 128 per cent.

Now, not only are the consumers virtually unable to repay their debts, their wealth has also been reduced to a fraction of what it was earlier. Added to this is rising unemployment. Hence they are dramatically cutting back on their spending.

## Baby Boomers Hit Hardest

The hardest hit has been the baby boomer generation. The baby boomer population of 76 million has begun to retire in 2008 and 10,000 people will join their ranks every day for the next two decades. The generation that couldn't care less for savings is seeing its wealth dissipate in front of its eyes. With many of them experiencing a substantial decline in their retirement fund, going forward it is expected that the US consumers would start saving more and cut back on consumption. Indeed, it is important to realise that a great deal of de-leveraging is waiting to take place as the US consumers are now scurrying for cover. Fact is, the dramatic rise in debt was accompanied by a steady decline in the personal saving rate.

The combination of higher debt and lower saving enabled personal consumption expenditures to grow faster than disposable income, providing a significant boost to US economic growth over the period. However, in the longer run, consumption cannot grow faster than income because there is an upper limit to how much debt households can service, based on their incomes. For many US households, current debt levels are clearly too high, as evidenced by the sharp rise in delinquencies and foreclosures in recent years. To achieve a sustainable level of debt relative to income, households may need to undergo a prolonged period of de-leveraging, whereby debt is reduced and saving is increased.

After a long gap, savings have indeed started to increase. But the indebtedness is still very high and there should be a lot of de-leveraging happening before things settle down. The minimum that should happen is that the debt to income ratio should at least fall to 100 per cent, if not less. On the other hand, savings rate should go up from the current 1 per cent plus. Even if it goes up by 1 per cent per year for a decade, it will still be 10 per cent, which would be short of 12 per cent reached during the 80s. Corollary: The US economy would continue to falter in the coming years as this adjustment takes place.

A recent study by McKinsey threw up some important highlights:

- As the baby boomers push the savings rate up to nearly 5 per cent (from 1 per cent), annual US consumption would come off by USD 400 billion.
- Before the bubble burst, the share of the baby boomers in the US' national disposable income in 2005 was 47 per cent while they contributed only 7 per cent to national savings.
- The demand destruction following the reduction in consumption by the baby boomers would result in an annual average US GDP growth of 2.4 per cent over the next three decades. In comparison, the GDP has grown 3.2 per cent a year since 1965.
- There are 69 per cent of the boomers aged 54 to 63 who are financially unprepared for retirement.


- Baby boomers' share of GDP growth during the bubble years of 1995 to 2005 was 78 per cent.

## Business In The Driver's Seat

Hence, even if the US economy has to recover, it is clear that it will not be consumer-driven. It is likely that the recovery might be business-driven. At least for some time there is every chance that the economy would show positive growth, simply because businesses were cutting back on production and were meeting demand through a huge draw-down in inventories. So much so that capacity utilisation is now down to about 68 per cent. It is expected that the production would pick up as they start rebuilding inventories. But, let's be clear about the fact that this is more of a technical rebound rather than any real fundamental growth. What will also aid the economy growing forward would be the effect of the humungous stimulus package announced so far.

A good example of that would be cash for clunkers programme with auto sales picking up as the consumers are being given substantial discounts to get rid of the old cars for new ones or credit offered to new home buyers. But the effect of these stimulus packages would be short-lived. Also, with the recovery likely to be jobless and unemployment rate likely to remain high for some time, there will be a limit to which business can lead the growth as constricted domestic demand will limit their ability to grow fast. Seemingly, this anxiety is creeping into the sentiments in the equity market as well, which a few months back was way too bullish as they became obsessed with various green shoots. There seems to have been a correction in their expectation about global recovery.

As can be seen from the adjacent chart, which shows the monthly movement in the P/E of the Dow Jones Industrial Average (DJIA): Running a simple linear regression between the GDP growth and the DJIA, P/E shows that a GDP growth of 2.5 per cent can support a P/E of around 17, while this year the GDP is expected to contract between 2.5 to 3 per cent. At this level of contraction, the market currently seems to be valued fairly enough. My guess is, going forward, the market would continue to remain volatile for months to come and the extent of uptick and downtick would depend on sighting of real green shoots or moss covered twigs. In essence, while the US economy is slowly moving further away from the precipice, it will continue to be haunted by the growth or the lack of it.