Our Perspectives:
Commentary on the economy & regulatory policies affecting financial companies

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The Longbrake Letter*

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I. Economic Recovery Intact, But Close to Stall Speed

In my April letter I observed that while economic recovery was forging ahead, albeit at a very slow pace, significant risks confront the economy and collectively these risks skew growth prospects in the direction of deceleration rather than acceleration. Two months later incoming data reports covering employment, consumer spending, housing construction, and manufacturing, to name a few of the more important components, confirm deceleration in the rate of growth.

May's employment report was very discouraging. Payroll employment rose only 54,000 and the unemployment rate rose from 9.0% in April to 9.1% in May. Employment needs to rise by at least 100,000 per month simply to keep the unemployment rate stable. Doubling payroll employment growth to 200,000 per month would bring the unemployment rate down over time, but to a much lesser extent than you might imagine — only about 0.8% over a year's time, which would bring the unemployment rate down to 8.3% a year hence.

It is not as though the disappointing employment news was unforeseen. There were plenty of warning signals, but optimists chose to focus on the average 220,000 monthly growth in payroll employment for February, March and April and ignored employment indicators that painted a less optimistic picture. Over the same three months, employment growth, based on the household survey, averaged only 117,000 per month; the average weekly number of new unemployment claims filed rose; and consumer expectations about the jobs outlook deteriorated

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While each business cycle always has unique elements, we have come to expect that aggressive fiscal and monetary policies can not only cushion the negative consequences of recession but also provide the necessary stimulus to reignite economic growth. Two years into recovery, policy indeed has dampened the negative impacts of the Great Recession and most certainly helped avert the possible downward spiral into Depression. But it is becoming clearer with each passing month that economic growth is sputtering and self-sustaining growth sufficient to close the enormous output gap and bring down the unemployment rate is far from assured, at least not within the time frames that we have come to expect.

In this month's letter I discuss the dismal state of the labor market and examine possible reasons why aggressive use of traditional monetary and fiscal policy tools has been and is likely to continue to be relatively ineffective in restoring full employment. To foreshadow, policymakers have assumed that the employment problem stems from inadequate demand. However, if the problem instead derives from a restructuring of the supply side of the global economy, as I suspect, policies focused only on demand stimulation will be ineffective in inducing the creation of the number and types of jobs necessary to close the employment gap on a sustainable basis. By applying logical analysis, it should be clear to you that if the problem is different from what it is supposed to be, then the remedies — policies — will also need to be different. We are taught that the first and most important step in problem solving is to define the problem. If we don't do that, then whatever solutions we devise will have a high probability of failing.

Two major and unresolved issues continue to cast a dark shadow over economic recovery. They are the ongoing European sovereign debt problem and the U.S. housing market problem. While each seems to be separate and distinct, they have many common attributes. The most important common attribute is that policymakers are engaging in avoidance strategies with the vain hope that "things will work themselves out". The reality is clearly otherwise. Avoidance and delay is making the problems worse and as time passes the danger of contagion and broader negative impact on economic activity is growing. This is a topic I intend to probe in next month's letter.

II. Where Are the Jobs?

Prior to the Great Recession, the most severe recession that the U.S. economy experienced since the Great Depression of the 1930's occurred during the period of extremely high inflation from 1980-82. In previous letters I have compared key economic indicators for the 1980-82 recession and those from the Great Recession of 2008-09. These comparisons show two things. First, the Great Recession generally had consequences at least as severe, if not more severe, during the recession itself. Second, the recovery from the 1980-82 recession occurred relatively quickly in the two to three years following the end of the recession; such has not been the case so far in the nearly two years that have elapsed since the end of the Great Recession.

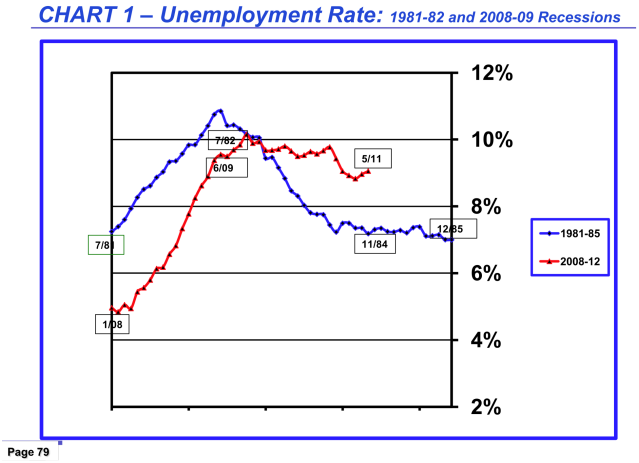
There were significant policy differences between the two recessions with monetary policy being very restrictive during most of the 1980-82 recession with the objective of quashing inflation. Fiscal policy provided moderate support during the 1980-82 recession but only turned aggressive when the Reagan tax cuts were implemented after the recession had officially ended. It is fair to conclude, however, that both monetary and fiscal policies were stimulative during the recovery period following the 1980-82 recession and undoubtedly contributed to rapid return to conditions of full employment. Unlike the 1980-82 recession aggressive monetary and fiscal policies were applied during the early stages of the Great Recession and the magnitude of stimulus far surpassed that applied during and after the 1980-82 recession. For example, the deficit to GDP ratio was about -3.0% at the end of the 1980-82 recession and peaked a year later after the Reagan tax cuts took hold at -5.5%. In contrast, the deficit to GDP ratio rose from -1.3% at the state of the Great Recession in December 2007 to -8.9% at its end in June 2009 and peaked at -10.1% three months later.

As for monetary policy the real Fed Funds rate (nominal rate minus the inflation rate) was extremely positive at the end of the 1980-82 recession and remained highly positive until 1987. In contrast the real Fed Funds rate became negative shortly after the start of the Great Recession and has remained consistently negative since then. In fact, if the impact of quantitative easing were taken into account, the real rate would be even more negative. Negative real rates of interest are stimulative; positive real rates are restrictive.

Based solely on the differences in timing and amount of monetary and fiscal policy stimulus, we should have rebounded strongly and quickly from the Great Recession. It is that expectation that has fueled persistent anxiety about the possibility of runaway inflation. But, a strong rebound has not occurred and increasingly seems unlikely to materialize. When the play book doesn't work, that is a strong clue that the problem is very different from it is supposed to be.

1. Employment — Comparing the 1980-82 Recession With the Great Recession of 2008-09

Chart 1 shows the unemployment rate for two time periods. The starting



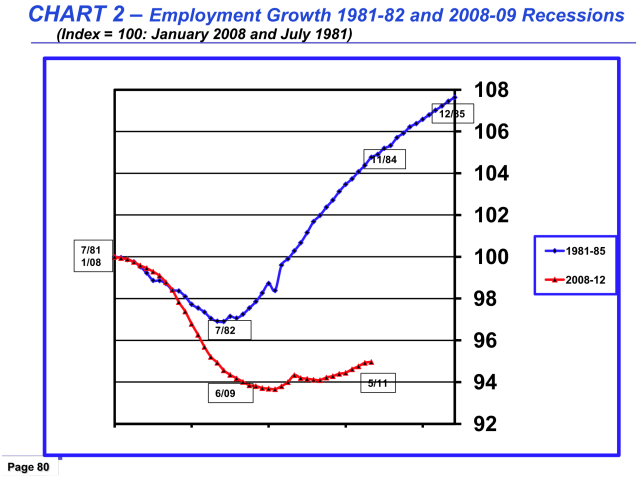
date for each period is the month in which total payroll employment peaked, which is either the month that the recession officially commenced or within one or two months of that date. The second set of dates on the chart is the approximate month that marks the end of the recession — June 2009 for the Great Recession and July 1982 for the 1980-82 recession. The third set of dates on the chart shows the trajectory in the unemployment rate during the recovery, aligned for the May 2011 date, the last month there is data available for the recovery period since the Great Recession. The last date at the right edge of the chart shows the on-going downward drift in the unemployment rate following the 1980-82 recession through December 1985.

Chart 1 shows that the unemployment rate was higher in the month that payroll employment peaked in the recession of 1980-82 compared to the Great Recession. It was higher for two reasons. First, the 1980-82 recession was a double-dip twin recession with employment rebounding to a peak in July 1981 between the first and second parts of the recession. The second reason was that the tail end of the baby boom generation was still entering the labor force with the effect that the unemployment rate generally was somewhat higher throughout the late 1970's and 1980's.

What is important to observe in **Chart 1** is that the unemployment rate fell quickly from the peak of nearly 11% to about 7% by November 1984. While the unemployment rate peaked at a slightly lower level of10.1% in the Great Recession, by May 2011 it has fallen only to 9.1%, well above the 7% level achieved during the recovery following the 1980-82 recession.

Overall, the message in **Chart 1** is clear — the unemployment rate is not moving down nearly as quickly in the current recovery as it did following the 1980-82 recession.

Chart 2 compares employment growth over time by setting the employ-

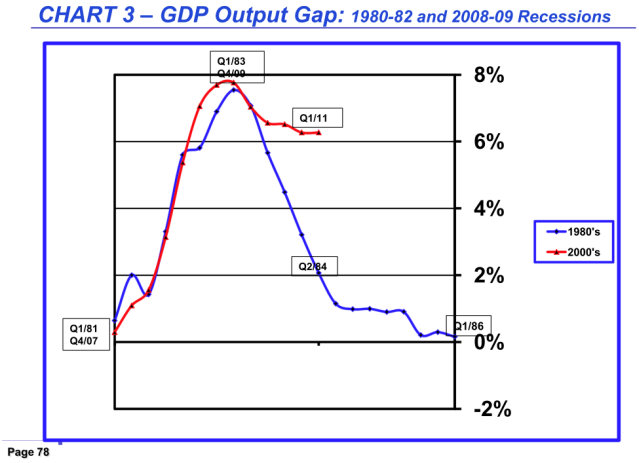


ment peak month at the beginning of the recession equal to an index value of 100.

At the end of the 1980-82 recession in July 1982, the employment index

fell to 96.9, indicating approximately a 3% decline in total jobs. However, the index at the end of the Great Recession in June 2009 had fallen further to 94.6, indicating a loss of jobs exceeding 5%. The real story, however, is what happened during the recoveries following the end of the two recessions. After the end of the Great Recession the employment index continued to fall, bottoming out at 93.7 in February 2010 and then recovering only to 95.0 in May 2011. In contrast, the employment index moved up immediately following the end of the 1980-82 recession. By the 23rd month of recovery, a comparable time period following the end of both recessions, the index had climbed to 104.8 compared to 95.0 following the Great Recession. The overall difference is an astonishing 10 percentage points.

Chart 3 compares the GDP output gap, as calculated by the Congres-



sional Budget Office, between the 1980-82 recession and the Great Recession. The behavior of the GDP gap tells a story similar to that embedded for employment in **Charts 1** and **2**. However, **Chart 3** shows vividly that the two recessions mirrored each other almost exactly from start to finish. But, the real story, as is the case for employment, is the substantial divergence during recovery. Five quarters after recovery had commenced, by the second quarter of 1984, the GDP gap fell from a peak of 7.5% to 2.1% and one quarter later the gap had all but disappeared. However, as of the first quarter of 2011, five quarters after recovery from the Great Recession began, the output gap had fallen only from 7.8% to 6.3%.

It is very clear that the current recovery is disappointingly sluggish in spite of unprecedented and massive amounts of fiscal and monetary stimulus.

2. May Employment Data

Payroll employment rose only 54,000 in May following three strong months of 232,000 in April, 194,000 in March and 235,000 in February.

As I have mentioned, the May payroll employment report unfortunately corroborated weaknesses in other employment data, which I reviewed in last month's letter. For example, the one statistic which usually receives the greatest amount of attention, the unemployment rate, was 9.0% in April compared to 8.8% in March and rose further in May to 9.1%. The unemployment rate is calculated from the household employment survey rather than from the payroll survey. The number of people looking for work, who are counted as unemployed, rose 167,000 in May after rising 205,000 in April while the labor force rose 287,000 in April and May. This means that the number employed fell by 85,000 over the two month period.

Over the last year, the number of people eligible to work has increased 1.8 million. Many of those eligible to work voluntarily chose not to do so. The household employment survey asks those eligible to work whether they are either employed or looking for work. This measure is called the labor force. The labor force decreased 544,000 over the last 12 months. The relationship between those eligible to work and those willing to work is termed the "participation rate". During the last 12 months the participation rate decreased from 64.94% to 64.22% (see **Chart 4**) and it is down approximately 2% since the start of the Great Recession. A 1% change in the participation rate equals approximately 2.4 million people who have chosen not to seek employment either voluntarily or because they have become discouraged.

Generally, over long periods of time the payroll employment survey and the household survey of those employed track each other relatively closely (see **Chart 5**). However, the two surveys, because of differences in sampling methods, will sometimes diverge on a month-to-month basis. This was the case in both April and May. While payroll employment increased 232,000 in April, household survey employment decreased 190,000. But the relationship reversed in May. Payroll employment rose only 54,000 but household survey employment rose a greater 105,000. When the two months are combined,

CHART 4 – Labor Force Participation Rate

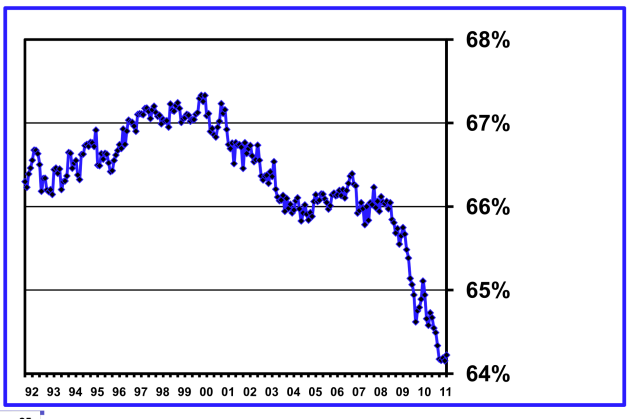
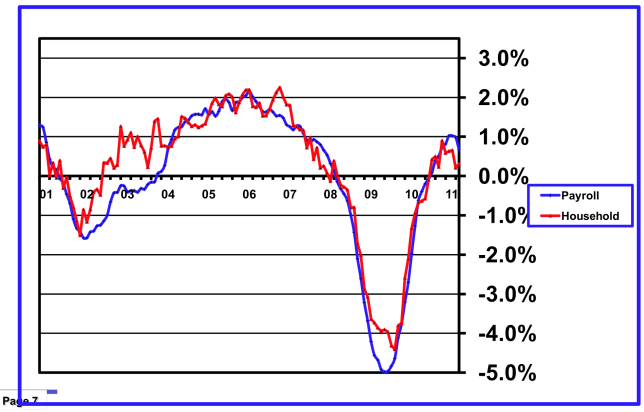


CHART 5 – Employment Growth *(annual rate of change)*



the disparity diminishes — payroll employment increased 286,000 over the two months, while household survey employment fell 85,000. Nonetheless, the divergence between the two reports has persisted over the last 12 months during which payroll employment rose 870,000, but household employment rose a much smaller 426,000.

A possible explanation for this sustained difference, which is unusual, could be embedded in the payroll survey estimation methodology used to

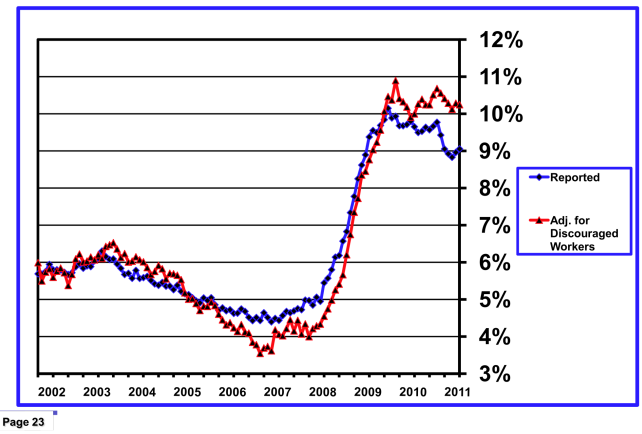
account for self-employed individuals and persons employed by small businesses. Generally, the payroll survey underestimates the number of such employees during the recovery phase of the economic cycle, as can be seen in **Chart 5** during the economic recovery that followed the 2001 recession. The recent result is exactly opposite to what happened after the 2001 recession. It could be that the continued extremely weak small business survey data might be telling us that the typical recovery in self-employment and small business employment is not occurring this time. Since the payroll survey focuses on combining data from large employers and with estimates for small business and self-employed workers, it is possible that the supplemental estimates are overstating the true situation. Payroll data are benchmarked annually on a retrospective basis. Household data are never revised. Thus, it is reasonable to posit that in times of potentially significant structural change in labor markets, the household survey will be more reliable than the payroll survey. The May report supports this pattern as the growth in payroll employment is slowing and converging toward the weak household survey employment growth rate, which peaked about three months sooner than the peak in the payroll employment growth rate.

3. Labor Force Participation

Participation changes over time because of demographic changes and cultural considerations, such as greater entry of women into the labor force. Over shorter periods of time labor participation is also influenced by workers who exit the labor force during difficult times only to re-enter the labor force during good times.

Demographic factors have driven a slow decline in labor force participation since it peaked just prior to the 2001 recession. There was a bit of a rebound in the late part of the cyclical expansion prior to the start of the Great Recession in December 2007. As can be seen in **Chart 6**, however, the decline in participation over the last three years is much greater than can be explained by demographic factors alone. The primary demographic reasons for declining participation are an aging workforce with a lower participation rate in the oldest cohorts and a declining participation rate among young workers, probably reflecting a larger proportion going to college. Demographic considerations have accounted for about a 0.5% decline in the participation rate since the start of the Great Recession. Other factors have

CHART 6 – Reported Unemployment Rate & Adjusted for Discouraged Workers



contributed to the remaining 1.3% decline from the peak of 66.0% at the onset of the Great Recession. Principal among these other factors is discouragement, which prompts workers to give up looking for work and drop out of the work force. Such workers could well re-enter the labor force when job prospects improve and the labor market tightens. However, some of the decline could also stem from structural unemployment for workers that are simply unemployable because they do not have skill sets any employer needs.

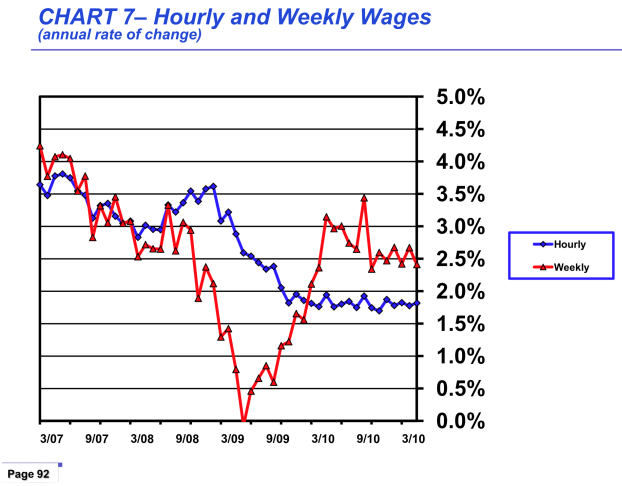
There are currently approximately 1.8 million workers who have dropped out of the labor force for reasons unrelated to demographic considerations. If all of these workers are discouraged and plan to re-enter the labor force as the labor market improves the May unemployment rate would have been 10.2% rather than the reported rate of 9.1% (see **Chart 6**).

A steady, but gradual, decline in the labor force participation rate means that employment will grow more slowly in the future, but it will probably not affect the unemployment rate or, for that matter, other growth rates to any material extent. What it will affect, however, is the level of personal income, the level of retail sales and any other aggregate measures of household income and spending. This trend will matter in the following way. A 2% to 3% permanent decline in the labor participation rate means that household income, and probably spending as well, will be approximately 2% to 3% lower for the same population base. This is a decline in the level. It does

not affect growth rates. Growth rates, which are how most all economic data are reported, describe changes in levels. A 3% change from a low level appears to be the same as a 3% change from a high level. But, it should be obvious that a 3% change from a high level is better than a 3% change from a low level. Overall, this is not good news for nominal tax collections that are geared to levels of income or retail sales that are at lower levels because of the reduced level of employment.

4. Wage Growth

Average hourly wage growth, which is an indicator of the intensity of excess labor supply relative to demand, has stabilized over the last year. **Chart 7** shows the annual rate of change in the hourly average employee wage rate



and the annual rate of change in weekly wages. The growth rate in average weekly wages adjusts for the average number of hours worked. The growth rate in weekly wage earnings is a measure of spending power of consumers. Weekly wages had grown since mid-2009 as average hours worked slowly increased, but now appear to be converging downward toward the growth rate in average hourly wages. Overall **Chart 7** tells a story of a very weak labor market that is in the process of stabilizing. In the long run, the more important of the two measures is growth in the average hourly wage rate. Average weekly hours fluctuate with the strength of the business cycle,

falling during recessions and rising when the economy is expanding. Early in the recovery phase of the business cycle, employers increase the number of hours worked by employees. But, as employers gain confidence in the sustainability of the expansion, they begin to hire additional workers. Earlier this year we passed through the transition point. The transition is reflected in the increase in payroll employment growth during the months of February, March and April at the same time as the average number of hours worked stabilized. With the stabilization in the number of hours worked the average hourly wage rate is once again the better indicator of the tightness of labor supply relative to demand.

The rate of growth in the average hourly wage rate is also a leading indicator of inflationary pressures. As long as it remains at a very low and stable level there will be little to no upward pressure on inflation.

5. Where Are the Jobs — Clues in the Data

Consider the significant changes that have occurred over the last 30 years since the 1980-82 recession:

- About 2 billion of the world's population — China, India and countries comprising the former Soviet Union — have moved into the global market economy.
  - Cheap labor and substantial advances in communications technology have made it relatively easy and extremely cost effective to relocate work just about anywhere in the world.
- The U.S. has a large and persistent trade deficit, which was 3.5% of GDP in April 2011compared to less than 1% 30 years ago.
  - China is intentionally pursuing a mercantilist policy to spur exports by pegging its currency to the dollar, which inhibits adjustments in trade imbalances through the exchange rate mechanism.
- Consumer debt as a percentage of income has soared from about 65% 30 years ago to 116% in the fourth quarter of 2010, which was down from a peak of 130% in the third quarter of 2007.

  - Growth in consumer debt has contributed to consumption-based economic growth versus investment-based growth.
  - Growth in consumer debt has facilitated non-productive asset price bubbles.
  - Debt-fueled wealth creation has reduced the need for consumers to save out of current income, forcing investment increasingly to be financed by foreigners (large trade deficits trigger corresponding return flows of foreign-controlled dollars into us financial and real assets).

- Income inequality in the U.S. has worsened steadily over the last 30 years; since 1977 real income has increased:
  - 20th percentile — 10.6%
  - 50th percentile — 13.8%
  - 95th percentile — 46.9%

- Driven by an explosion of financial derivatives and increasingly sophisticated data software, an growing share of financial activity and profits now derive from trading compared to intermediation services — credit and savings — and advisory services.
  - Trading activity involves the transfer of wealth rather than the creation of wealth. Some might argue that trading improves financial market efficiencies and results in better distribution of risk. Although there may be some substance to this viewpoint, its impact is probably relatively small and is more than offset by nonproductive speculative activity. In fact, as we experienced during the Great Recession, speculative trading, which tends to spawn asset price bubbles, can have disruptive and destructive consequences.
  - Increased trading activity appears to be correlated to the frequency and amplitude of asset price bubbles.

- The portion of government spending devoted to transfer payments, such as social security, Medicare, Medicaid, unemployment insurance, family assistance and the like, has risen steadily; the portion going toward investment in research, education and infrastructure is decreasing. Investment creates wealth, transfer payments do not.

  - 10.3% of personal income came from government transfer payments, net of payroll taxes, in 2010 compared to 5.0% in 1977. (Gross government transfer payments rose from 11.9% of personal income in 1977 to 18.3% in 2010.)
  - More recently government borrowing has exploded to support government transfer payments to consumers, thus perpetuating debt-based consumption-led economic growth. Generally, consumption patterns remain intact; all that has changed is that the government is borrowing and sustaining consumption spending through transfer payments rather than consumers doing so directly by borrowing against their own assets.

- Government spending on goods and services, which excludes spending involving transfer payments, has decreased from 23.6% of GDP in 1977 to 19.4% in 2010. Over the same time period, the portion of household personal income going to pay taxes has decreased from 12.1% to 9.3%.
  - While much of government spending goes to pay for a variety of services, a portion can fairly be characterized as investment. Cutbacks in discretionary spending in recent years have taken a greater adverse toll on investment than on services.
  - While many argue that shrinking the size of government by cutting taxes and spending and transferring spending power to the private sector will result in more efficient market-based allocation decisions, this argument is flawed at least to the extent that the transfer results in less investment and more consumption spending. Some forms of investment are better coordinated by the public sector. An example would be construction of the interstate highway system during the 1950's and 1960's. A modern day example would be a comprehensive program aimed to achieve energy independence through development of cost-effective alternative sources to oil.

- Investment spending as a portion of GDP has remained at a relatively constant 13% of GDP; however, the quality of investment in terms of creating a foundation for wealth creation over time has slipped.
  - For example, construction of residential homes is counted as investment, but larger and more expensive homes do not stimulate wealth creation. Such activity is really a form of consumption rather than investment. And, importantly, to the extent that

> low quality investment crowds out higher quality investment because of government subsidies, wealth creation will be adversely impacted over time.

There is a clear pattern evident in these data clues. The U.S. economy has placed an increasing emphasis over time on consumption-based economic growth rather than investment-based growth. For years the expansion of consumption-based economic growth was facilitated by rising consumer debt relative to income and foreign excess savings stemming from recycling dollars derived from huge trade surpluses with the U.S. When consumers finally reached the breaking point where the debt burden had simply become too great and were forced to retrench, government stepped in and continued debt-fueled consumption-based economic growth through deficit financing and consumer transfer payments.

6. Where Are the Jobs?

The simple answer to the question: "Where are the jobs?" is that they aren't there. And, if they aren't there, traditional monetary and fiscal policy tools will not be able to bring them back. The more complicated question is: "Why aren't the jobs there?" This is the issue that needs to be explored, because finding answers to the question — defining what the problem is — is the first necessary step to developing policy responses that will lead over time to creation of jobs.

In past business cycles, employment fell during recessions as the imbalances and excesses that had built up over the previous expansion phase of the cycle were purged. Then, with a little help from automatic stabilizers, such as unemployment insurance, and additional help from tax cuts and spending programs, aggregate demand stabilized and initiated the virtuous circle of the expansion phase of the next cycle. A virtuous circle starts with increased spending supported by expansionary monetary and fiscal policies. It proceeds with the creation of jobs, which in turn leads to greater income and more spending. This process gathers momentum. Another component involves the easing of access to and cost of credit. As the expansion gains momentum, risks diminish and credit becomes easier to obtain.

This virtuous circle has occurred following every recession since World

War II. So, in a way it is natural for policymakers to assume that the traditional remedies should prompt a repetition of past economic recoveries. But, as time has passed following the end of the Great Recession, the failure of the economy to respond in the expected, traditional manner is perplexing. To date the response has been that insufficient stimulus has been applied and more is needed. And, as the reasoning goes, just a little more stimulus ought to finally push the economy into a self-sustaining virtuous circle.

But, for the virtuous circle to take hold and work in the expected manner, requires relative stability in the structure of the U.S. and global economies. From the examination of data clues above, it should be very clear that this condition is not met. Some jobs have been lost to emerging economies. Other jobs have been lost because investment in infrastructure, education and research has been inadequate to foster new job creating industries and initiatives. This further diminishes the competitiveness of the U.S. economy over time in an increasingly competitive global economy.

Loss of job momentum is not a new phenomenon courtesy of the Great Recession. Significant structural changes in the global economy have been building for nearly two decades. Pressures on U.S. jobs have built gradually in tandem with these changes. The pace has been gradual enough that policymakers have paid little attention to the full extent of the accumulating consequences. Two other factors have reinforced this myopia. First, policymakers and analysts are captives of the traditional economic paradigm — both as to how the economy is structured and as to what policy tools are appropriate and how they should be used to manage the economy over the course of the business cycle. Paradigms often become dogma that walls off contrary thinking and criticism. Second, courtesy of the consumer credit boom and housing bubble, which persisted during much of the decade of the 2000's, millions of jobs were created. This gave the appearance of full employment. However, as we know now, many of these jobs were artifacts of the bubble and will not return. Had the bubble not occurred, for which we are paying dearly now, the shortfall of jobs would have been more evident years ago.

Interestingly, measured worker productivity has actually risen during the last two decades. What that means is that for the jobs that exist, technological advances and capital investments have contributed to increasing output per unit of input. However, robust productivity growth does not automatically lead to the creation of additional jobs. When investment focuses on

making existing job more productive, increasing productivity results in job destruction. When investment leads to the creation of new technologies and new industries and improves the U.S.'s global competitiveness, it will result both in rising productivity and job creation.

7. Policy Makers Need to Redirect Resources from Stimulating Consumer Spending to Fostering Investment and Creating Jobs That Increase U.S. Global Competitiveness

It will be hard to redirect policy to do what is needed to restore U.S. global competitiveness and stimulate job growth. This kind of intervention should have been the focus of the Obama economic recovery program authorized by Congress in early 2009. Two years have passed and little has been accomplished in spite of the most massive fiscal policy intervention since World War II other than to avoid descent into depression. A negative consequence is a skyrocketing public debt to GDP ratio which is approaching levels that threaten the U.S.'s AAA credit rating. The size of public debt to GDP ratio has taken away precious policy maneuvering room because of the need to stabilize that ratio. And, stabilization requires reducing substantially the size of the current budget deficit.

So, even if there were agreement on what should be done, which there is not, there is no longer the kind of financial flexibility in governmental finances to implement the polices with the magnitude and timeliness essential to address the problem of creating jobs.

As to the policies most likely to make a difference and the right kind of difference that will be sustainable, I can only venture general observations. However, were the administration and congress to engage in a "Manhattan"-like initiative, or more realistically establish a commission similar in scope and charge to the Simpson-Bowles Fiscal Commission, there is plenty of good thinking that could be brought to bear on devising detailed policies and programs.

The general theme needs to focus on redirecting government resources away from consumption and toward investment. On the one hand this should involve diminishing or eliminating incentives and subsidies that promote consumption, such as the mortgage interest tax deduction. On the other hand a portion of government expenditures should be shifted from transfer pay-

ments that promote consumption to investment initiatives that create jobs. While some infrastructure investing was contained in the 2009 economic recovery program, the amount was small and infrastructure development projects were mostly left to the discretion of local governmental bodies. The opportunity to initiate an energy-independence research program never received serious consideration. Basic and applied research, which has been fundamental to the U.S.'s economic prosperity over many decades, has systematically been starved of government funding over the last two decades.

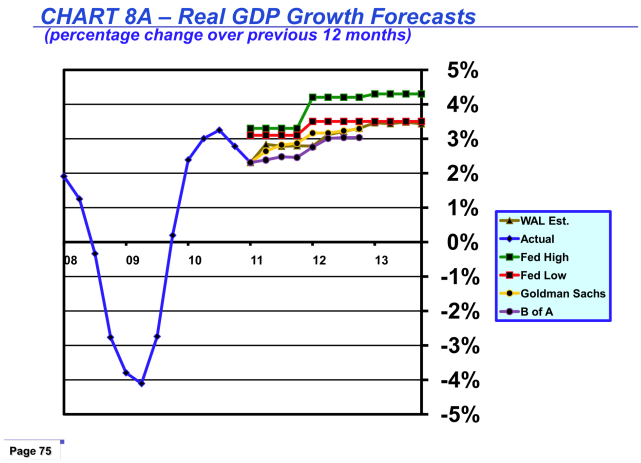
Then there is the issue of China, a matter our policymakers tiptoe around. Let there be no doubt that China's economic policies are in China's best interests, not ours. Of course, China is bent on increasing the standard of living of its citizens rapidly and that is a laudable and essential policy to enable global political stability. But China is also determined to increase its prominence in global politics. Again, by itself, this is not necessarily a bad thing. But China's ascension is coming partly at the expense of the U.S. By acquiescing to Chinese economic policy, U.S. policymakers are not only sacrificing jobs in the short run but also are endangering the balance of global leadership and the U.S. role in decades to come.

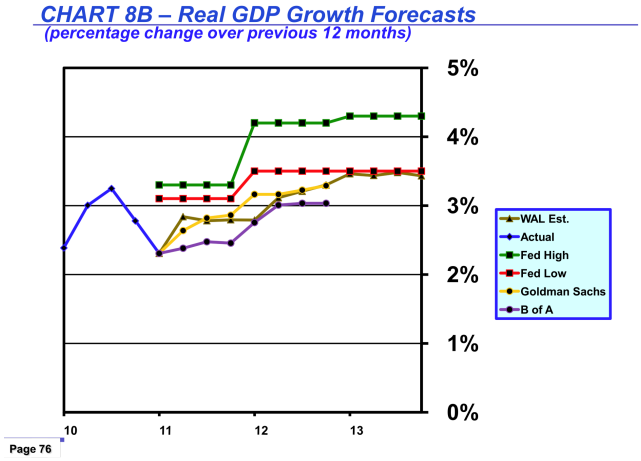
As a final note, I would observe that working our way out of overindebtedness at all levels is better accomplished and with less pain by fostering sustainable economic growth than by engaging in cost cutting and spending reductions. But, unfortunately the current policy debate is not focused on growth but rather on cutting taxes and spending without an appreciation, beyond adherence to the dogma that less government is good, whether such policies will be any more successful than consumption-based economic policies have been.

III. U.S. Economic Outlook

1. GDP Forecasts

GDP forecasts from the Federal Reserve, Goldman Sachs (GS), Merrill Lynch/Bank of America (B of A) and myself (WAL est.) are shown in **Charts 8A** and **8B**. **Chart 8B** reduces the time period to 2010-13 and the scale of the chart has been altered to show better the differences in the forecasts.





The Federal Reserve's most recent forecast decreased the expected range of GDP growth in 2011 from 3.4% to 3.9% to 3.1% to 3.3%. This downward adjustment reflected the weak GDP growth in the first quarter but also anticipates that higher food and energy prices will retard economic growth during the remainder of 2011. The Fed reduced the upper bound of its forecast range for 2012 GDP growth from 4.4% to 3.5% to 4.2% to 3.5%, most likely because of impacts stemming from the withdrawal of monetary and fiscal stimulus by the end of 2011. The Fed also reduced its forecast

range for 2013 GDP growth from 4.6% to 3.7% to 4.3% to 3.5%. These downward adjustments follow a pattern of consistent downward adjustments and are not surprising given that the Fed forecasts tend to be more optimistic than those of many analysts.

Following a fairly consistent pattern, the Fed's forecast is at the optimistic end of the forecast range. The B of A, GS and my forecasts all fall below the lower end of the Fed's forecast range. There is very little difference between my forecast and those of B of A and GS through the end of 2012. While B of A and GS have not yet released forecasts for 2013, my forecast indicates a gradual increase in GDP growth to about 3.5% in 2013, which is similar to the lower bound of the Fed's forecast for 2013.

Because potential real GDP growth, which is driven by population and productivity growth, is approximately 2.5% to 2.75%, it will take several years of 3.5% real growth to bring down the 6.2% gap that prevailed, according to Congressional Budget Office estimates, during the first quarter of 2011.

2. 2011 Q1 GDP

The "second estimate" of first quarter GDP growth was unchanged at an annualized rate of 1.8% (see **Table 1**).

Personal consumption was revised sharply lower from 1.91% to 1.53% and inventory accumulation was revised upward from .93% to 1.91%. Even though the overall GDP growth rate rose fractionally, taken collectively, the consumer spending and inventory revisions were negative and indicate considerable weakness. Consumer spending should be increasing at an annual rate of about 3%. If it were, the contribution to GDP growth would be 2.1% (70% of 3%). Viewed in this way, an increase of 1.5% is a weak result for the second year of economic recovery. Growth in consumer spending had been rising steadily quarter-by-quarter since the end of the Great Recession two years ago until the first quarter of 2011. Over the last four quarters real consumer spending has risen 2.46%, but is still well short of the long-term average of 3.0%. First quarter consumer spending growth marks a reversal of the improving trend. Rising oil prices really did not begin to bite until the second quarter. This means that a further slowdown in consumer spending growth is likely in the second quarter and, even if the number manages

Table 1
2011 First Quarter GDP Estimates

	Advance Estimate	Second Estimate	Final Estimate
Personal Consumption	1.91%	1.53%	
Private Investment			
Nonresidential	.18%	.33%	
Residential	-.09%	- .07%	
Inventories	.93%	1.19%	
Net Exports	- .08%	- .06%	
Government	-1.09%	-1.07%	
Total	**1.76%**	**1.84%**	

to surprise to the upside, it still would be a low-quality result because it would reflect forced spending on more expensive energy products and less spending on other kinds of consumer goods and services. In fact, according to monthly personal income and spending data, real consumer spending growth peaked at an annual rate of 2.60% in January but has fallen since then to 2.30% in April.

Investment in inventories was much stronger than desirable given weak spending growth. Overstocking eventually leads to production cutbacks and the second quarter declines in the manufacturing and service purchasing manager indices are direct evidence of response to overstocking.

Perhaps most surprising was the extraordinarily large decline in government expenditures. As a reminder, GDP only measures government spending on goods and services. It omits all transfer payments which have been the primary component of government spending that has driven the budget deficit up. Most all government transfer payments are accounted for in GDP through consumer spending. Again, it seems that the large decline in government spending was a statistical anomaly.

All-in-all first quarter GDP growth tells a story of a weak economy that

is struggling to gather sustainable momentum.

3. Prospects for GDP During the Rest of 2011

Forecasts for second quarter GDP growth have been reduced by most all analysts and generally range between 2% and 3%. Downward forecast adjustments are following weaker than expected monthly data reports. Growth should be sustained over the remainder of the year but it increasingly looks like actual results will fall short of most forecasts. That is because risk factors remain significant and collectively are tilted more in a negative than a positive direction. Nonetheless, odds of a period of negative GDP growth remain low; the more likely outcome is lethargic growth that is insufficient to reduce unemployment significantly.

Japan Supply Shock. Some of the greater than expected current economic weakness is due to transitory factors. The global supply shock created by the Japanese earthquake will depress second quarter growth, but the impacts are likely to be very limited in the third quarter and of little consequence after that.

Oil Price Shock. The greater negative influence has been the oil price shock. Oil prices have now receded about 10% from the high point reached in April but remain about 25% above year ago levels. There is clear evidence that the oil price shock has negatively impacted consumer spending. However, demand destruction and somewhat slower global growth should keep the lid on further increases in oil prices for the time being. In this sense the impact of the oil price shock is transitory and the consequences of the shock will work their way through the economy over the next two or three quarters. However, given tight global oil supplies, the likelihood of some reacceleration in emerging markets economic growth and political risks in Middle East oil producing nations, the potential for further increases in oil prices in a few months time is significant.

Manufacturing. There is accumulating evidence that U.S. manufacturing, which has performed well since the end of the Great Recession, is slowing. First quarter GDP inventory accumulation was too large and so some pull back in production is likely. Softening consumer demand because of the oil price shock is giving impetus to production cutbacks. So, too, is somewhat slower global growth, which is diminishing demand for U.S.

exports a bit. I would note that the plunge in the purchasing managers manufacturing index in May probably overstates the extent of deterioration in manufacturing because of anomalies in the seasonal adjustment methodology stemming from gyrations in manufacturing activity during the Great Recession.

While manufacturing has been one of the few bright spots in the U.S. economy over the last two years, the sector has contributed very little to helping reduce unemployment. Productivity gains continue to be very significant in this sector.

Monetary Policy. Monetary policy is in the process of shifting from supporting economic growth to neutral. No extension of quantitative easing seems likely after the Fed completes the large scale asset purchase program this month. This means that the constant injections of liquidity, which have had a great deal to do with good times in the stock and commodity markets and have contributed to a significant decline in volatility, will soon end.

Stock and Commodity Markets. It will be interesting to watch the markets in coming months to see whether the appetite for risk assets will be sustained without abundant doses of liquidity. However, near zero interest rates on short term money and Wall Street's trading culture could sustain the bull market in stocks and commodities. Also, one of the benefits of the unbalanced U.S. economy is that corporate profits are very strong and growing nicely thanks to strong global growth and weak labor bargaining power. As long as profits remain high and continue to expand, the probability of a significant bear market would appear to be low, although volatility is likely to rise. The risk to profits would come from greater than expected slowing in global growth.

Fiscal Policy. While there is some chance that federal government transfer payments that expire at the end of 2011 will be extended, the prevailing politics and configuration of Congress suggest that extension has a low probability. However, the probability of extension could increase, if the emerging slowdown in economic growth worsens and persists. Although the 2% cut in payroll taxes and extended unemployment benefits, both of which expire at the end of 2011, are viewed as efficient instruments of fiscal policy because most of these transfers are spent on consumption relatively quickly, the quality of the kinds of consumer spending that the policy prompts, insofar as igniting a self-sustaining recovery, is questionable (see discussion of

"Where Are the Jobs?" elsewhere in this month's letter).

Already fiscal policy is shifting from stimulus to neutral and it is likely to have a negative impact of at least 1%, or a little more, on real GDP growth during 2012. Increasingly, there is chatter that Congress will agree to $2 trillion in spending cuts over the next ten years as part of a deal to increase the debt ceiling. This could increase the negative impact of fiscal policy during 2012, but if past practice is a reliable guide, spending cuts will be back loaded and will not have a significant negative impact on economic growth until after the 2012 presidential election.

To get to a realistic $2 trillion amount will require at least some tinkering with Medicare. Based on the frosty reception that Paul Ryan's deficit reduction budget proposal has received, it will be impossible to restructure Medicare until after the 2012 presidential election, and even then it will be an uphill battle. Nonetheless, some cuts in Medicare expenses could be engineered through policy changes that lower payments to health care providers. Also, there is a strong likelihood that some form of spending cap rule will be adopted, which will permit Congress to assert that it has approved a high level of spending reductions, even though specific identification of what is to be cut will be left to a later time. Congress' track record of sticking with spending rules, particularly when the economy is underperforming, has not been stellar. It is easier to promise than to deliver.

Housing Construction. About the only good thing that can be said about residential housing is that construction is probably about as low as it's going to get. B of A estimates that there are 2.8 million excess homes currently and that that number will actually increase to 3.0 million by the end of 2013. Further B of A believes that it will take until 2020 to absorb excess inventory and housing starts will not return to normal levels for another 5 to 6 years. There is moderate reason to be optimistic that multifamily housing construction will soon expand. Rents are rising and vacancy rates, although still above long-term average levels, are now contracting. An ongoing shift from owning to renting will help stimulate new apartment construction. Limited access to financing and broken securitization markets for real estate collateralized product, however, could inhibit a rapid turnaround in nonresidential construction.

Residential Housing Prices. The story here is very negative and the risks of further, and substantial, losses to holders of residential mortgages,

particularly major financial institutions, are much larger than realized. Residential housing is in the grip of a severe negative deflationary spiral, which five years after the peak in housing prices, rather than playing itself out, appears to gathering new momentum. No effective strategies exist or are in sight to create additional demand to help absorb excess supply, thus B of A's pessimism that excess supply will continue to grow through the end of 2013. But worse yet is the absence of any effective policies to deal with foreclosures and the 22.7% of homeowners, which according to CoreLogic, have mortgages that exceed the current market value of their homes by an average of $87,000 each. This translates into 12.5 million homeowners with negative equity totaling $1.1 trillion. There is not enough capital available to absorb this amount of loss should all these mortgages be marked at a minimum to the current market value of the homes, and this ignores very substantial additional costs that accompany foreclosure.

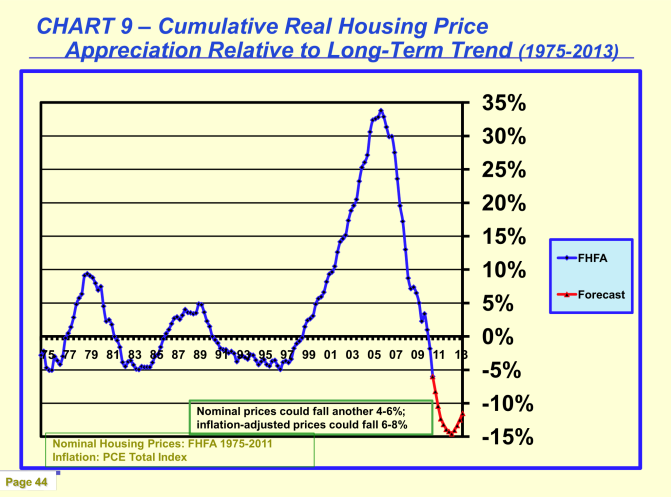
The absence of any resolution mechanism means that housing prices will remain under persistent downward pressure, even though traditional measures of housing affordability are at all time highs. Simply put, why should someone buy when he/she believes the value is likely to fall. Rational action indicates that the person would postpone purchase and rent. Moreover, why should a lender extend a loan with a high current loan to value ratio when equity protection against losses is likely to erode. The lender will not make marginal loans at all and will demand higher down payments and higher rates and fees. Thus, it is little wonder that about the only mortgage game in town these days are mortgages purchased and securitized by Ginnie Mae (FHA), Fannie Mae and Freddie Mac which have explicit government backed credit guarantees. Negative price expectations reduce current demand.

Correspondingly, supply is inflated because no truly broad-based and effective way has yet been devised to encourage stressed homeowners with underwater mortgages to make mortgage payments. Loan modifications and short sales are of some help but the unwillingness, or perhaps the more accurate characterization is the financial inability, of investors to reduce both principal owing and monthly payment levels means that most underwater mortgages are ignored with the hope that the homeowner will continue to make payments. Many do make the payments, but some are not doing so and, even for those who continue to make payments, it takes only a small financial setback to tip many of them over. Everyone knows that the costs of foreclosure are much greater than the cost of restructuring a loan to align it with current market values. But marking to market all underwater mort-

gages would thrust several prominent financial institutions into insolvency. To do selective principal forgiveness, with the intent to avoid mass write downs and the recognition astronomical losses, might be a solution but this is probably impossible without some kind of intentional government support and perhaps valuation forbearance on part the Financial Accounting Standards Board. So, the current result by default is that limited intervention is occurring with the hope that home prices will rise and reduce and perhaps even eliminate the problem.

Thus, negative price expectations and an inability to reduce the amount of distressed sales have combined to widen the supply-demand gap. This maintains persistent downward pressure on prices in a way that perpetuates the problem and drives prices well below long-term reasonable value based on new construction costs and financing costs. If no intervention occurs, eventually prices will reach a low enough level where affordability will finally win out and prices will stabilize. No one knows for sure, however, how low prices will have to go before that occurs.

Several years ago I constructed **Chart 9**. The chart shows cumula-



tive deviations from the long-term trend in inflation-adjusted (real) housing prices. The chart is constructed in the following way. A regression trend line is fitted to the logarithm of inflation-adjusted home prices, as calculated by the Federal Housing Finance Agency (FHFA), for the time period covering the first quarter of 1975 to the fourth quarter of 2001. Over this 27-year

period inflation-adjusted housing prices rose an average of 1.15% annually. You can immediately see the two housing price cycles with peaks in the late 1970's and late 1980's. Also, it is notable that the de-trended price cycles are roughly symmetric in amplitude with inflation-adjusted prices falling nearly as much in the down part of the cycle as they rose above trend during the up part of the cycle. Data points shown in **Chart 9** for quarters beyond the fourth quarter of 2001 simply assume that the long-term trend of an inflation-adjusted return of 1.15% annually is a stable long-term phenomenon. For a long time, as the cumulative deviations built and finally reached a peak of 34% in the second quarter of 2006, I was cautious about the likelihood of symmetry in the down part of the current housing cycle. However, with each passing quarter it increasingly appears that the 1.15% inflation-adjusted price trend remains valid and I am now more persuaded that the approximate symmetry in positive and negative cyclical amplitude will recur in this cycle. As of the first quarter of 2011, cumulative deviations stood at -6.0% and consensus forecasts for nominal home price declines and inflation indicate that cumulative deviations should bottom out at approximately -15% by the end of 2012 before the cycle turns up.

European Sovereign Debt. Increasingly it appears that a second bailout of Greece will be stitched together that avoids default and debt restructuring. This is a strategy that buys time and avoids an immediate crisis. But it is a deeply flawed strategy that will ultimately fail. And when it does fail, the hole will be far deeper than it is today and the challenges and pain associated with finally dealing with the problem head on will be considerably greater than had the problem been resolved a year ago when the Greek crisis first erupted. The passage of time and patchwork interim solutions are not working as the last year clearly demonstrates and there is no reason to expect that more of the same kind of policy will change the outcome for the better.

In the meantime, the ECB continues to conduct monetary policy based on its assessment of inflation prospects with only passing and limited consideration of the consequences of tighter monetary policy for European economic growth and the financial difficulties of troubled member countries. For example, ECB president, Jean-Claude Trichet, in remarks on June 8, 2011 hinted strongly that the ECB would raise its lending rate 25 basis points in July. This would be the second increase of 25 basis points this year.

The ECB, unlike the Federal Reserve, focuses on total inflation, which, of course, thanks to the energy price shock, has risen sharply this year. The impact is worse in Europe because oil is denominated in dollars and the euro has been appreciating in value against the dollar. Higher interest rates will depress economic activity but Europe's economic sway in the global order will have little impact on oil prices and, worse, higher interest rates in Europe relative to the U.S. will only serve to spur further appreciation in the value of the euro. Thus, it is hard for me to understand why it is so important for the ECB to tighten monetary policy because of a phenomenon they can't control and which may be transitory.

Interestingly, the ECB upgraded not only its estimates of inflation but also its estimates of Eurozone growth. I remember the ECB interest rate increase in July 2008 just ahead of the collapse in global financial markets. That timing was deeply flawed and the ECB's actions in 2011 may turn out to be just as ill-timed and ill-advised as they were in 2008. One immediate consequence was that the yield on two-year Greek debt soared more than 150 basis points to 25.6% in the immediate aftermath of Trichet's remarks. A little math tells you that investors are discounting a default and restructuring of Greek debt within the next two years that would result in about a 50% reduction in principal or in the present value of principal.

I will have more to say about the European sovereign debt problem in next month's letter.

U.S. Employment — Where Are the Jobs? Job growth is likely to stay on a moderate growth trend, probably averaging more than 100,000 per month. However, this will result in only a very gradual decline in the unemployment rate from 9.1%. There is nothing I can see in the outlook that suggests we are due for an acceleration in job growth. Without greater job growth and a falling rate of unemployment, economic growth will remain weak. Moreover, as long as unemployment remains significant, annual nominal wage increases will remain near 2%. Total compensation, which includes benefits, might grow a little faster. But, overall, productivity increases should keep unit labor cost growth near zero or even negative. This will be good for corporate profits and investors, but it is not good for consumer spending and economic recovery. While I would like to be more optimistic, policymakers have yet to focus on the underlying cause of anemic employment growth and, thus, current demand-stimulus policies are misdirected and relatively ineffective. Alternative policies that would focus on job

creation are not under active consideration. This leads me to expect weak employment growth for the foreseeable future and because of this, GDP growth will remain weak as well.

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