Webster®
We Find a Way

Economic Review

Issue L
May/June 2011

Nicholas S. Perna, **Economic Advisor**

Happy Anniversary! Hope you don't mind some repetition, but I want to share some further thoughts on the "uneven" recovery we wrote about in the last issue. The good news is that jobs have begun to grow faster.

The long and deep recession that started in December 2007 ended two years ago in June 2009. Whenever I mention that the recession has been over for a couple of years, people start snickering. How can I claim this when we all know people who've been out of work for quite some time? How about the neighbors struggling to sell their home or to just hang on to it? When economists say the recession has ended, they simply mean the overall economy as measured by real gross domestic product (GDP) has started rising again.

The "Recovery Scorecard" table summarizes the behavior of a few key indictors during and after the recession. The most familiar is the Dow Jones Industrial Average which peaked at 14,165 in October 2007, bottomed at 6,547 in March 2009 and recently stood at 12,685. The last column compares how many points the DJ has risen (6,138) with how many it fell (7,618). Since March 2009, it has regained 81% of what it lost during the previous 15 months.

Through the first quarter of this year, real GDP has more than recovered all the lost ground. The gain certainly has grown larger during the second quarter.

Reported earnings per share (EPS) for the S&P 500 have recovered all the lost ground and then some. Profits bottomed out in the final quarter of 2008 when enormous losses were recorded.

The CEO Compensation line is from a study commissioned by the Associated Press which examines reported total pay for CEOs of the S&P 500. Salaries are included and so are bonuses and the value of stock options. Last year, the median pay was $9 million, which is above the both the 2009 recession low and the pre-recession peak.

By now, it is all too well known that the labor market has posted much smaller improvements. A whopping 8.7 million jobs were lost during the recession and only 1.7 million – or 20 percent of those lost – have been regained. Unemployment shows the same gloomy picture, falling only one point during the past two years of recovery.

And after plunging more than 30 percent, the Case-Shiller index of house prices for 20 major U.S. cities has shown essentially no improvement.

The half-fast recovery meets rapid productivity.
Why do we have this frustrating "two track" recovery? It reflects the combination of slow economic growth and aggressive cost cutting. Average real GDP growth of less than 3 percent during the past two years is paltry by comparison with recoveries from previous deep recessions. This is less than half the size of the rebound from the severe 1981-82 recession. Back then, real GDP grew close to 6½ percent per year and the jobless rate fell nearly 3.5 points from 10.8 percent to 7.3 percent during the first two years of recovery.

There are many possible explanations for the tepid GDP growth. Some economists claim that there hasn't been sufficient fiscal or monetary stimulation. Nobel Laureate, Joseph Stiglitz, recently said that the Fed could do more to encourage banks to increase lending. Part of the problem is that all those profits we've been talking also mean many firms are cash rich and do not need business loans! The financial implosion that occurred before and during the recession continues to retard expansion. It has left a legacy of foreclosures, empty homes and falling prices that has prevented the housing sector from performing its normal role of leading the economy out of recession.

U.S. businesses have been very effective in reducing costs and lowering their breakeven points. Cutting costs usually entails cutting labor input, which shows up as a gain in the productivity data. Productivity measures real output per unit of labor input. It normally usually picks up towards the end of the recession and early in the recovery and then subsides. During the four quarters that ended in March of last year, productivity growth in the private nonfarm sector soared almost 7 percent.

Musings & Amusings: Winston Churchill

"Americans can always be counted on to do the right thing, after they have exhausted all other possibilities."

"Mr. Attlee is a very modest man. Indeed he has a lot to be modest about."

"We have always found the Irish a bit odd. They refuse to be English."

Businesses have thus been able to earn very decent returns with only modest increases in volume. There's really little need to expand by hiring in advance of demand growth in the newly discovered sweet spot.

Productivity is not the only factor that has been favorable to earnings growth. The declining dollar exchange rate has also helped improve profit margins on exports as well as domestically sold goods that compete with imports. The lower dollar also means large "translation gains" for companies when that repatriate earnings from overseas operations and convert them to dollars. However, the lower dollar does not stunt hiring while productivity has.

While I don't think GDP growth will accelerate much, productivity gains have gotten smaller – which is normal in recoveries. During the past four quarters, it has risen only has risen 1.3 percent vs. 6.7 percent in the previous four quarters mentioned above.

Some further thoughts. The process I have been describing has numerous implications and raises many issues.

Some have claimed that the Federal Reserve has created yet another stock market bubble through its massive injections of funds into the economy in recent years. While it is always difficult to determine whether equities are over- or under- valued at any point in time, the huge rebound in corporate profits during the recovery certainly justified a large increase in share prices. How large is open to discussion.

As mentioned above, the slower productivity means businesses will have to ramp up hiring even if GDP continues to grow at the less than 3 percent pace of the past couple of years. This seems to have already started, with payroll jobs increasing well over 200,000 during each of the past few months. Even with my forecast of less than 3 percent GDP growth over the next 12 months, the unemployment rate drops by a percentage point. If, as a number of economists predict, GDP grows even faster, then unemployment will fall more.

While productivity will still grow, the pace is apt to be in the vicinity of 1.5 percent. This means that profits are unlikely to rise anywhere near as fast as they have been. Smaller productivity gains means a smaller offset to increases in worker compensation (wages and benefits) as shown in the table which has my forecasts for 2011-12.

Productivity etc: Private Nonfarm Business

% Change*	2009	2010	2011	2012
Compensation	2.8	1.8	2.5	3.0
Minus: Productivity	6.5	2.0	1.5	1.5
Equals: Unit Labor Cost	-3.7	-0.2	1.0	1.5

% change from 4th quarter of previous year.

It is noteworthy that unit labor costs actually fell in 2009. And even with slower productivity gains and larger compensation increases, the coming rise in unit labor costs is still very modest by any historic yardstick. Labor costs constitute some 60 percent of total economy-wide costs. As a result, the outlook for relatively tame overall inflation as measured by the Consumer Price Index. So long as energy prices continue to behave, we can have some further increases in food prices without pushing the CPI rise above 2 to 2.5 percent during the coming 18 months.

What about housing? The extra job growth that we're beginning to experience should help increase the ability of families to buy homes.

Finally, my intention is not to paint productivity as a bad thing. In fact, in the longer run, it is the *only* basis for improving real living standards. I only want to point out that in the short run too much of a good thing can cause problems by inhibiting hiring when GDP isn't growing fast enough.

National Recovery Scorecard

	Peak	Low	Latest		% Regained
GDP (Bil '05 $)	13,364	12,810	13,439	Q1/11	114
Dow Jones	14,165	6,547	12,685	5/9/11	81
EPS ($/share)	21.88	-23.25	22.64	Q1/11	–
CEO Comp (Mil $)	8.4	7.2	9.0	2010	150
Jobs (thous.)	137,996	129,286	131,028	4/11	20
Unemployement (%)	4.4	10.1	9.0	4/11	19
House prices (CS)	206.6	141.3	141.6	2/11	0

Economic Review is published by Webster Financial Corporation. The opinions and views in this publication are those of Dr. Nicholas Perna, Webster's economic advisor, and are not intended to provide specific advice or recommendations for any individual. Consult professional advisors with regard to your individual situation. For more information or to submit a story idea to *Economic Review,* contact Bob Guenther by telephone at 203-578-2391 or by email at rguenther@websterbank.com.

For an online version of *Economic Review* visit us at WebsterBank.com/EconomicReview.