Contact:
Thomas D. Higgins, PhD
Chief Economist
ph: 213 830-4302
email: thiggins@payden-rygel.com

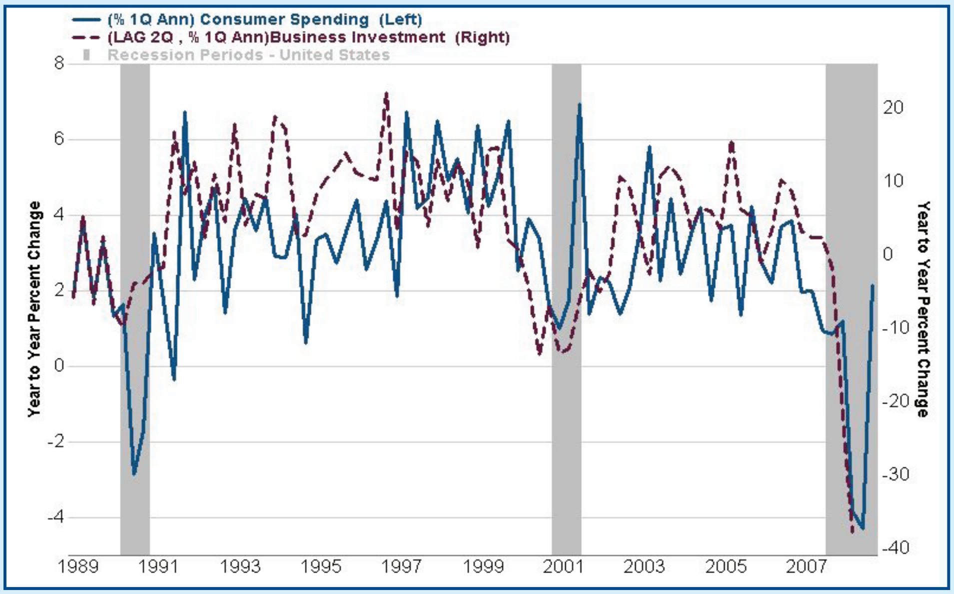
Consumers Lead, Businesses Lag

The U.S. economy shrank at an annual rate of 6.1% in Q1 2009 after contracting at a 6.3% pace in Q4 2008. Together the two quarters mark the weakest economic performance since the recession of 1957-58. Business investment was the largest detractor from growth, falling at an annual rate of nearly 38%, as firms aggressively reduced inventories to bring them back in line with reduced consumer demand. The decline in business investment was the worst recorded during the post-war era.

The U.S. economy shrank at an annual rate of 6.1% in Q1 2009 after contracting at a 6.3% pace in Q4 2008 -the worst two quarter performance since the 1957-58 recession.

The silver lining in the report was that consumer spending increased for the first time in the last three quarters. Personal consumption expenditures rose at an annual rate of 2.2% in Q1 after plunging 4.3% in Q4. Historically, consumer spending has tended to lead business investment by two quarters. Therefore, the combination of a sharp reduction in inventories along with an increase in consumer spending may bode well for a pick up in production and overall economic activity in the second half of the year.

Consumer Spending Rebounds Before Business Investment



Source: Commerce Department

A Policy Mistake Remains Biggest Risk

The question is whether an improvement in the US economy can be sustained. Although many economists are focusing on the labor market as the biggest risk to sustainable economic growth, an often overlooked danger is that policymakers may cut back on monetary and fiscal stimulus too soon. This is what happened in Japan in the mid-1990s and in the United States during the Great Depression of the 1930s.

Although many economists are focusing on the labor market as the biggest risk to sustainable economic growth, an often overlooked danger is that policymakers may cut back on monetary and fiscal stimulus too soon.

In 1997, the Japanese Diet hiked the country's consumption tax just as the economy was emerging from recession because it was concerned that growing budget deficits would fuel future inflation. Ironically, not only did they wind up stalling a nascent recovery in the Japanese economy, they pushed the country into deflation.

A similar mistake was made in the United States during the Great Depression. After the U.S. abandoned the gold standard, GDP growth rose at a double digit pace between 1934 and 1937 and the unemployment rate dropped close to ten percentage points, down to 15%. However, the U.S. economy was still in a precarious position and a self-sustaining recovery had not fully taken hold. Nevertheless, taxes were increased with the establishment of the Social Security Program in 1937. To add insult to injury, the Federal Reserve doubled its reserve requirements that year, fearing the return of inflation. The result was a deep recession over the next two years.

Today, the pressure of removing stimulus too soon may be even greater since many commentators blame excessively easy monetary policy under former Fed Chairman Alan Greenspan for our current predicament. Policymakers should heed the lessons of the past. There are only a handful of leading indicators suggesting a turnaround may eventually unfold for the U.S. and global economy sometime in the next year. It would be a shame to see a policy mistake quash the few green shoots that are emerging.

Fed Disappoints

The Federal Reserve may have made a policy mistake today by letting up on the monetary accelerator just as its earlier moves are starting to gain some traction. The central bank disappointed those expecting it to increase its purchases of US Treasury securities in order to keep market interest rates low in support of an eventual U.S. economic recovery.

The Fed appears to be more optimistic than the average economist that the few signs of stabilization that we are seeing in the US economy are going to lead to a sustainable rebound in economic growth later this year.

The Fed reaffirmed that economic conditions are likely to warrant an exceptionally low federal funds rate for some time and reiterated its plans to purchase up to $300 billion in Treasury securities and up to $1.25 trillion in agency debt and mortgages. However, bond investors had been hoping for a further expansion of the Fed's purchasing program given the sharp back up in Treasury yields over the past month. Unfortunately, none was forthcoming and, as a consequence, the yield on the 10-year Treasury broke well above the 3% level that investors perceived the central bank to be targeting. The question now becomes: how much higher will the Fed allow the market to push Treasury yields before it steps in again?

The Fed appears to be more optimistic that the average economist than the few signs of stabilization that we are seeing in the US economy are going to lead to a sustainable rebound in economic growth later this year. The central bank may have to backtrack on this position in the coming months by expanding its purchases of Treasuries and its overall balance sheet quite a bit more than currently anticipated.