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Payden & Rygel Economic**Research**

April 30, 2010

US Recovery Gradually Transitioning to Sustainable Expansion

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Highlights

- Real GDP increased at an annual rate of 3.2% in Q1 2010 marking the third consecutive quarterly advance after the 2008-09 recession.
- Temporary factors, such as government spending and private inventories, are playing a much smaller role in driving the economic recovery.
- More sustainable sources of growth, including consumer spending and business investment, have picked up the slack.

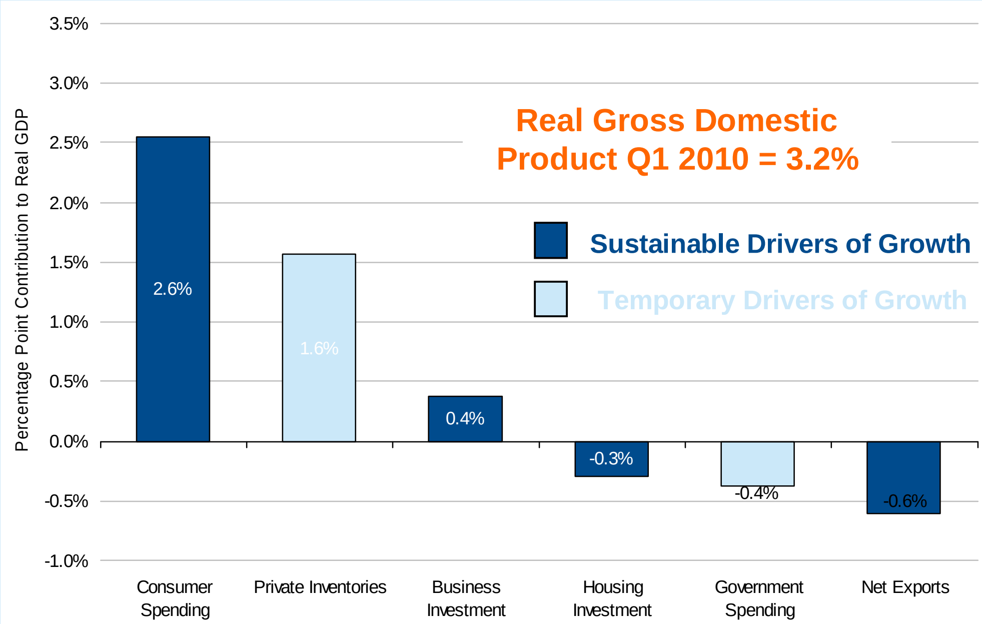
The first quarter figures on gross domestic product (GDP) provided the clearest evidence yet that the US economic recovery is transitioning to a sustainable expansion. Real GDP increased at an annual rate of 3.2% in Q1 2010 marking the third consecutive quarterly advance after four quarters in which the economy declined during the 2008-09 recession. Although the current situation in Greece suggests that the global recovery is fragile, the probability of a double dip recession in the United States is falling. Stronger economic growth along with the improved functioning of financial markets has given the Federal Reserve greater confidence that it can continue its strategy of gradually *normalizing* monetary policy.

The Composition of Growth Continues to Improve

Temporary factors, such as government spending and private inventories, are playing a much smaller role in driving the economic recovery than they had in the second half of last year. Indeed, government spending actually subtracted from growth during the first quarter while the contribution of private inventories was cut in half from Q4 2009. More sustainable sources of growth, including consumer spending and business investment, have picked up the slack. Consumer spending rose at an annual rate of 3.6% in Q1 2010 —its fastest pace in three years. Moreover, the gains were broad based with spending increases across a variety of goods and services.

Business investment in equipment and software was up at a double-digit pace for the second quarter in a row, increasing 13.4% in Q1 2010. New orders for non-defense capital goods excluding aircraft, a key leading indicator of business investment, suggest that the rebound will continue in Q2 2010. We expect new hiring to follow suit and this will lay the groundwork for a sustained expansion of private demand during the second half of 2010. Private sector payrolls accounted for three-quarters of the increase in employment in March and roughly 60% of private industries were hiring compared to less than 20% in the depths of the recession.

Private Sector Demand Is Playing a Key Role in Driving the Recovery



Source: Bureau of Economic Analysis

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- American households are in the early stages of a deleveraging process that will take the better part of the next decade.
- The US economy may be transitioning to more sustainable sources of growth, but it is still vulnerable to shocks. The biggest near term risk to a sustained expansion is a policy mistake.
- Although the US fiscal situation is not nearly as dire as it is in Greece, the Administration must develop a credible plan for reducing the budget deficit.

Household Deleveraging Implies More Moderate Growth

Looking ahead, we expect US economic growth to remain positive, but to moderate from its current pace. American households are in the early stages of a deleveraging process that will take the better part of the next decade. This implies consumers will need to rebuild savings and pay down debt. Household debt to disposable income has already fallen from its record high of 131% Q1 2008 to 124% today. However, the ratio needs to move back below 100% in order to be sustainable in the long-term. Thus far, most of the decline has been due to the reduction in mortgage debt associated with an increase in foreclosures. The heavy lifting begins when ordinary households are forced to begin using savings to repay the money they have borrowed.

A study by the San Francisco Fed suggests that if Americans save roughly 7% of their income and allocate 80% of this savings toward debt repayment, the ratio of household debt to disposable income will fall back below 100% by the end of the decade. An increase in the personal savings rate of this magnitude implies that Americans will have less to spend, which means slower economic growth. Therefore, the US economy probably cannot sustain the 3-4% growth rates it experienced in the 2002-2007 expansion. Instead, potential GDP is likely to average around 2.5% until the deleveraging process runs its course. The Federal Reserve is doing its part to aid household efforts to delever by keeping interest rates at historic lows. Following its April 27-28 policy meeting, the Fed left its benchmark rate unchanged in a range between 0% and 0.25% and reiterated that economic conditions were likely to warrant low interest rates for an “extended period.”

Still Vulnerable to Shocks

The US economy may be transitioning to more sustainable sources of growth, but it is still vulnerable to shocks. The biggest near term risk to a sustained expansion is a policy mistake in which fiscal or monetary policy is tightened prematurely. Gradually, over time, the balance of risks will shift toward keeping policy too loose for too long. That is why it is critical for both the Fed and Congress to develop exit strategies from ultra-easy monetary and fiscal policies. The Fed has already provided a detailed exit plan and has phased out most of its emergency credit facilities. By contrast, neither Congress nor the Administration has yet to lay out a road map to return us to fiscal balance.

Several countries in Europe – particularly Greece – have come under considerable pressure as large budget deficits and high debt to GDP ratios have caused the credit ratings agencies and government bond investors to question their ability to repay debt. Although the US fiscal situation is not nearly as dire as it is in Greece, the Administration must develop a credible plan for reducing the budget deficit, which will reach a post-war high of 10% of GDP this year. Otherwise, we run the risk of undermining investor confidence, which will push up borrowing costs at a time when we can least afford it.