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Highlights

- The improvement in the payroll data over the last four months suggests that the rate of decline in real GDP is moderating.
- When we do emerge from this recession sometime later this year, the trajectory of US economic growth is likely to be shallower than it has been in past recoveries.

Turning the Corner?

The US economy shed 345,000 jobs in May, about half the average monthly decline during the prior six months, suggesting the labor market may finally be turning the corner. The improvement has been broad based with job losses moderating in construction, professional and business services, and retail trade. However, the manufacturing sector continues to struggle with the ongoing restructuring in the automobile industry leading to the loss of an additional 30,000 jobs in May.

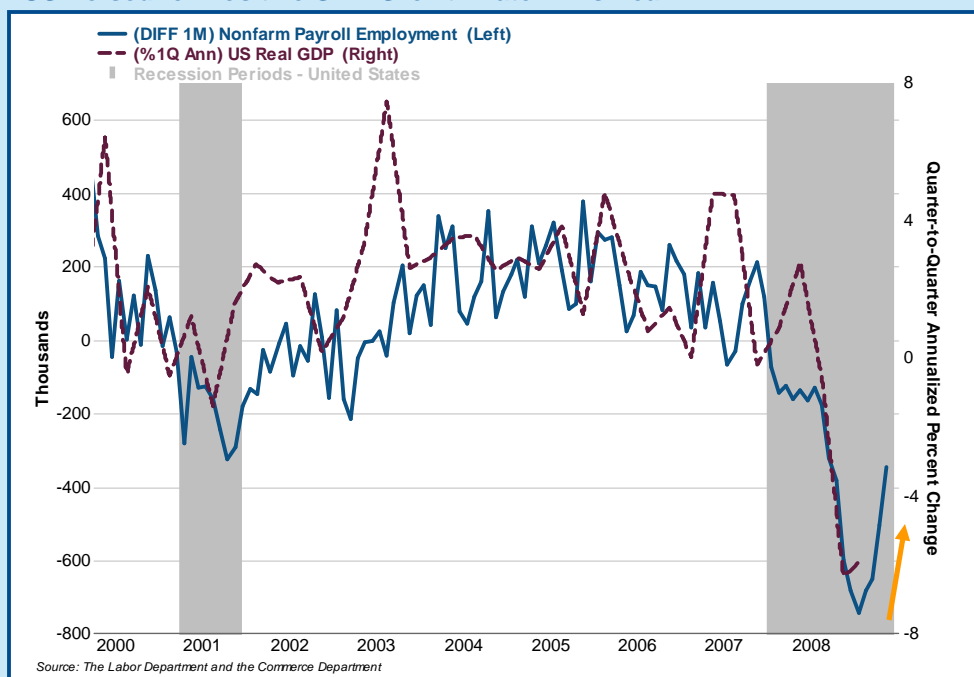
Overall, roughly one-third of the 271 industries surveyed were hiring last month compared to one-fifth back in March. To put this into perspective, during the typical economic expansion one would expect to see at least half or maybe three-quarters of all industries hiring. Thus, even as conditions improve, it is important to realize that the labor market is still quite weak and the economy is in fragile condition.

No statistic makes this point any better than the unemployment rate, which stands at 9.4% - its highest level since 1983. But the unemployment rate is a lagging indicator that will continue to rise well after the US economy is on the road to recovery. By contrast, the non-farm payroll data is a coincident indicator that tends to bottom at the same time as the overall economy. Therefore, the improvement in the payroll data over the last four months suggests that the rate of decline in real GDP is moderating. We continue to believe that the US economy will contract at an annualized rate of 3% in the second quarter of 2009 after shrinking 5.7% in the first quarter. Real GDP growth should turn positive by the fourth quarter of 2009.

Lower Expectations

When we do emerge from this recession sometime later this year, the trajectory of US economic growth is likely to be shallower than it has been in past recoveries for at least three reasons: 1) a lack of productive investment during the last economic cycle 2) reduced leverage throughout the financial system 3) and a need to rebuild savings.

US Poised for Positive GDP Growth Later This Year



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- The reduced speed limit for the US economy will be bad news for those Americans who are looking for jobs since it implies that the unemployment rate is likely to remain elevated.
- While the worst has probably passed, it will probably be some time before it feels that way for the average American.

In the US economic expansion that occurred between 2001 and 2007, Americans put most of their savings into housing. While increased homeownership is a worthy goal, it does little to enhance the productive capacity of the economy. Had this pool of savings been invested in new technology or plant and equipment, it could have raised the speed limit at which the US economy could grow in the long-term without generating inflation (also known as *potential output*). Instead, the investment dollars that went into housing have largely been wasted.

Investment in housing was fueled by increased leverage in the financial system with investment banks leveraging up 30:1 on their capital. Today, many of these investment banks have either disappeared or been transformed into traditional bank holding companies, which can only leverage up 10 times on their capital. Consequently, if the US economy could grow at an annualized rate of 3% to 4% with investment banks lending out \$30 for every \$1 of capital, the trajectory of economic growth is probably on the order of 2% or less in an environment where traditional bank holding companies can only lend out \$10 for every \$1 of capital.

The reduced speed limit for the US economy will be bad news for those Americans who are looking for jobs since it implies that the unemployment rate is likely to remain elevated even after the economy has fully recovered. Over the past two decades, economists came to believe that the lowest the unemployment rate could go without generating inflation –the so-called *natural rate of unemployment* –was somewhere around 5%. Today, it may be as high as 6% or 7%.

In an environment of higher long-term unemployment, Americans are likely to save more. The need to increase savings is compounded by the decline in the values of other assets including homes and retirement accounts. Savings as a share of disposable income stood at zero in April 2008, but has since risen to 5.7% in April 2009. Historically, the average savings rate has been closer to 7% or 8% of disposable income, so households may sock more away in the coming months and years. None of this precludes a US economic recovery by the end of 2009. However, it may raise questions about the speed with which the markets have priced in good news. While the worst has probably passed, it will probably be some time before it feels that way for the average American.