Can Pickup Persist?

Those "green shoots" keep popping up

Hardly a day goes by without another sign that an economic recovery is underway. Looking at a basket of individual indicators, in July and again in August, there appeared to be a bottoming in the composite coincident indicators index, which includes some key components used by the National Bureau of Economic Research (NBER) Business Cycle Dating Committee to help identify business cycle peaks and troughs. Moreover, with the leading economic indicators (LEI) index up for the fifth straight month in August, more good news on coincident indicators likely lies ahead. (See accompanying exhibits.) In this setting, we remain comfortable with our forecasts of quarterly annualized real GDP growth of 2.5% in Q309, 3.0% in Q409, and 2.6% in calendar 2010. (See details in forecast table on page 7.)

Why is the recession ending?

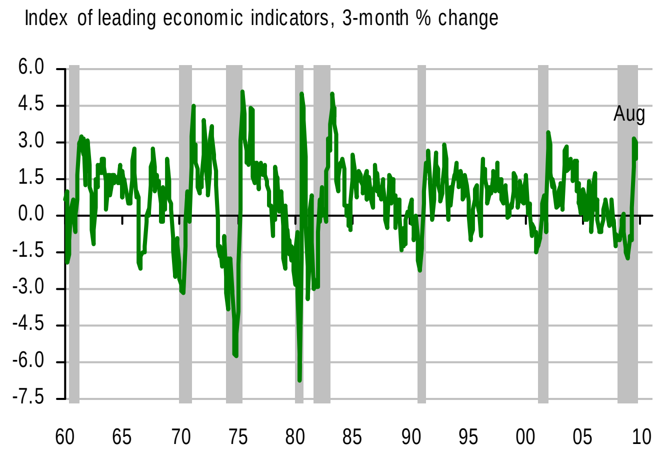
Recessions are started for a variety of reasons in different business cycles; however, exits from cyclical downturns have much more in common. In the public sector, there are countercyclical monetary and fiscal policy responses once the downturn becomes reasonably obvious. In the private sector, firms slashing labor, inventories, and capex eventually stop doing so once they have reduced those inputs into better alignment with below-normal output and sales levels. Households naturally become more cautious during a recession, as they postpone some expenditures and typically raise their savings rate. However, legislated tax cuts and Fed-induced interest rate reductions stimulate consumer spending, and at some point, households become more satisfied with a higher savings level commensurate with their changed economic and financial circumstances. In the second half of 2009, this history is starting to repeat itself.

The coincident index "basket" of four indicators—jobs, income, industrial production and business sales—is stabilizing.

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug
Coincident index (% ch)	-0.9	-0.7	-0.8	-0.5	-0.4	-0.4	0.1	0.0
Payrolls (ch 000's)	-741	-681	-652	-519	-303	-463	-276	-216
Real pers. income less trans pymt (m/m ch, ar $ B)	-174.4	-133.2	-74.8	-39.3	-6.4	-59.1	3.3	12.1
Industrial production (m/m % ch)	-2.2	-0.8	-1.6	-0.6	-1.1	-0.3	0.9	0.8
Real mfg & trade sales (m/m ch ar, $ B)	-174.3	19.2	-120.2	-72.6	-77.0	-68.1	20.9	10.1

Note: The August data for personal income and manufacturing and trade sales are Conference Board estimates. All other data are actual.
Source: The Conference Board, Federal Reserve, Bureau of Labor Statistics, and Bureau of Economic Analysis

The index of leading economic indicators increased 0.6% m/m in August, the fifth consecutive monthly gain.



Note: Shaded bars denote periods of recession.
Source: Conference Board

The Fed "printing press" has been "pressing on"

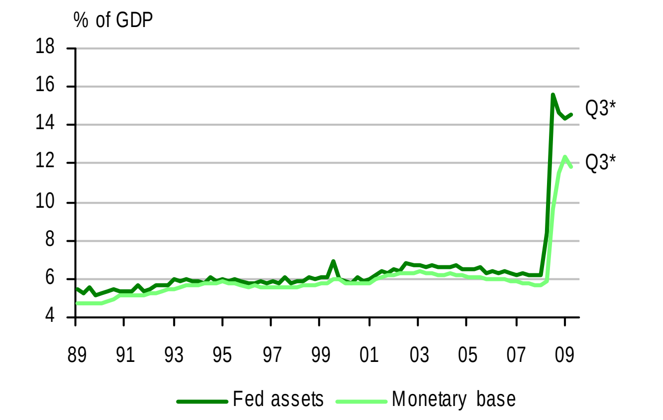
Countercyclical monetary policy has played a pivotal role in the recent recession as the Fed addressed an unprecedented financial system crisis and credit crunch with an also unprecedented surge in its balance sheet. The accompanying succor for the global financial markets has been evidenced in the sharp compression of yields versus Treasury rates in the US mortgage-linked and corporate bond markets. (See accompanying charts.) (Note: From a funds flow perspective, the Fed has been buying mortgage-linked, agency, and Treasury securities from sellers who have directed part of those proceeds to the corporate bond market.)

Fiscal policy also is pushing harder than ever

Fiscal policy stimulus has also been unprecedented. Federal income tax cuts and higher transfer payments started to boost after-tax, disposable personal incomes in H109, and more of the planned stimulus on the spending side of the ledger has started to come through in Q309. (See accompanying charts.)

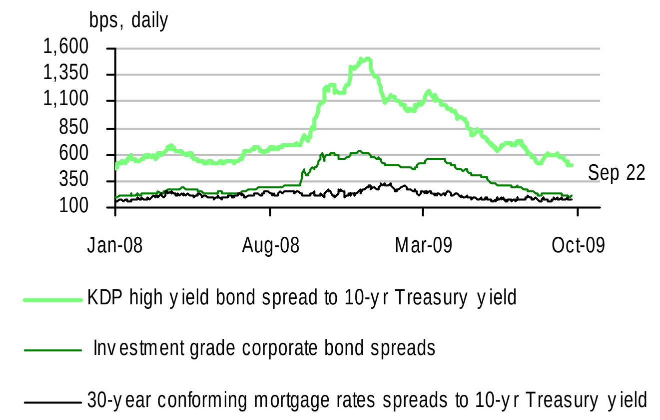
While countercyclical public policies have been playing a powerful stabilizing role so far this year, there are limits to how far policymakers can proactively raise

The surge in the Fed's balance sheet...



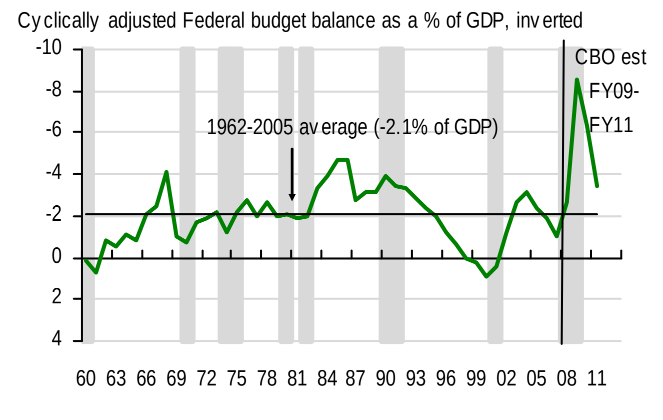
* Q3 through July calculated using Q3 estimate for GDP; all other history are quarterly averages. Source: Federal Reserve and UBS estimates

...has helped to dramatically lower credit market risk spreads.



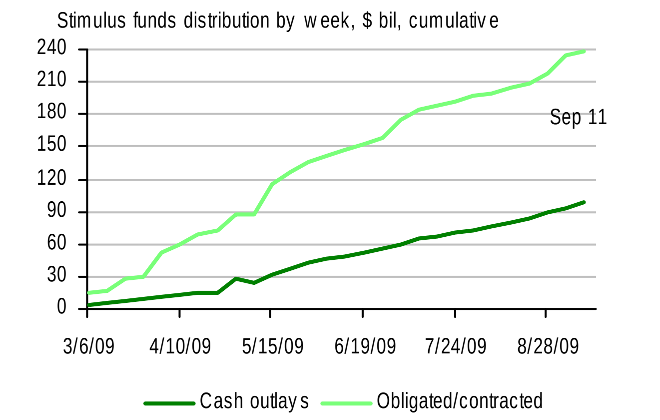
Source: The Yield Book, KDP Investment Advisors, Federal Reserve Board, and Bankrate.com

The cyclically adjusted Federal budget deficit—a measure of discretionary fiscal policy—has been surging.



Note: Shaded bars represent periods of recession.
Source: Congressional Budget Office (CBO)

The fiscal stimulus package is being increasingly reflected in higher government outlays.



Note: The decline in outlays in the week of May 8 reflects a Labor Department accounting adjustment.
Source: Recovery.gov

the Federal deficit and the Fed's balance sheet. Such actions are necessary to initiate a recovery. However, there must be follow-through from households—by far the largest element of aggregate demand. And that follow-through reflects two critical considerations—incomes and the personal saving rate.

A sustained recovery must get households more involved soon

Although the personal saving rate has risen, as it usually does during recessions, it remains comparatively low versus its longer-term history. Thus, an ongoing debate is whether American consumers must save still more to reduce debt and build financial assets in the wake of the sizable declines, on balance, in the prices of stocks and residential real estate in recent years. Our view has been that the approximate 3.0 percentage point upward personal saving rate adjustment from its 2005 level of just 1.4%—the lowest calendar average level in the past half century—to around 4.4% in H109 represents about as much adjustment as should occur, at least on a multi-quarter measurement basis. That is because our research indicates that the net worth (NW)/disposable personal income (DPI) ratio and interest rates are much more tightly correlated with savings behavior than is the unemployment rate, which has increased to almost 10%. (See our March 16, 2009 Q-Series report, *Are We Saving Enough Yet?*) Recently, our estimated personal saving rate model with both NW/DPI and the three-month Treasury bill rate as explanatory variables was consistent with a Q209 personal saving rate of 4.8% versus the actual reported 5.0%. (See accompanying exhibits.)

Is the necessary upward personal saving rate adjustment essentially completed?

Our saving rate model suggests that the personal saving rate has remained much less than in past similarly serious recessions for two main reasons. First, relatively low interest rates have been limiting interest income—a comparatively highly-saved form of personal income. Also, the NW/DPI ratio, despite being at around its lowest level of the current decade, still has been higher than in past serious recessions.

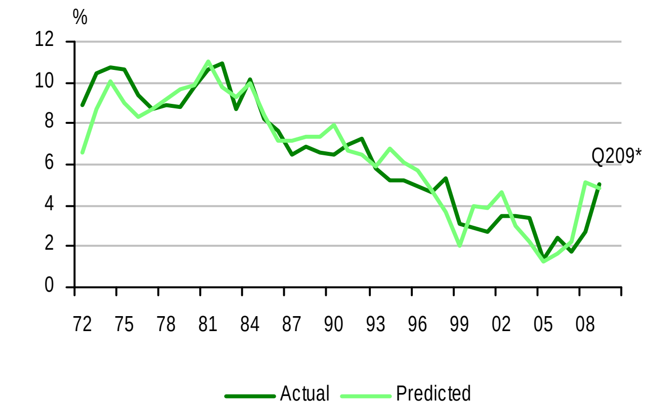
During past severe recessions, when interest rates were higher and wealth was lower, Americans saved more than they are now

Model of NIA saving rate measure, 1972-2008.

Independent Variables	Estimated Saving Rate Effects
Constant Term	21.48
	(10.82)
Net Worth/Disposable Personal Income	-3.43
	(-9.86)
Three-month Treasury Bill Rate	0.34
	(4.67)
Adjusted R-Square	0.87
* t-statistics in parentheses below coefficients	

Source: Commerce Department, Federal Reserve Board of Governors, and UBS

Our NIA saving rate model usually tracks the reported saving rate relatively well, such as in the recent Q209.



* Q209 quarterly savings rates are the actual and the predicted using our equations.
Source: Bureau of Economic Analysis and UBS

The other critical consideration for consumer spending is income formation. In H109, household purchasing power was boosted by Federal income tax cuts and higher transfer payments (eg, a 5.8% Social Security cost-of-living adjustment). These constituted a one-time permanent boost to the DPI level but just a temporary booster of DPI growth, unless there are further tax cuts, for example. In H209 and 2010, the key to income formation will be aggregate wages and salaries—53.5% of overall pretax personal income last year. After falling sharply during most of H109, wage and salary disbursements edged up in July as job losses slowed and average hourly earnings continued to grow, albeit at a slower rate than before the recession. (See accompanying chart.)

Household purchasing power "switching engines"

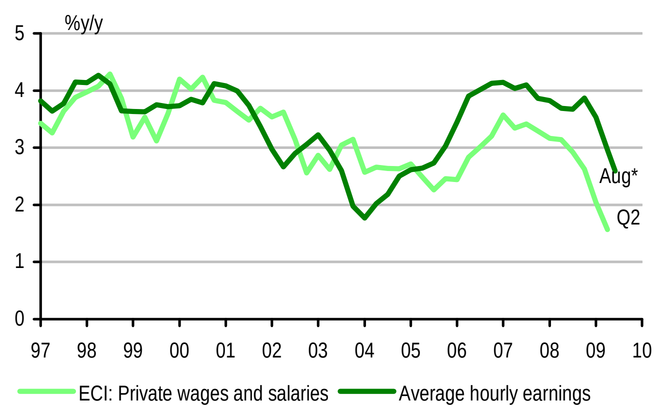
Labor market weakness should continue to fade. Gross job losses still exceed gross hiring. However, hiring levels rose somewhat in July. (See accompanying chart.) Moreover, layoffs have been declining, with the latest four-week moving average of 554,000 weekly initial claims for state unemployment insurance in the week ended September 19 being the lowest since January. *As signs of more stable product demand persist, there should be fewer firms incrementally reducing their headcounts, and layoffs should fall further and closer to already stabilizing gross hiring levels.* Note: One major sign of stabilizing product demand already has been reported in Q209, when real final sales edged up at a 0.4% annual rate after falling at a 3.9% annual rate over the three previous quarters. (For more recent product demand evidence, see charts on page 7.)

Employers' headcount reductions should diminish further in response to already stabilizing aggregate product demand

While cutting jobs, capex, and inventories made sense in response to slumping product demand, continuing to do so once demand stabilizes starts to raise market share and competition-related risks. Firms apparently already are starting to appreciate that the rapid pace of inventory liquidation earlier this year now entails growing risks of losing sales due to inadequate inventories of goods for sale. (See accompanying chart on page 7.) And continuing to delay addressing critical capital replacement needs entails growing competitive cost disadvantages versus those domestic and foreign competitors that have forged ahead with the adoption

"Animal spirits" are not stirring yet, but survival entails not cutting labor, capex and inventories too much

Wage gains are slowing but have not turned negative.

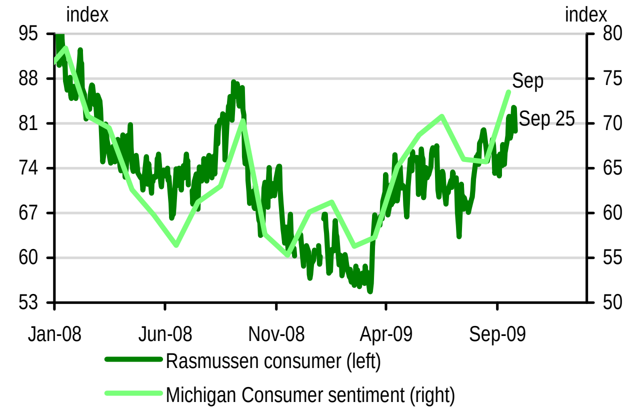


* Latest monthly data; all other history are quarterly.
Source: Bureau of Labor Statistics

The summer hiring started to catch up with job market separations—mainly layoffs and quits.

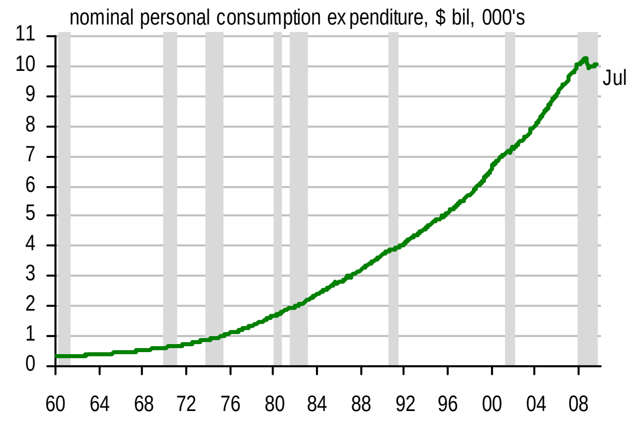
Source: Bureau of Labor Statistics

Consumer confidence is a key to consumer spending.



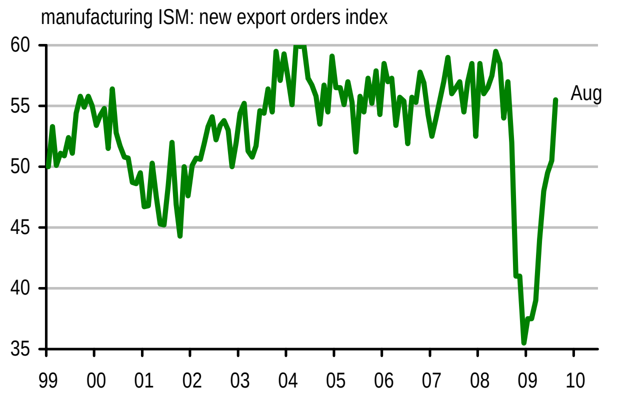
Source: University of Michigan and Rasmussen Reports

Household goods and services spending is stabilizing.



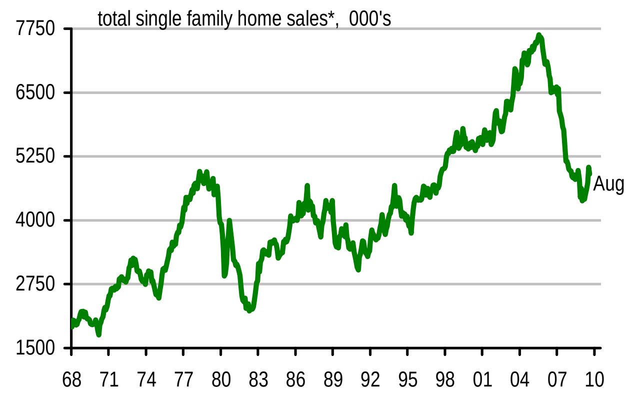
Note: Shaded areas mark periods of recession.
Source: Bureau of Economic Analysis

Domestic manufacturers' orders from overseas are now rising.



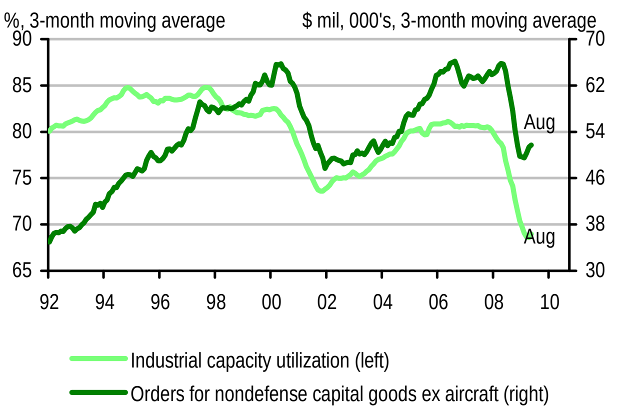
Source: Institute of Supply Management

Home sales are up, on balance, from their earlier cyclical low point.



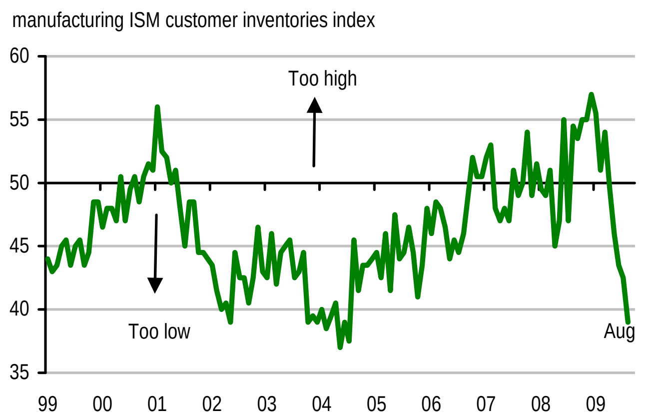
*New and existing.
Source: Census Bureau and National Association of Realtors

Capex orders are stabilizing despite low capacity utilization.



Source: Federal Reserve Board and Census Bureau

Manufacturers' purchasing agents now see their customers' inventories as too low.



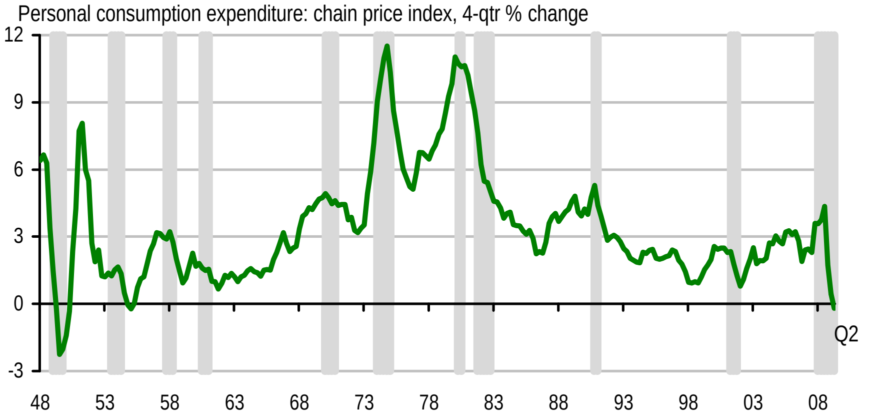
Source: Institute for Supply Management

of the latest cost-saving technologies. Thus, *capex orders have been just about stabilizing even at very low industrial capacity utilization rates.* (See chart on previous page.) In addition, headcounts can be cut too much, with negative consequences for retaining talent and maintaining quality of services for customers.

Low prices are a "mixed bag"

Firms also are influenced by pricing power, which will remain limited with still abundant spare productive capacity in the global economy. However, the related weakness in consumer prices over the past year (see accompanying chart) has represented a redistribution of overall current dollar national income to the household sector. And American consumers will play a critical role in heading off a relapse into another recession in 2010.

Low business pricing power is a plus for the household sector's purchasing power.



Note: Shaded bars mark periods of recession. Source: Bureau of Economic Analysis

Maury Harris

U.S. GDP, Interest Rate, and Inflation Forecasts

Percent change, seasonally adjusted at annual rates, except where noted, as of October 14, 2009

	2009				2010				Annual change			4Q/4Q change		
	1QA	2QA	3QE	4QE	1QE	2QE	3QE	4QE	2008A	2009E	2010E	2008A	2009E	2010E
Real GDP (Chain)	-6.4	-0.7	3.5	3.0	2.5	2.7	3.0	3.1	0.4	-2.4	2.6	-1.9	-0.2	2.8
Personal consumption expenditures	0.6	-0.9	3.2	1.7	1.8	2.2	2.5	2.7	-0.2	-0.5	2.0	-1.8	1.2	2.3
Goods	2.5	-3.1	7.0	1.3	1.5	1.7	2.0	2.2	-2.1	-2.0	2.0	-5.9	1.9	1.8
Services	-0.3	0.2	1.5	1.9	2.0	2.5	2.7	3.0	0.7	0.2	2.0	0.3	0.8	2.5
Fixed investment	-39.0	-12.5	6.2	-5.1	2.5	4.0	7.6	5.6	-5.1	-18.1	1.6	-9.6	-14.4	4.9
Business fixed investment	-39.2	-9.6	5.8	-7.8	0.4	0.4	4.8	4.9	1.6	-17.2	-0.4	-6.0	-14.4	2.6
Equipment & software	-36.4	-4.9	16.0	-4.0	3.0	3.0	7.0	7.0	-2.6	-16.4	3.4	-10.7	-9.4	5.0
Structures	-43.6	-17.3	-11.0	-15.0	-5.0	-5.0	0.0	0.0	10.3	-18.8	-7.7	3.2	-22.9	-2.5
Residential	-38.2	-23.3	8.0	6.0	11.0	18.0	17.5	8.0	-22.9	-21.3	9.0	-21.0	-14.2	13.5
Government purchases	-2.6	6.7	1.7	3.7	0.9	1.0	1.0	1.0	3.1	2.0	1.9	3.1	2.3	1.0
Federal	-4.3	11.4	6.0	7.9	2.4	2.4	2.4	2.4	7.7	5.5	4.4	8.9	5.1	2.4
State & Local	-1.5	3.9	-1.0	1.0	0.0	0.0	0.0	0.0	0.5	0.0	0.3	-0.3	0.6	0.0
Net exports ($ bil.)	-387	-330	-338	-346	-348	-352	-351	-351	-494	-350	-351	-471	-346	-351
Exports	-29.9	-4.1	14.9	5.0	5.0	5.0	8.0	8.0	5.4	-10.8	6.2	-3.4	-5.1	6.5
Imports	-36.4	-14.7	13.3	5.7	4.5	5.1	6.1	6.7	-3.2	-15.1	5.0	-6.8	-10.1	5.6
Change in inventories ($ bil)	-114	-160	-148	-86	-62	-42	-38	-26	-26	-127	-42	-37	-86	-26
Real domestic purchases	-8.6	-2.3	3.7	3.2	2.5	2.8	2.9	3.1	-0.7	-3.4	2.6	-2.5	-1.1	2.8
Final sales	-4.1	0.7	3.1	1.1	1.7	2.1	2.8	2.7	0.8	-1.6	2.0	-1.4	0.2	2.3
Domestic final sales	-6.4	-0.9	3.3	1.3	1.7	2.2	2.7	2.7	-0.4	-2.6	1.9	-2.1	-0.8	2.3
Net exports contribution (pct pts)	2.6	1.7	-0.2	-0.2	0.0	-0.1	0.1	0.0	1.2	1.0	0.0	0.8	0.8	-0.1
Inventory contribution (pct pts)	-2.4	-1.4	0.4	1.9	0.7	0.6	0.1	0.4	-0.4	-0.9	0.7	-0.5	-0.4	0.5
Nominal GDP	-4.6	-0.8	5.3	4.2	4.1	4.3	4.6	4.8	2.6	-1.1	4.1	0.1	0.9	4.5
Key business indicators														
FRB industrial production index	-19.0	-10.5	4.0	4.3	4.1	4.2	4.5	4.5	-2.2	-10.1	3.2	-6.7	-5.8	4.3
Capacity utilization rate (%, level)	70.4	68.6	69.5	70.1	70.5	71.0	71.5	72.0	77.6	69.7	71.3	74.2	70.1	72.0
Civilian unemployment rate (%, level)	8.1	9.3	9.6	10.0	10.3	10.2	10.1	10.0	5.8	9.2	10.2	6.9	10.0	10.0
Housing starts (millions)	0.53	0.54	0.60	0.60	0.65	0.75	0.80	0.80	0.90	0.57	0.75	0.66	0.60	0.80
Current account balance (% of GDP)	-2.9	-2.8	-2.8	-3.1	-3.3	-3.1	-3.2	-3.4	-4.9	-2.9	-3.3	-4.3	-3.1	-3.4
Inflation														
GDP Chain Price Index	1.9	0.0	1.7	1.2	1.6	1.6	1.6	1.6	2.1	1.4	1.4	1.9	1.2	1.6
CPI-U	-2.4	1.3	3.8	1.1	1.7	-0.6	1.6	0.5	3.8	-0.4	1.3	1.5	1.0	0.8
Core CPI-U	1.5	2.4	1.5	1.0	0.7	0.5	0.5	0.5	2.3	1.7	0.9	2.0	1.6	0.5
PCE Chain Price Index	-1.5	1.4	3.1	1.1	1.3	0.0	1.2	0.5	3.3	0.2	1.2	1.7	1.0	0.8
Core PCE Chain Price Index	1.1	2.0	1.5	1.1	0.8	0.6	0.5	0.5	2.4	1.5	0.9	2.0	1.4	0.6
Market-based core PCE Price Index	1.9	2.3	1.3	0.9	0.6	0.4	0.3	0.3	2.3	1.9	0.7	2.3	1.6	0.4
PPI-finished goods	-6.2	1.4	10.4	1.4	3.7	-2.5	4.0	0.3	6.4	-2.2	2.6	1.4	1.6	1.3
Income indicators														
Average hourly earnings	2.7	1.3	2.5	2.0	2.0	2.0	2.0	2.0	3.8	2.8	2.0	3.9	2.1	2.0
Nonfarm business compensation	-4.7	0.3	3.2	3.2	3.2	3.2	3.2	3.2	2.8	0.6	3.0	2.6	0.4	3.2
Employment cost index	1.1	1.5	2.6	2.6	2.6	2.6	2.6	2.6	3.0	1.9	2.5	2.6	1.9	2.6
Real disposable income	0.2	3.8	-4.3	1.5	1.6	3.6	2.5	1.3	0.5	0.4	1.4	0.3	0.3	2.3
Saving rate (%, level)	3.7	4.9	3.1	3.1	3.0	3.3	3.3	3.0	2.7	3.7	3.2	3.8	3.1	3.0
Memo: Nonfarm business productivity	0.3	6.6	4.4	4.3	3.2	1.8	1.9	2.0	1.8	2.5	3.2	0.9	3.9	2.2
Federal budget balance ($ bil, FY)									-459	-1,380	-1,290			
% of fiscal year GDP									-3.2	-9.7	-8.8			

Source: Department of Commerce, Federal Reserve Board, Bureau of Labor Statistics, Treasury Department, and UBS estimates

Interest rates

Percent	2009				2010				Annual averages			End of period		
	1QA	2QA	3QA	4QE	1QE	2QE	3QE	4QE	2008A	2009E	2010E	2008A	2009E	2010E
Federal funds rate	0.13	0.13	0.13	0-0.25	0-0.25	0.50	0.75	1.00	2.08	0.13	0.49	0.1	0-0.25	1.00
2-year government notes	0.8	1.1	1.0	1.8	2.3	2.8	2.9	3.0	2.0	1.1	2.6	0.8	1.8	3.0
10-year government notes	2.7	3.5	3.3	3.8	3.8	3.8	3.9	4.0	3.7	3.3	3.9	2.3	3.8	4.0

Note: Quarterly forecasts are for end of period yields.

Source: Federal Reserve Board and UBS estimates

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