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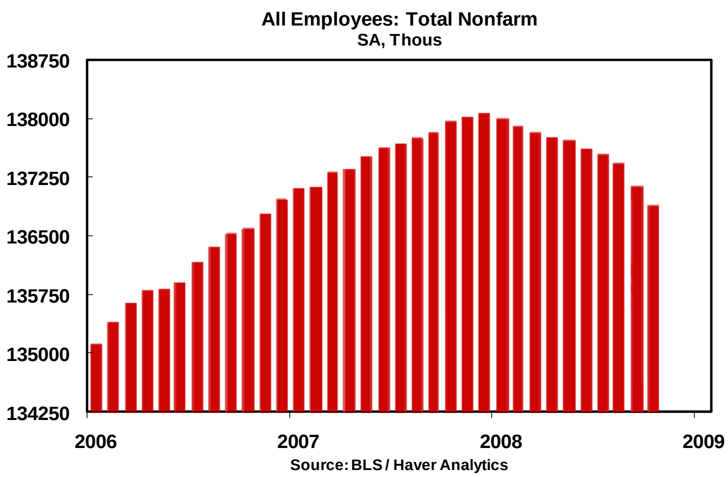
Economic Commentary

NBER Makes it Official

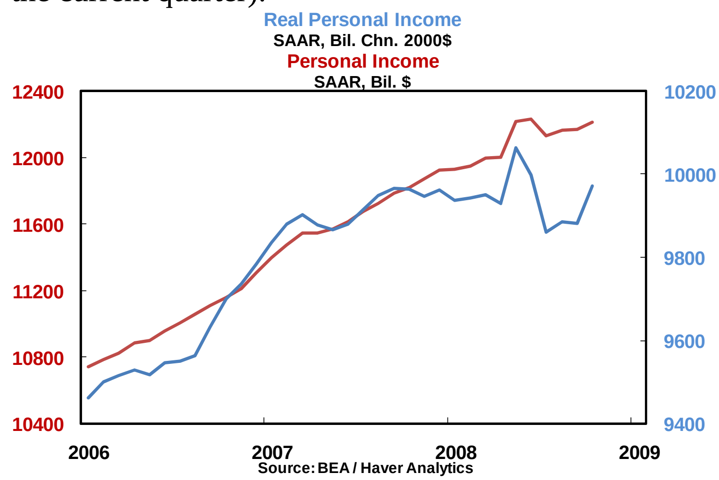
The official arbiter of US business cycles, the National Bureau of Economic Research, has made it official: the US economy is in recession. However, contrary to our belief that the US avoided recession until the third quarter of 2008, the business cycle dating committee of the NBER (a group of academic economists) decided the expansion that began in November 2001 came to an end in December 2007.

Dating a recession is part art and part science. Contrary to popular belief, a recession is not two consecutive quarters of declining real GDP. The NBER says a recession "is a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in production, employment, real income, and other indicators."

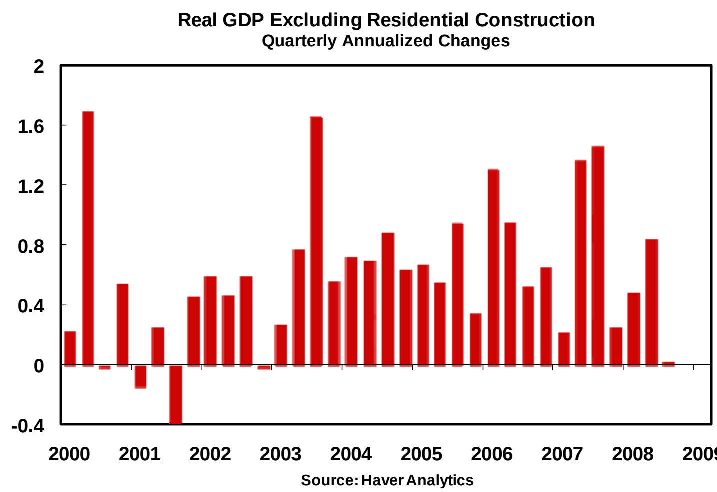
It seems the NBER paid particular attention to employment – which peaked in December 2007 – the month the NBER ultimately chose as the start of the recession. Industrial production peaked in January 2008. Real personal income (excluding transfers) and real manufacturing and trade sales both peaked in October 2007.



What is most interesting are developments that are not captured by this broad data. For example, the production of construction supplies peaked in January 2006 and has fallen 11.5% since then. The collapse in housing has been so steep and deep that it has made everything look bad. Excluding housing from GDP, the US has not yet experienced a negative quarter of real economic growth (although it is very likely to in the current quarter).



Also, the massive rise in oil prices that began last September has undermined real incomes. The CPI was up 6.2% at an annual rate in the 10 months after September. This overwhelmed income growth, pushing it down on a real basis. Now that oil prices have plummeted, real incomes are likely to rise over the next few months.



Even with rising inflation, and falling home construction, real GDP contracted at only a tiny 0.2% annual rate in the fourth quarter of 2007, and grew in the first two quarters of 2008, including a quite healthy 2.8% growth rate in Q2.

Not since 1970 has the NBER called a recession for a period including such a strong quarter of real GDP growth (and remember that the 1970 data has been revised substantially in the intervening years). In fact, GDP data were much worse than in recent quarters during 2000-2001 and using them could have led the NBER to date the last recession to mid-2000, not March 2001, and it would have been called the Clinton Recession, not the Bush Recession.

One way the NBER gets around the issue of real GDP peaking well after December 2007 is by also focusing on real GDI (gross domestic income). In theory, GDP and GDI should equal each other. Every $1 of production should generate $1 in income to either workers, the owners of capital, or the beneficiaries of government transfer programs. In recent quarters, real GDI growth has been weaker than real GDP growth and real GDI went negative in the fourth quarter of 2007.

However, subtracting residential construction from GDI shows that the first quarter of negative growth was in the third quarter of 2008. So, it appears that the NBER has said a strong enough decline in one sector of the economy (in this case, housing) can actually lead to a recession, even if the rest of the economy seems to be doing relatively well.

In our view, despite the dating of the start of the recession to December 2007, the current recession would not have been a recession at all without the "risk aversion hysteria" that struck the financial system and broader economy in September 2008. This coincided with the collapse of Lehman Brothers, and unlike other recessions, this one has not been caused by tight monetary policy, rising tax rates, or higher barriers to international trade. Instead, the recession was caused by a combination of (1) idiotic mortgage loans generated by an overly loose monetary policy earlier this decade and (2) overly stringent mark-to-market accounting rules, which were an overreaction to the business management scandals in 2001-02.

As a result of this being a different kind of recession, we believe that rather than being a lagging signal of economic growth, consumers will lead the way out of recession, ramping up buying well before businesses – made skittish by recent events – reassert a normal level of risk-taking.

In addition, while the historical record will not show it, we expect a "V" shaped downturn, with a recovery starting in the very near term. While we expect a 4% decline in real GDP during the fourth quarter, we expect real GDP growth to improve rapidly in 2009.

The rebound in consumer spending so evident in this holiday shopping season, an apparent stabilization in initial unemployment claims, a huge drop in gasoline prices, a strong rebound in mortgage applications, and the placement of new corporate bond issues, suggest that risk aversion is abating.

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