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US Recession Threatens Due To Household Spending Decline

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By Shobhana Chandra and Steve Matthews

Aug. 11 (Bloomberg) -- Recession signals in the world's largest economy are flashing red again.

Growth in the second quarter slowed to a pace that has typically been followed by a contraction within a year.

Household spending fell in June for the third straight month; never in the past five decades has this happened outside of a slump. The Standard & Poor's 500 Index plunged 16.8 percent in 11 days, performance that's occurred only twice since at least 1970 without indicating a downturn.

"With so many red flags, the chances of a recession are rising," said Jonathan Basile, a senior economist at Credit Suisse in New York. "A lot of the economic indicators are teetering. We've gone very quickly from a slowdown scare to a recession scare."

Signs that the flagging U.S. recovery may fizzle haven't been lost on Federal Reserve Chairman Ben S. Bernanke and his colleagues, who pledged this week to hold interest rates at a record low through at least mid-2013. Officials said they "discussed the range of policy tools" to strengthen growth and are "prepared to employ these tools as appropriate."

"Downside risks to the economic outlook have increased," according to the Federal Open Market Committee statement after the Aug. 9 meeting. Consumer spending has "flattened out," the labor market has deteriorated and the expansion is "considerably slower" than expected.

'Increased Recession Risk'

"The sum total of the indicators over the last six months" points to "increased recession risk over the coming year," said Jeffrey Frankel, a professor at Harvard University who is a member of the Business Cycle Dating Committee of the National Bureau of Economic Research, the official arbiter of when recessions start and end.

Five of the nine economists on the NBER committee say the expansion's staying power may be waning. While the group doesn't forecast the odds of a contraction, individual members can make their own predictions. Martin Feldstein, also at Harvard in Cambridge, Massachusetts, and a member of the NBER panel, said last week he sees a 50 percent chance of a new recession.

Gross domestic product, adjusted for inflation, cooled to a 1.6 percent rate in the second quarter from a year earlier.

About 70 percent of the time when the pace has fallen below 2 percent, a slump has followed within a year, according to data since World War II in an April study by Jeremy Nalewaik, a Fed board staff economist.

'Policy Mistake'

"At a minimum, the conditions are ripe for a recession," said Mark Vitner, a senior economist at Wells Fargo Securities LLC in Charlotte, North Carolina. "When growth slows to less than 2 percent on a year-to-year basis, the economy is simply unable to withstand a major shock or policy mistake."

One major source of weakness is consumer spending, which accounts for about 70 percent of the economy. Household purchases adjusted for inflation dropped in

June for the third consecutive month -- the first such occurrence outside of a recession since 1959, according to economists at JPMorgan Chase & Co.

Household sentiment, as measured by the Thomson Reuters/University of Michigan index for July, has receded to a level seen during the last recession. The Bloomberg Consumer Comfort gauge already is in territory reflective of a slump.

"Consumers are dealing with a labor market that's gotten weaker, a hit to their wealth through declines in the stock market and just a lot of bad news and uncertainty," said Julia Coronado, chief economist for North America at BNP Paribas in New York. "It makes them want to be more cautious in their spending."

Losing Momentum

Manufacturing, which helped pull the economy out of the contraction that began in December 2007 and ended in June 2009, is losing momentum. The Institute for Supply Management's factory index fell last month to 50.9, the lowest since July 2009, from 55.3 in June. Figures less than 50 signal a contraction.

The spread between ISM gauges of new orders and employment turned negative for the last two months in the Tempe, Arizona, group's manufacturing and service industry surveys. This has happened only three other times in the 14 years overlapping the two sets of data, and a recession ensued in two of those three, according to Credit Suisse.

The probability of a slump in the next six months has soared to 30 percent from 5 percent at the end of July, Credit Suisse's Basile said. The latest reading contrasts with mid- 2010, when economists were concerned about a so-called double- dip. That scare barely registered, as the recession probability was 4 percent at the time, he said.

Jobless Claims

Credit Suisse bases its forecasts on measures including stock prices, payroll momentum, jobless claims, housing permits, consumer expectations and energy costs.

"It's worrisome, no matter how you slice it," said Basile, the chair of the ISM's New York business survey.
"There's a lot of anxiety in the financial markets. The ground is shifting quickly."

The string of weak data, combined with a downgrade of the nation's credit rating by Standard & Poor's last week, threw markets into turmoil that underscores the threat to the economy.

A 16.8 percent plunge in the S&P 500 index over 11 days, in the period to Aug. 8, has occurred just twice without signaling a recession, according to figures going back to at least 1970 from ISI Group Inc. In 1987 and 2002, there was a jump in unemployment claims with a short lag, ISI said in an Aug. 9 report titled "Recession Risk Rising."

The stock market declines reflect investor concerns that the U.S. may be tipping into a contraction, and also aggravate that concern by wiping out wealth, said BNP's Coronado.

'Self Reinforcing' Uncertainty

"The uncertainty in financial markets is becoming self- reinforcing," said Coronado, who was on the Fed board's forecasting team. "People are seeking safety, and that's not a signal of confidence in anything. They're not ready to go out and hire workers or increase investment or make any kind of decisions that increase growth."

The bond market also is signaling a less-encouraging outlook. The yield on the 10-year U.S. Treasury note has been moving down from 3.77 percent in February and briefly touched a record low of 2.03 percent on Aug. 9 after the Fed's dimmer assessment of the economy.

The slope of the yield curve has a "reasonable track record in reflecting the change in the economic environment,"
said Michael Feroli, JPMorgan's chief U.S. economist in New York. "It tells you, generally, the outlook for growth and inflation are lower than previously thought," as people are "scaling back expectations over a longer period of time."

Shrinking Gap

The shrinking gap between the 10-year Treasury note and the target for the federal funds rate may be another signal of recession, according to Paul Kasriel, chief economist at Northern Trust Corp. in Chicago. With the benchmark rate on overnight loans among banks stuck at near zero since December 2008, the spread between short-term and 10-year rates has declined in tandem with the falling 10-year yield.

"A narrowing trend in the spread generally indicates weaker economic growth ahead," he said in a note following the Fed's statement. "The fact that the spread narrowed this much in such short time under these conditions is a necessary ingredient for the formation of a recession."

Some regional reports point to a slump in the making. A three-month average of the Federal Reserve Bank of Chicago's national index of economic activity was minus 0.6 in June.
Readings less than minus 0.7 following a period of economic expansion signal an increasing likelihood a recession has begun.

Sign of Trouble

Unemployment is another sign of trouble. If the three-month average of the rate increases by more than three-tenths of a percentage point, the economy has either entered recession or will do so within six months, according to Goldman Sachs Group Inc. Chief Economist Jan Hatzius.

Joblessness, while up from 8.8 percent in March, slid to
9.1 percent in July from 9.2 percent the prior month as discouraged workers left the labor force, so "we're not there"
in terms of the recession criterion, Hatzius said in an Aug. 5 Bloomberg Television interview. "But if we were to see further spot increases over the next couple of months, that would definitely be a warning sign."

He forecasts a one-in-three chance of a renewed recession within the next nine months. The unemployment rate will rise to
9.25 percent by the end of next year, Hatzius said last week, when he cut his growth forecasts through the first quarter of 2012.

'Muddle Through'

"Clearly, this is what keeps Bernanke up at night," said Robert Eisenbeis, former head of research at the Federal Reserve Bank of Atlanta and now chief monetary economist at Sarasota, Florida-based Cumberland Advisors Inc. "The employment situation is key, but my best guess is that we'll continue to muddle through."

Eisenbeis said he's not convinced another recession is near because corporate profits are climbing.

"I am not sure why the label is that important," he said, referring to a possible contraction. "Slow growth is slow growth, regardless of what we call it."

The economy may ride out the slow patch, said Chris Rupkey, chief financial economist in New York at Bank of Tokyo- Mitsubishi UFJ Ltd. Consumer spending was weakened in part by gasoline prices, which have fallen from May's three-year high, and an easing of supply disruptions from Japanese automakers may help lift car sales and production. Jobs are being created, and unemployment claims are declining, Rupkey said.

"A good definition of recession is three consecutive monthly declines in nonfarm payroll jobs," he said in an Aug. 5 note. "This is not happening, and there is no sign it is going to happen."

For economists at JPMorgan, Goldman Sachs and BNP Paribas who have reduced forecasts for the remainder of 2011 and next year, there's still enough cause for concern.

The chance of a recession is "at 50-50 and it has been rising," said Coronado, who until last week had put the odds at one in three. "We're very close to a tipping point."