

Economic Perspectives

Is there any good news out there? Yes, but is it sustainable?

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The economy has officially been in recession for nearly 17 months, far exceeding the duration of all previous recessions since World War II. Indeed, this downturn is the deepest and most far reaching of any since the Great Depression over 70 years ago. With most U.S. metros and many of our global trading partners in recession, there is virtually nowhere to hide. In Florida and most Seacoast markets, evidence suggests the recession probably started 10 months before the nationwide recession was declared. Nevertheless, there are a few emerging signs of economic life. The obvious question is whether the signs are first signs of sustainable recovery or just early green shoots that will wither and die.

There has been little good economic news for much of the last two years. Consumers have grown weary in what seems like a never ending downturn. Job losses continue to mount month after month and foreclosures are at an unprecedented level and still continue to rise. Credit is impaired, household wealth has declined dramatically and both consumer and business balance sheets are in desperate need of repair. All that begs the obvious questions, when will it end? How will we know? Is there *any* good news out there?

While the worst of the recession could be behind us, as evidenced by some recent rays of hope, it is not over and recovery could still be long and painful. Nevertheless, let's look at the good, the bad and the ugly and decide whether some of the green shoots are genuine signs of recovery or whether they are destined to wither and die only to be replaced by new green shoots another day.

The economic freefall that began last fall with the near collapse of the U.S. Banking system appears to be slowing. While the recession is far from over and recovery remains a work in progress, both consumer and business sentiment appear stronger than they have been in recent months. The Conference Board's Consumer Confidence Survey, for example, surged to a seven month high in March after two of the lowest readings on record in January and February. The downside is that the level of consumer confidence is still historically low and will likely remain that way until employment improves

Equities are up over 20% in the last six weeks not only in the U.S. but also in 42 of the world's most economically influential markets. History suggests that stock market gains are often a precursor to recovery.

The rate of median house price decline has slowed and sales volumes are increasing both nationally and in most Seacoast markets. Indeed, there is evidence that existing home median prices began to stabilize in the first quarter of 2009. Pending home sales also rose and that usually bodes well for sales 30 to 60 days in the future. Finally, construction spending — both public and private — rose in March.

Mortgage interest rates remain at record lows and funds are generally available for qualified buyers. We're also witnessing renewed affordability which will lure potential buyers back to the marketplace.

Will three months of reasonably positive housing experience turn in to a sustainable trend? One would hope so but several powerful obstacles remain. Unemployment is still likely to rise throughout 2009 and into 2010. That will force more foreclosures which are already at record highs. Additional foreclosures could quickly erase the gains of the last few months and drive prices even lower. Moreover, broad and sustainable demand does not yet exist. Home sales are being driven by foreclosures and other distress transactions. The majority of buyers are first time home buyers taking advantage of government incentives and renewed affordability. Speculators have also re-entered the market and that could disrupt recovery. Move up buyers are still on the sidelines. Looking behind the numbers, there is still very little sales activity in the \$350,000 and up category. Overall, there appears to be little broad and sustainable purchase demand in housing.

Consumers have gotten some much needed relief in recent months due to lower energy prices, larger tax refunds, modest payroll tax cuts and higher social security payments. Most damage to household wealth has likely already occurred. As a result, consumers look forward to rebuilding badly damaged balance sheets and perhaps restoring some of their lost wealth.

Commercial real estate began to deteriorate badly in 2008 and the worst is almost certainly yet to come. Nevertheless, the Architectural Billing Index is up. This index is based on the premise that an architect is involved in most commercial real



Sprouts of new life will emerge but not all will take root and grow.

estate projects 18-24 months before ground is broken. As a leading indicator, the implication is that some renewed private development activity could come in the next two years or so. Nevertheless, the short term story for commercial real estate is decidedly negative. More on the commercial sector later.

Despite so-called green shoots, the outlook is not all positive. The first quarter shrinkage in gross domestic product at 6.1% exceeded most expectations. That followed a 6.3% decline in the fourth quarter of 2008. Taken together, the two month contraction was larger than any other similar period in 60 years.

If there is good news in such a contraction, it is that it resulted largely from a huge decline (\$104 Billion) in business inventories. Business also stopped producing product and that also contributed to the decline in inventories. While those events intensify the current GDP slide, they also set the stage for more rapid expansion when demand stabilizes. Indeed, without the inventory component, GDP contraction would have been much smaller at about 3.5%±.

First quarter GDP was also heavily influenced negatively by business investment in plant and equipment. Indeed, non-residential fixed investment slid an astounding 38% — by far the largest decline since World War II. That alone subtracted 4.7 percentage points from first quarter growth.

The “green shoot” in this negative information is these are events that history shows typically occur *late* in a recession and the current experience is no exception. These components also tend to come back to life soon after a recession ends.

As we’ve written previously, consumer spending drives about 70% of economic activity. The consumer is a leading indicator in the sense that consumption tends to increase in the *later* stages of recession. In fact, in the first quarter, personal consumption grew at an annualized rate of 2.2% — the highest quarterly growth rate in two years.

Clearly, the pattern in GDP component change is consistent with post war historical experience implying that we may indeed be in the later stages of the recession at least in the context of GDP growth.

Employment is a lagging indicator in a contracting economy as the job losses usually show up after they have actually occurred and long after the slowdown that precipitated the cuts. About 5.5 million U.S. jobs have been lost since the official start of the recession in December 2007. The Labor Department will release its April advance estimate on May 8th and it is likely that an additional 650,000± jobs were lost pushing the nation’s unemployment rate to about 8.7%. Unemployment tends to remain elevated even after the official end to a recession. We expect employment to bottom in early 2010 and unemployment to peak at slightly over 9% later in 2010. The green shoot in employment is that new claims for unemployment compensation have slowed recently however it is still too early to call that a trend.

Commercial real estate began to show clear signs of weakness in early 2008 and the story has gotten worse since then. Despite the rising Architectural Billing Index referred to earlier, there will be huge obstacles to private development in the interim. These include absence of renewed sustainable demand, structural changes in industry sectors — especially retail — and the relative absence of secondary market financing. The CMBS market (commercial mortgage backed securities) — the largest source of funding for commercial projects remains virtually shut down and commercial banks do not have balance sheet capacity to absorb the shortfall. That will lead to a surge in defaults, foreclosures and bankruptcies — the effects of which are likely to last into 2012.

It’s about supply and demand. There will be many false dawns as the economy moves toward recovery. To have sustainable recovery, we must have real demand — not demand that is artificially stimulated or temporarily propped up. Such artificial demand will quickly dissipate when the stimulus is withdrawn or the prop removed. Real demand implies desire for a good or service backed up by purchasing power. Today, real demand does not exist in real estate as the supply and demand equation is out of balance. During the residential bubble inflation, somewhere between 25% and 40% more homes were built than there were people to occupy them either as owners or renters. Today that oversupply is being worked down but the process is slow. Commercial real estate is much the same. New shopping centers were built to follow the new housing. Warehouses and offices were built to support the needs of contractors and others serving the industry. Today, that is gone and the market struggles to absorb all forms of commercial space.

While the *green shoots* are welcome, most will not rise quickly to the level of a trend. Moreover, the current green shoots contain at least two decision traps for consumers and policy makers alike. First, confidence could be misplaced and the rays of hope are misinterpreted as the beginning of a strong recovery when all they really show is that the rate of decline has slowed and the economy is merely “*less bad.*” Decisions made in the early stages of recovery are often shown to be incorrect.

The second decision trap is that policy makers see the green shoots as sustainable recovery and reduce or withdraw stimulus. During the Great Depression, the economy began to show signs of recovery in 1936. In response, the Federal Reserve began a series of rate hikes which plunged the economy into a recession (1937) within the Great Depression and the economy did not begin to accelerate again until the build up for World War II in 1940 and 1941.

The bottom line. In my view the green shoots are real and they signal the beginning of recovery. In even the best case, however, recovery will be a long, rocky and sometimes painful journey. While the economy will recover, it will almost certainly be years before we see the robust growth of the not too distant past.

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