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Apr 10, 2008

Economic Commentary

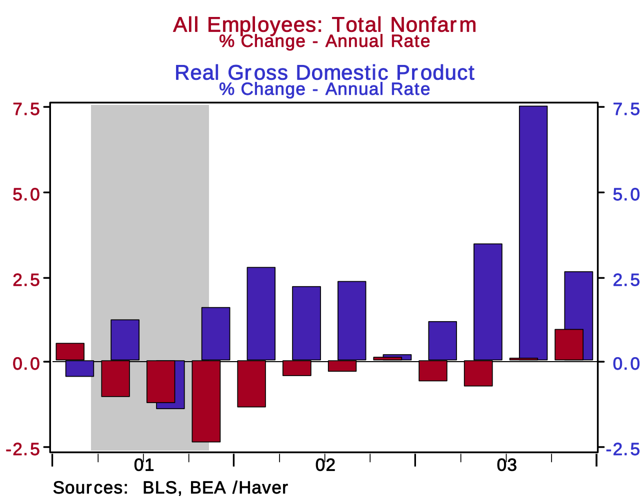
# Still No Recession in Our Forecast

**Summary:** Despite a loss of payroll jobs in the past three months, it is likely that real GDP grew at about a 2% annual rate in the first quarter. While real GDP may slow to just 0.5% in the second quarter, we still expect a sharp rebound to 3%+ growth in the second half of 2008. In other words: No Recession.

## Declining Payrolls ≠ Recession

Government estimates put March job losses at 80,000, the third consecutive monthly decline. Many analysts saw this as final confirmation that the US economy is in recession. We disagree. Moderately declining payrolls are a sign of sluggish growth, not a contraction in output.

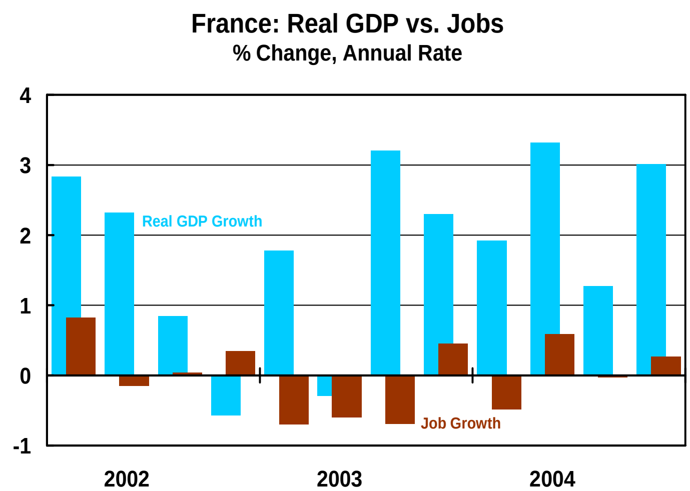
Economic growth can ultimately be broken down into two major components: the number of hours worked and output per hour. In order for the labor market to signal recession, hours worked must decline by at least as much or more than productivity increases. For example, in the last official recession, hours worked fell 3.5% at an annual rate between April and December 2001. While productivity remained very strong in this period, it was not strong enough to hold off a recession.




That is unlikely to have happened in the first quarter. Total hours worked fell at a 1.2% annual rate in Q1, but the trend in productivity growth has been comfortably above this level.

Declining payrolls during a period of expansion would not be a new phenomenon and is likely to occur more frequently in the years ahead. In 2001-03, there were eight quarters in which payrolls declined, but real GDP contracted in only one quarter.

The same pattern has occurred outside the US. For example, French employment was essentially unchanged between 2002 and 2004, yet French real GDP continued to grow.




The reason declining payrolls may be less indicative of recession is that the general trend in job growth has slowed, largely due to the aging of the Baby Boom generation. Labor force participation (people who are working or are looking for work) drops steeply after age 50. And even though Boomers are working more than their parents did at the same age, Boomers are working less than they themselves were working ten years ago. This slows down job growth.

As a result, while the trend in payroll growth in the 1980s and 1990s was about 200,000 per month, the new long-term trend is about 120,000 per month. Another way of putting this is that when it comes to payroll reports -80,000 is the "new" zero.

Some analysts are claiming the US can have a recession without large declines in payrolls because recent job growth has been less than in other expansions. In other words, they are saying businesses do not have a surplus of workers to fire.

However, this argument does not take into account productivity growth. The stronger productivity growth, the greater the decline in employment and hours worked needed to push the economy into recession.

**Our Forecast**

Recent economic data supports the case for sluggish growth in the first half of 2008, but not recession. At an average level of 49.2 in the first quarter, the Institute for Supply Management says its manufacturing index is consistent with real GDP growth of 2.5%. Meanwhile, our models that use weekly data on unemployment claims – both new claims for benefits and continuing claims – are consistent with real GDP growth of about 2% in Q1.

As the table above shows, our base case remains that real GDP grew at a 2% annual rate in the first quarter. However, we get that 2% figure by assuming inventories and international trade add a total of 2 percentage points to growth.

As a result, our forecast for the Q1 growth rate of *final sales* (GDP excluding inventories) is 0.5% and our forecast for *final sales to domestic purchasers* (GDP excluding inventories and trade) is 0%, which would be the first time since 1991 that this measure has not grown.

**Estimated Real GDP Growth - Q1**

| *GDP Components* | *% Change, Annual Rate* | *Contribution to GDP* |
|---|---|---|
| Consumption | 1.1 | 0.8 |
| Business Investment | 0.0 | 0.0 |
| Home Building | -25.5 | -1.1 |
| Government | 1.6 | 0.3 |
| Trade | NA | 0.5 |
| Inventories | NA | 1.5 |
| Total | 2.0 | 2.0 |

Beyond the first quarter, we forecast sluggish 0.5% real GDP growth in Q2, after which the economy will start to expand more rapidly. We attribute the sluggish growth in the second quarter to lingering expectations of further cuts in the federal funds rate. Loose monetary policy will substantially add to real GDP growth in the year ahead. But the boost to growth due to loose money will not start until the Federal Reserve is finished cutting rates. Until then, consumers and businesses tend to postpone activity to take advantage of lower borrowing costs.

**Brian S. Wesbury, *Chief Economist***
**Robert Stein, *Senior Economist***

| | Actual | | | | Forecast | | | |
|---|---|---|---|---|---|---|---|---|
| | Q1.07 | Q2.07 | Q3.07 | Q4.07 | Q1.08 | Q2.08 | Q3.08 | Q4.08 |
| **Real GDP Growth:** | | | | | | | | |
| Q/Q Annual Rate | 0.6 | 3.8 | 4.9 | 0.6 | 2.0 | 0.5 | 4.5 | 3.5 |
| Year-to-Year Change | 1.5 | 1.9 | 2.8 | 2.5 | 2.8 | 2.0 | 1.9 | 2.6 |
| **Unemployment Rate*** | 4.5 | 4.5 | 4.7 | 4.8 | 4.9 | 5.2 | 5.1 | 5.0 |
| **CPI**** | 2.4 | 2.6 | 2.4 | 4.0 | 4.2 | 3.9 | 4.0 | 3.5 |
| **GDP Deflator**** | 2.9 | 2.7 | 2.4 | 2.6 | 2.4 | 2.5 | 2.9 | 2.9 |
| **Rates (End-of-Period):** | | | | | | | | |
| Federal Funds Target | 5.25 | 5.25 | 4.75 | 4.25 | 2.25 | 2.00 | 2.00 | 2.00 |
| 10-Year Treasury | 4.65 | 5.03 | 4.59 | 4.04 | 3.45 | 3.85 | 4.25 | 4.65 |

*quarterly average    ** year-to-year percentage change