On Second Thought, Make That a Single-Dip

By Kerry Pechter *Wed, Jul 14, 2010*

Vanguard analysts put the chance of a double-dip recession at about 20%. The bond yield curve suggests only a 6% risk, but the yield curve isn't as reliably predictive as it used to be, they say.

Although economists generally forecast a strengthening recovery in the U.S., researchers at the Vanguard Group calculate the chances of a “double-dip” recession in the second half of 2010 at about 20%.

In their June Research Note, “Assessing the risks to the U.S. economic recovery,” Vanguard researchers said that “most leading indicators continue to project a modest ‘U-shaped’ recovery” but added that “actual economic growth statistics should provide more volatile than the consensus growth trajectory.

“Current U.S. stock market prices anticipate a weaker-than-expected recovery while the bond market has already priced in a much stronger-than-expected recovery,” wrote the Note’s authors, Joseph H. Davis, Ph.D., Roger Aliaga-Diaz, Ph.D., Andrew J. Patterson and Charles J. Thomas.

The stock market is pointing to as much as a 34% chance of negative growth going forward, while the bond market, as expressed by the shape of the yield curve and corporate bond spreads, suggests as little as a 6% probability of a double-dip, according to Vanguard’s indexes.

But, thanks to the Fed’s zero interest rate policy, the yield curve isn’t the reliable indicator of investor sentiment that it has usually been in the past.

“Historically, when the yield curve was this steep, a recovery followed,” Aliaga-Diaz told RIJ. “The shape of the yield curve has predicted six of the last seven recessions. But under the current circumstances, where the short end of the curve has been artificially maintained at a floor level, the yield curve isn’t a reliable indication of a bull market.”

Considering that over a year has passed since the end of the 2007-2009, Aliaga-Diaz added, it is surprising to see a lingering 20% probability of a relapse into a new recession, or so-called double-dip. “That’s high for an economy that’s recovering,” he said. “It’s a weak recovery, however, and there’s some downside risk.”

Economic problems in the Eurozone, where the weaker economies have struggled with debt and spending reductions, are often mentioned as a possible threat to the U.S. recovery.

Aliaga-Diaz believes that the threat comes mainly from the possibility of contagious investor anxiety and not from a reduction in European purchases of U.S. exports. “Only about 12% of our exports go to Europe,” he said. “The bigger problem would be lack of risk appetite.”

Vanguard’s assertions are based on a proprietary “dashboard” of more than 70 individual financial and economic components that anticipate recessions and recoveries in the U.S. The dashboard is the basis for the Vanguard Economic Momentum Index.

The VEMI, which measures the change in the rate of change of the leading indicators, shot up in February 2009, predicting the job growth that occurred from November 2009 to 2010. As of June, the index was on the rebound, at slightly above zero, after falling sharply for most of the year.

"The VEMI has not yet turned significantly negative to recession-like levels as it did before the double-dip recession of 1982," Vanguard wrote.

The Vanguard team is less upbeat than the 44 professional forecasters surveyed quarterly by the Federal Reserve Bank of Philadelphia. In mid-May, their consensus was that "the outlook for the U.S. economy over the next few quarters looks stronger now than it did just three months ago."

The forecasters, representing major banks, investment companies, universities, consulting firms and industry groups predicted GDP growth of 3.3% (annualized) in the middle quarters of 2010, with a decline to 2.8% and 2.7% in two subsequent quarters. They predicted a drop in the unemployment rate to 7.1% by 2013.

Fed Chairman Ben Bernanke hasn't seen any signs that the growth rate or inflation rates merit an increase in interest rates. On June 23, the Federal Open Market Committee (FOMC) announced that it would maintain a zero to 0.25% federal funds rate "for an extended period."

"Investment in nonresidential structures continues to be weak and employers remain reluctant to add to payrolls," the FOMC said in a release. "Housing starts remain at a depressed level. Financial conditions have become less supportive of economic growth on balance, largely reflecting developments abroad. Bank lending has continued to contract in recent months." It added that "substantial resource slack" will keep inflation down.

This sentiment was noted by the forecasters at Prudential. In its Global Economic Outlook for July-August 2010, Prudential International Investments Advisers, LLC, commented, "Looking beyond Q2, the financial backdrop has turned less supportive of growth following the Eurozone crisis, while housing activity appears to have weakened more than expected following the expiration of the tax credit in April."

The report continued, "These factors are raising concerns about the U.S. growth outlook for [the second half of 2010], prompting the Fed to strike a more cautious tone in its June Statement."

On the question of inflation, the Survey of Professional Forecasters in May maintain their earlier predictions that prices will rise by more than 25% over the next 10 years. They expect the "headline inflation" rate—the rate that reflects spikes in food and energy costs that the "core inflation" rate excludes—to average 2.4% per year from 2010 to 2019. They expect both types of inflation to be under 2% in the second half of 2010.

Judging by the minutes to the June 22-23 Federal Open Market Committee meeting, the Fed governors are divided in their inflation expectations. Some see the slow economy, ipso facto, as predictive of low inflation.

Others see the massive government borrowing and Fed lending over the past 18 months as highly inflationary in the long run.

“Several participants noted that a continuation of lower-than-expected inflation and high unemployment could eventually lead to a downward movement in inflation expectations that would reinforce disinflationary pressure,” the minutes said. “By contrast, a few participants noted the possibility that a potentially unsustainable fiscal position and the size of the Federal Reserve’s balance sheet could boost inflation expectations and actual inflation over time.”

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