

We Found Bottom!

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The recession is over! Barring more government panic, we hit bottom around April 2009. However, let's be clear: government panic and subsequent market incursions both lengthened and deepened the cyclical recession that was underway in mid-2008, creating our third post-WWII "super-recession." Based on 15 broad economic indicators, the current downturn earned the dubious distinction of being "the worst" recession over the last 40 years in the first half of 2009, narrowly edging out the recessions of 1973-1975 and 1980-1982 (which would have been a single long super-recession by today's definition of a recession).

The good news is that real GDP bottomed in May, while monthly job losses have slowed to near zero. Once job declines end, there will have been a net loss of about 7.24 million jobs over the duration of the current recession. This is equivalent to about four years of normal job growth, which is about 1.8 million jobs per year.

Most economic indicators hit bottom between February and July of this year. Most dramatic in this regard was the stock market (S&P 500), which reached a low of 677 in March. Since then it has rebounded nearly 65% (as we write).

To put the situation in perspective, real GDP (2008 \$) was about \$14.8 trillion at the start of September 2008, falling by a total of 3.8% (\$566 billion) over the next 12 months. However, GDP bottomed in May 2009, and increased by 2.2% on an annualized basis in the third quarter.

Not surprisingly, U.S. employment and unemployment continue to worsen, as they are lagging indicators. However, we expect job gains to begin in March 2010. Real household wealth bottomed in the first quarter of 2009 at \$51.8 trillion (2008 \$), and has since climbed \$833 billion over the second and third quarters. Automobile sales hit a low in February 2009 at 387,800 vehicles sold, rebounding to 665,000 vehicles in August. Auto sales have since moderated, at 454,000 and 466,000 vehicles in October and November, respectively, due to time shifts induced by the ill-conceived cash-for-clunkers programs. Industrial output bottomed in June 2009, while retail sales have been rising since their low in April.

Consumer confidence bottomed in November 2008 at 55.3, but stood at 67.4 one year later. We anticipate that it will continue a rolling rebound in 2010, much as it did in 1976 and 1983. According to ShopperTrak, Black Friday sales were up versus 2008 by 0.5% to \$10.66 billion. However, year-over-year Black Friday performances

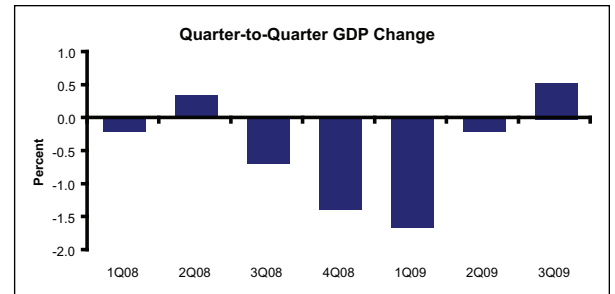


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varied by region: West (+4.7%); Midwest (+1.3%); South (+0.6%); Northeast (-4.9%). In comparison, Black Friday sales grew by 3% in 2008 over 2007, but that turned out to be the worst holiday season in 40 years. Online Black Friday sales increased by 35% and made up an estimated 28.5% of all retail sales that weekend.

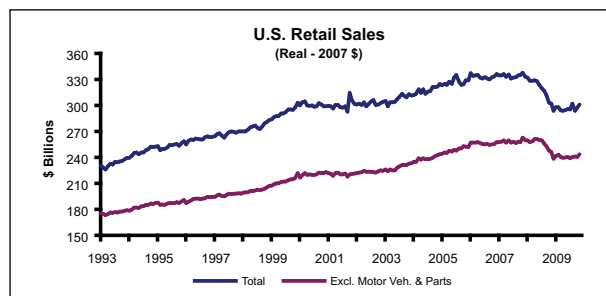
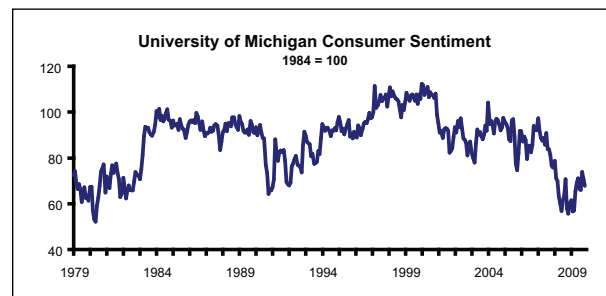
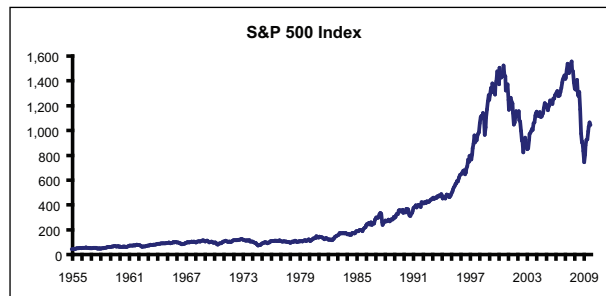
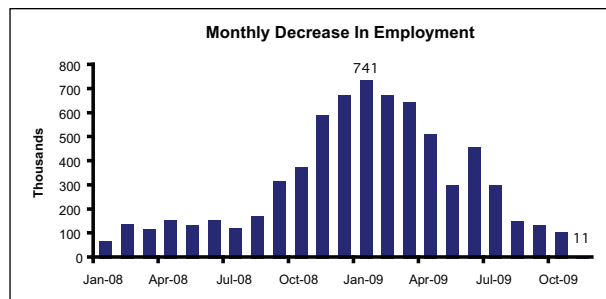
While retail sales bottomed in mid-2009, they still are quite weak. Real retail sales have fallen year-over-year by 1.9% and 0.5% through October and November 2009, respectively. However, real auto-related sales have increased 3.8% and 3.4% over the same respective periods, buffered in part by the cash-for-clunkers program. Retailers were caught off-guard in 2008 when the government-induced panic occurred, but they were more proactive with deep discounts and low inventories during the 2009 holiday season. We anticipate a strong rebound in 2010, potentially in the latter half of the year as job growth occurs.

Commercial and industrial contracts continue to plunge, and we expect a further 30-50% decline through 2011, due to high vacancy rates and an absence of construction debt. Home prices, after-tax corporate profits, consumer sentiment, and housing starts all showed signs of improvement in the second half of 2009.

From August 2008 to June 2009, manufacturing capacity utilization plummeted by 1,020 basis points, to a stunningly low 65.1%. It has since risen 250 basis points through October 2009 (compared to a 20-year average of 79%). U.S. private commercial investment fell by 20% from the second quarter of 2008 through the third quarter of 2009, but at a declining rate, and was essentially flat over the last two quarters.

Manufacturing has been crushed, with durable goods production down 20% and non-durables down 7% since peaking in December 2007. The declines in manufacturing production have moderated slightly, with year-over-year decreases of 12% and 3% for durable and non-durables, respectively, through October 2009. Auto and light truck production was down 34% between December 2007 and October 2009, and 11% year-over-year through November. Energy production peaked in mid-2007 and bottomed in January 2009 (-65%), but rose through 2009 to a level 36% below the 2007 peak.

After-tax corporate profits hit bottom in the fourth quarter of 2008, rising by 15% through the end of the third quarter of 2009. This represents approximately \$137 billion in increased corporate profits after tax, reversing 50% of the \$269 billion decline in after-tax profits which occurred in the previous six quarters. To date, this profit rebound has been focused on cost reductions rather than revenue enhancements, with each of the 7.2 million jobs lost to date increasing profits by approximately \$19,000. However, we are about to enter the phase where corporate profits will continue to rise as a result of revenue increases rather than cost reductions. Ultimately, this will result in increased employment, as one can only utilize a



strategy of “the beatings will continue until morale improves” for so long. Eventually, new employees are required to efficiently meet increased demand. This increased demand will be the result of both growing population and pent-up demand.

Real disposable personal income rose by 2.2% year-over-year through October. Real wage and salary income is down 3.3% year-over-year through October and 5.2% since the beginning of the recession.

Third quarter 2009 real net household wealth declined from the second quarter, but was still 1.6% above its first-quarter low, leaving it at the same level recorded in 2000. It is interesting to note that household wealth fell by some 20% (\$12 trillion) between the first quarter of 2008 and the first quarter of 2009, of which \$2.5 trillion was the loss in equity value on homes, with the remainder accounting for the decline in value of other assets. This \$12 trillion decline compares to the \$10 trillion decline in stock values during the tech wreck. In contrast, declining home values have resulted in a loss of less than \$4 trillion since their 2005 peak.

Real personal consumption expenditures are down by just 0.1% year-over-year through the third quarter of 2009, and up 0.8% over the second quarter. Real housing expenditures rose by 0.8% over the last year through the third quarter, while auto expenditures grew by 11.6% over the same period. Real personal expenditures on gasoline rose by 5%, as reduced gasoline prices have encouraged greater auto usage. Service consumption rose by 0.4%, with medical expenditures increasing by 2.8% year-over-year through the third quarter of 2009.

Meanwhile, consumer credit has fallen by roughly 3.6% over the trailing 12 months through October 2009, as consumers have reduced durable goods consumption, paid down some debt, and hoarded cash in the face of uncertainty and skyrocketing future tax liabilities associated with soaring federal deficits.

Other indicators hitting bottom include: average weekly hours worked (even in manufacturing); hours of overtime worked; unemployment claims; vendor deliveries; new orders received by manufacturers (both for defense and non-defense goods); single family housing starts; industrial production of business equipment and consumer goods; non-durable and durable goods sales; inventories; and housing prices.

Taken together, these factors indicate that the economy turned for the better only slightly later than what had been widely forecasted prior to the stimulus bill and disastrous government interventions. But recovery is not present in every dimension of the economy. Most notably, declines continue in employment and in commercial construction.

