THE CARLYLE GROUP
GLOBAL ALTERNATIVE ASSET MANAGEMENT

# Economic Outlook

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## The Long Hard Slog

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Economic data received since the end of July point to an economy that is substantially weaker than most observers would have anticipated just a few months ago. Professional forecasters have responded by slashing growth forecasts and openly speculating on the odds that the U.S. economy will slide into another recession. This is a remarkable turnaround for an economy expected by consensus estimates to grow well above its historical average in both 2011 and 2012. Growing at 1.5% is not the same thing as contraction, however, and recession is hardly the most likely scenario going forward. Data received in August point to an economy that continues to grow, albeit at a slow and unsatisfying pace. With corporate profits and liquidity positions strong, the recent sell off in equity markets seems to reflect a shift in sentiment and risk aversion rather than the start of something much worse.

**U.S. Economy Smaller Than Previously Believed**

On July 29, the Bureau of Economic Analysis (BEA) at the Commerce Department released its advance estimate for Gross Domestic Product (GDP) in the second quarter. While growth came in below consensus expectations (1.0% annualized growth compared to an expectation of 1.8%), more consequential for the economic outlook was the substantial revisions to previous GDP reports. In July of each year, the BEA updates its previous estimates of economic activity to reflect new data obtained from the IRS and other agencies. This year, the new data caused BEA to revise down its GDP estimates from 2008-2009. BEA now estimates that the "Great Recession" subtracted 5.1% from real GDP rather than 4.1%, as previously estimated. This means that the U.S. economy is now 0.5% smaller (in constant, 2005 dollars) than it was in the fourth quarter of 2007. Previous estimates suggested the economy had already expanded beyond its previous business cycle peak in the third quarter of 2010.

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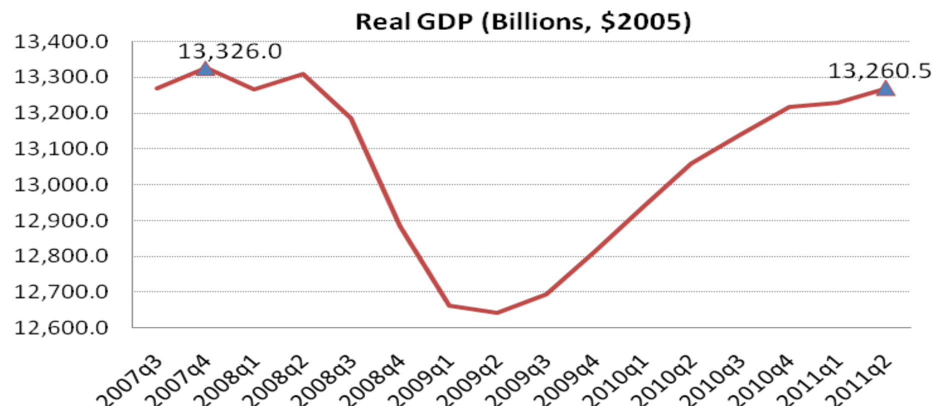
**Figure 1:**

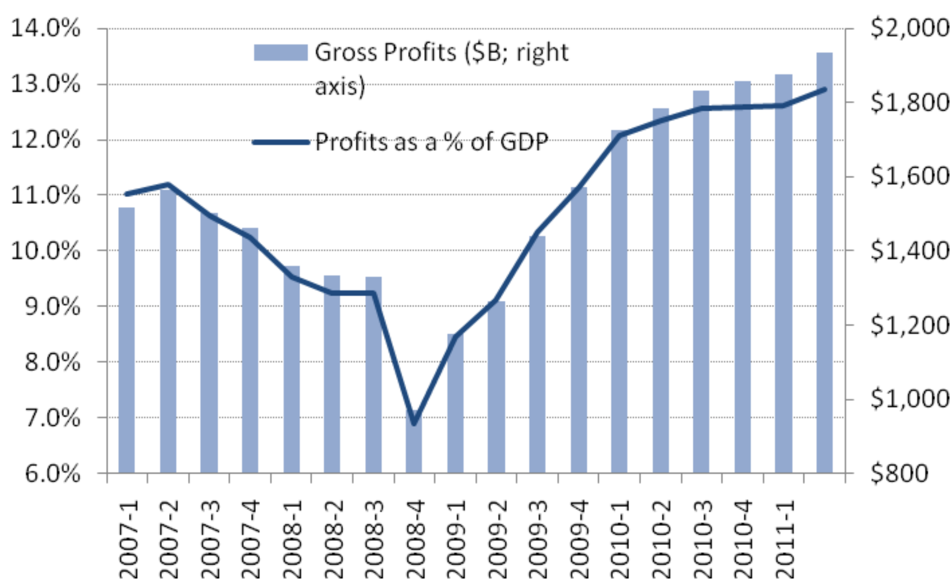



Source: BEA

In addition to a deeper recession, BEA now estimates that the initial recovery was somewhat faster than previously estimated, while growth since June 2010 has been substantially slower. Growth in full-year 2010 was revised upward to 3.1% thanks to the deeper trough in 2009 and faster growth in the first two quarters of 2010. However, growth was revised downward by 0.7% since June 2010, meaning economic growth in the twelve months ending in June 2011 was only 1.5%.

As has previously been the case with this recovery, the lone bright spot to the report was an upward revision to corporate profits. Corporate profits are now assumed to have grown by 9.1% in 2009, by 32.2% in 2010, and by 8.3% in the twelve months ending in June 2011. In the second quarter of 2011, corporate profits were equal to 12.9% of GDP, which is above the previous business cycle peak of 12.3% recorded in the third quarter of 2006 and more than 5 percentage points (or 87%) above the trough recorded at the end of 2008. Cash holdings also remain well above previous cyclical peaks (however measured) as nonfinancials in the S&P 500 combined to hold $1.023 trillion in cash and cash equivalents at the end of the first quarter, a 14.6% increase relative to the first quarter of 2010.[1]

**Figure 2:**




**Source: BEA**

**Forecasters Trim Growth Outlook Substantially**

As recently as June 22, the Federal Reserve Open Market Committee anticipated GDP growth for 2011 of between 2.7% and 2.9%, with growth expected to accelerate to between 3.3% and 3.7% in 2012. Less than seven weeks later, the Fed was forced to acknowledge economic growth "has been considerably slower than the Committee had expected" and that "temporary factors" like bad weather and the Tsunami "account for only some of the recent weakness in economic activity." The Fed responded by announcing that economic weakness and anchored inflation expectations would "likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013."

Even more striking is the fact that June's GDP forecast had already been reduced by nearly one-half of a percent from the Fed's April outlook. Within a span of five months, the Fed has gone from anticipating 2012 growth to be 40% above its 30-year average to believing that next year's growth will be so anemic as to require overnight lending rates of near zero well into 2013.

[1] See: http://www.standardandpoors.com/products-services/articles/en/us/?assetID=1245304926923

**Figure 3:**

| As of August 2011 | 2011-Q3(E) | 2011-Q4(E) | 2012(E) |
|---|---|---|---|
| Moody's | 1.5% | 2.6% | 3.3% |
| Morgan Stanley | 3.0% | 2.4% | 2.2% |
| Citi | 1.6% | 1.8% | 2.5% |
| Goldman Sachs | 2.0% | 2.0% | 2.1% |
| Blue Chip Survey | | 1.6%[1] | 2.7% |
| CBO | | 2.3%[1] | 2.7% |
| **As of April 2011** | **2011-Q3(E)** | **2011-Q4(E)** | **2012(E)** |
| Moody's | | 3.3%[1,2] | 4.3% |
| Morgan Stanley | 4.0% | 4.3% | 3.5% |
| Citi | | 2.5%[1] | 3.3% |
| Goldman Sachs | 4.0% | 4.0% | 3.8% |
| Blue Chip Survey | | 3.3%[1] | 3.2% |
| CBO | | 3.1%[1] | 2.8% |
| Federal Reserve | | 3.3%[1,2] | 3.9%[1,2] |

(1) Full year estimate for 2011

(2) midpoint of central tendency

As shown in Figure 3, the Fed was hardly alone in anticipating a more robust recovery. A broad consensus had been established in late 2010 that the U.S. economy – to borrow the euphemism of that moment – had finally "gained traction."[2] Nearly every forecaster had anticipated growth in the mid-3% range. When the first quarter fell below expectations, it was natural to assume that it was due to temporary factors like the weather's impact on nonresidential fixed investment in January and the aftermath of the Japanese Tsunami in March. As the Fed explained in its August policy statement, forecasters now know these temporary factors were not the drivers of the poor performance and forecasts have been downgraded as a result. Growth for all of 2011 has been revised downward by an average of 1.7% and expected growth in 2012 has been trimmed by 0.9%, on average.

**Are We at 'Stall Speed'?**

These downward revisions have resulted in substantial changes to the metaphorical landscape. Rather than "gaining traction" or achieving "escape velocity,"[3] the economy now appears to be traveling at "stall speed."[4] An aerodynamics metaphor, the premise is that the economy, like an airplane, has a minimum velocity threshold that it needs to maintain to keep moving. If GDP growth falls below this threshold, the economy is hypothesized to be more prone to fall into a recession.

While a recent Fed paper shows that the concept has some empirical validity, [5] expanding the analysis to other developed economies suggests that it would be a mistake to ascribe economic significance to any particular growth threshold. The Fed paper finds that the average growth rate in the "stall period" that precedes recession is generally between 0.5% and 2% with an average of 1.2%. This sounds perilously close to the current U.S. experience. However, it also sounds a lot like the growth rates in Italy, France, and Germany for about every quarter for the past 30 years.

Growth of under 2% is unfortunate and much too slow to meaningfully dent the high rate of unemployment. But it is not a level at which, in the words of a recent article, economies suddenly "lose traction and tumble." Economies in Germany, France, Italy, and the United Kingdom have grown substantially slower than that of the U.S., on average, but

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[2] HSBC, 2010.

[3] See: http://www.ft.com/intl/cms/s/0/cc4914da-3eb8-11df-a706-00144feabdc0.html#axzz1VzOdfu6O

[4] See: http://www.ft.com/intl/cms/s/0/cee70202-c9a8-11e0-9eb8-00144feabdc0.html#axzz1VzOdfu6O.

[5] Available at: http://www.federalreserve.gov/pubs/feds/2011/201124/201124pap.pdf.

have not experienced economic contractions with any greater frequency. France, for example, has grown at annual rates of less than 2% over 40% of the time (13 of 31 calendar years since 1980) but its economy has contracted less frequently (only 2 of 31 calendar years since 1980) than that of the U.S.

**Figure 4:**

| | Average Growth Rate | % Of Years with Sub 2% Growth | % of Years of Outright Contraction |
|---|---|---|---|
| United States | 2.69 | 12.9% | 16.1% |
| France | 1.87 | 41.9% | 6.5% |
| Germany | 1.74 | 48.4% | 12.9% |
| Italy | 1.33 | 48.4% | 16.1% |
| Canada | 2.11 | 19.4% | 9.7% |
| United Kingdom | 2.55 | 9.7% | 16.1% |
| Japan | 2.23 | 29.0% | 12.9% |
| Australia | 3.24 | 6.5% | 9.7% |

**Source: IMF, 1980 to 2010**

The predictive power of a sub-2% growth rate is entirely a function of average growth rates. The 2% threshold is significant for the U.S. only in so far as it represents a large statistical departure from average growth. Rather than reflecting an increased likelihood of "stalling out," the hugely disappointing growth numbers today may simply reflect the sluggish pace at which an economy recovering from a financial crisis tends to grow. The Fed paper itself makes clear that "false positives" tend to be generated in the aftermath of recessions.

**July Data Not Suggestive of Contraction**

With the notable exception of two Fed manufacturing surveys, data received in August continue to point to slow growth rather than contraction. U.S. retail and food services sales for July were up 8.5% relative to July 2010.[6] Industrial production and manufacturing increased 3.7% and 3.8%, respectively, relative to June 2010.[7] New durable goods orders in July were 9.1% higher than in July 2010.[8] The Conference Board also reported that the Index of leading indicators increased 0.5% during July and continues to point to slow growth rather than contraction for the remainder of 2011.[9] The weak data from July continued to be concentrated in the labor market. Average hourly and weekly earnings increased 2.3% and 2.6%, respectively, since June 2010, but this increase was too low to match the rise in headline inflation, which reduced real earnings relative to the previous year. The July employment report was disappointing relative to the current state of the economic cycle, but did result in an 117,000 increase in payroll employment and a 0.1% decline in the unemployment rate.

The July data reported in August came before the equity market volatility led to substantial reductions in the market capitalization and enterprise value of domestic businesses. Although asset prices are forward-looking, research since the early 1990s has found that the bulk of changes in stock prices are attributable to changes in the discount rate applied to future earnings rather than changes to the expected value of those earnings.[10] This means that fluctuations in stock prices tend to have more to do with changes in risk aversion and portfolio preferences than they do with changes in expected cash flows. These types of price declines result in more attractive pricing. As of August 24, the operating earnings yield on the S&P 500 – the trailing twelve month's EBITDA relative to enterprise value – was 13%, which is up about 1.2% from the end of 2010. Based on this measure, asset prices are about 29% less expensive today than in 2002-2003 when the average earnings yield was 9.2%.

[6] See: http://www.census.gov/retail/marts/www/marts_current.pdf
[7] See: http://www.federalreserve.gov/releases/g17/Current/
[8] http://www.census.gov/manufacturing/m3/adv/pdf/durgd.pdf
[9] http://www.conference-board.org/pdf_free/press/PressPDF_4269_1313655146.pdf.
[10] Campbell, 1991.



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**Conclusion**

Professional forecasters both in and out of government missed badly on their estimate for 2011 growth. While the economy has turned out to be substantially weaker than most forecasters would have anticipated, the data thus far are suggestive of slow growth, not contraction. The dramatic fall in asset prices during August has the potential to create interesting opportunities for investors as the market participants absorb the realities of the slow growth environment.

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