BY JAMES C. COOPER

The R-Word is 'Rocky,' Not 'Recession'

Why the economic ride ahead will be bumpy-but manageable

U.S. ECONOMY In the financial markets, a little fear is a good thing. It helps investors make smarter decisions and avoid complacency. Thanks to sage advice on the inevitability of the business cycle from former Federal Reserve Chairman Alan Greenspan, and as the result of a sudden plunge in Chinese stock prices, investors are coming back to the notion that the world is a risky place after all. But they shouldn't get carried away, especially with the R-word. Recessions are a fact of life, and they are largely unpredictable. It's a safe bet that the U.S. economy won't experience one anytime soon.

The classic warning signs just aren't there. Consider the economic landscape before the 2001 recession. Prior to the official start of that downturn in March, 2001, the Standard & Poor's 500-stock index had plunged 25% during the previous six months, and spreads between yields on corporate bonds and Treasury notes, a measure of credit tightness, had widened sharply. Corporate profits had been falling for more than a year. Businesses were caught with a mountain of inventories as the annual growth rate in overall demand slumped to 2.2%, from 4.2% the year before, and manufacturing output was headed straight down.

Fast-forward to 2007 As of Mar. 7, the S&P 500 index is off about 4% from its February peak. Credit spreads have widened, but not by much and from very narrow readings. Corporate earnings just finished 2006 with a record 14th consecutive double-digit advance. The problems with inventories are small, narrowly based, and already largely eliminated by resilient demand, which has grown 3.3% over the past year. And manufacturing output appears to be firming up, based on the February report from the nation's purchasing managers. These are not the kind of signs that point to big trouble.

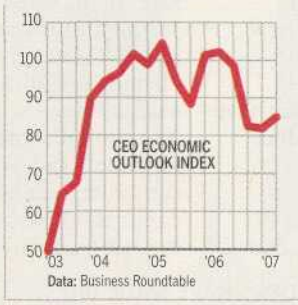
IT'S NOT THAT THE RECENT market turmoil is a nonevent. The cost of capital is now generally higher than it was, and investors and lenders have a lower tolerance for risk. This pattern raises some red flags. The one garnering the most press is the subprime mortgage market, which could generate a broader credit crunch. However, the bigger danger is rooted in the psychology of consumer and business behavior, not in any great economic impact from the market's plunge.

For example, the immediate wealth effect on consumers from the drop in stock prices so far is no hammer blow. The broad Dow Jones Wilshire 5000 index, which correlates well with the stock portion of household net worth, is still a shade above its fourth-quarter average and about 14% ahead of the low hit last June. Also, the resulting credit-tightening has not been great enough to adversely affect consumer borrowing outside of subprime mortgage lending or corporate financing for new equipment and expansion.

Nevertheless, both consumer and business confidence are bound to take a hit. For consumers, the shock will be mitigated by the strength in the job markets. Personal income from wages and salaries jumped 1.2% in January from December, partly reflecting a boost from bonuses, especially on Wall Street. Over the past year, overall wage income is up 5%, beating inflation by nearly 3%.

THE SECTOR TO WATCH most closely is U.S. business. The biggest threat to the economy in coming months is a major swing in corporate sentiment that cuts further into both capital spending and hiring. Corporate outlays have been a strong support under the economy, and the accompanying additions to payrolls have buoyed consumer spending, in the face of high gas prices and the housing slump. In recent weeks new claims for unemployment insurance have turned upward, a trend that bears watching. The rise could simply reflect a return to normal weather conditions after an early mild winter—or a new round of corporate caution.

CEOs EXPECT STEADY BUT SLOWER GROWTH



Data: Business Roundtable

Despite solid balance sheets and readily available funds from both internally generated profits and outside credit, businesses already were pulling in their horns beginning last summer. Questions over the economic impact of the housing slump and higher energy prices led to a drop in outlays for new equipment and buildings in the fourth quarter, and wariness continued into the first quarter. In January, production of business

CHARTS BY ERIC HUFFMANN/BW

equipment fell, and new equipment orders plunged. Now conies the market jolt, which is sure to prompt even more conservative decision-making in the boardroom.

The view from CEOs in the first quarter, prior to the Feb. 27 market slide, was a smidgen more upbeat than in the fourth quarter, based on the Business Roundtable's CEO Economic Outlook Survey. The group's Economic Outlook Index, a composite of CEO expectations for sales, capital spending, and hiring in the coming six months, rose three points, to 84.9, but this overall assessment remained at a relatively subdued level compared with 2005 and early 2006 (chart, page 31). Managers were looking for steady growth in coming months, with no big speedup or slowdown from current conditions, but ifs easy to see how recent events may have nudged expectations down a notch.

MORE THAN LIKELY, THOUGH, the current weakness in capital spending does not signal any great or lasting pullback. Regional surveys of capital spending plans by several district Federal Reserve banks suggest the lull is temporary. Economists at jPMorgan Chase have compiled these plans into an index that tracks equipment outlays fairly well, and the measure suggests capital spending will grow at a steady pace in coming months.

The softness in business outlays has coincided with the weakness in manufacturing, which is largely the result of efforts by businesses to reduce top-heavy inventories. Consider that manufacturers account for about one-fifth of all outlays for equipment. With output and rates of capacity utilization declining, many factories have temporarily shelved their expansion plans.

However, recent signs suggest the inventory adjustment, while not yet complete, is well advanced. In January manufacturing inventories fell for the first time in almost a year, and in February the Institute for Supply Management's factory activity index strengthened notably on gains in new orders and production (chart).

Moreover, when companies are ready to expand, financing shouldn't be an issue. With almost all of the S&P 500 companies having reported for the fourth quarter, earnings are up 11.7% from a year earlier, according to Thomson Financial. And excluding the big drop in the energy sector, they're up 15.9%. In the coming year, profits are bound to slow, but a high single-digit pace is hardly weak. Margins, while topping out, are still at a historically high level.

With central bank policies in the U.S. and around the world not overly tight compared with the restrictive financial conditions that often have preceded past recessions, the danger of a generalized credit crunch is small, at least for now. As long as credit is flowing, jobs and incomes are rising, and profits are growing, it's way too early to start talking about that R-word. •

HOUSING

Builders Bite the Bullet

INVESTORS GOT nervous after the big fall in January sales of new homes. But it's unlikely that the housing recession has suddenly deepened. Rather, homebuilders have set themselves up finally to reduce their inventories of unsold homes.

The month's 16.6% plunge in home sales sent share prices of homebuilders reeling on fears that demand may have dropped another peg. U.S. economist Michael Moran of Daiwa Securities believes, however, that the "lion's share of the adjustment in housing construction is behind us." Moran points to the average gap between housing starts and new single-family home sales in the three months through January, which sank to a 25-year low of 179,333 on an annualized basis. Historically, housing starts outpace sales by about 400,000 per year. The perennial difference is due to individuals who hire a builder to construct their homes. These are captured in the housing starts data but not home sales figures since the units never hit the market.

While sales have certainly slowed, the narrowing between starts and sales is largely the result of an abrupt pullback in new construction. Starts were off nearly 40% from a year ago in January, while sales were down 20% over the same period.

The adjustment in construction, especially relative to sales, will "lead to a drop in housing completions and a trimming of inventories," says Moran. Averaging the positive effects of mild weather on November and December housing statistics with the negative impact evident in January and (most likely) February, Moran sees sales hovering around an annual rate of 1 million homes. That would bring inventory levels back to a more comfortable level by early next year.

Clearly, risks remain. Government data don't put canceled purchases of new homes back into inventory figures. Tighter lending standards by banks could also reduce the number of potential buyers. Those factors would prolong the inventory adjustment. But otherwise it appears that the big economic drag from residential construction is set to ease. II

-By James Mehring in New York

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