

Media Room: Economy in free fall in fourth quarter

Article by Rex Nutting; 'MarketWatch'

Worst quarter since early 1980's, and more to come

WASHINGTON (MarketWatch) -- The U.S. economy contracted violently in the fourth quarter, with gross domestic product falling at its fastest pace in more than 25 years, economists said ahead of what promises to be a grim week of economic news.

"Real economic activity fell off a cliff during the fourth quarter, producing a sharp drop in employment, output and spending," wrote economists at Wachovia.

And the worst part is that it's not over. Economists expect another huge decline in the first quarter, with a smaller contraction in the second quarter.

GDP is expected to have fallen at a 5.5% annualized rate in the final three months of last year, according to the median forecast of economists surveyed by MarketWatch. That would be the biggest decline since the 6.4% drop in early 1982 and one of the worst quarters in the post-World War II era.

The government will release its first estimate of fourth-quarter GDP on Friday, the culmination of a very busy week on the economic calendar. See Economic Calendar.

Other major releases will include durable-goods orders for December, home sales for December, and consumer confidence surveys for January.

In addition, economists will be watching the weekly jobless claims data for more clues about the health of the labor market. We could see first-time claims breach the 600,000 mark for the first time since the early 1980s.

None of the news in the coming week is expected to be positive.

The bad GDP story

Almost everything that could have gone wrong did after the credit crisis worsened in September.

More than 1.5 million jobs were destroyed in the quarter. Consumer spending fell again. Businesses put investment plans on hold. Home builders threw in the towel. Export markets dried up.

The only bright spot was the collapse in prices for oil and other commodities, a sudden reversal caused directly by the global slump. This has boosted consumers' spending power, but has also slammed corporate profits.

"The weakness was very widespread, with every type of final expenditure falling," wrote economist Michael Feroli of J.P. Morgan, who expects final sales to fall 5.9% annualized, which would be the third worst quarter since 1949.

According to Feroli's estimates, consumer spending likely declined at a 3.6% annual pace, about the same as the 3.8% drop in the third quarter. Business investment probably declined at a 20% pace, while residential investment plunged at a 30% pace, the worst yet in this episode. He expects non-residential construction to fall 2%, the first decline in about three years, with bigger drops to come. And net exports are expected to fall, a big turnaround from earlier in the year when exports kept the economy above water.

The only positive contributors to GDP are expected to be government spending and inventories.

Government spending is expected to surge in the coming quarters given the huge fiscal stimulus being promised by the Obama administration and Congress.

On the other hand, inventories are expected to be a drag on growth going forward. Companies have kept their inventories lean, but not lean enough.

"Given the rate at which sales are falling, that means that the inventory-to-sales ratio is rising sharply, and production will have to fall further in the first quarter to work off the excess supplies," wrote Brian Bethune and Nigel Gault, economists for IHS Global Insight.

Every other time in the modern era that the U.S. economy has contracted more than 5% in a quarter, falling inventories have been a major reason, if not the single biggest factor. Usually, really bad recessions are worsened by the need for companies to get rid of all the stuff they made but nobody bought. Once the inventories are sold off, the economy can grow quickly again because idled workers are called back.

But so far in this recession, the inventory cycle hasn't been a major factor, outside of the housing and auto sectors. That means that we can't look forward to a quick reacceleration as the inventory cycle turns. This recession is rooted in a severe credit squeeze and a fundamental readjustment in consumer demand, not in the typical inventory cycle.

Policy to the rescue?

Most economists are cautiously optimistic about a modest recovery later this year. The turn in the inventory cycle is one reason, but a bigger cause for hope is the massive amount of work by the Federal Reserve and the government.

"Despite the current and expected near-term weakness, we caution against simply extrapolating. While momentum is currently downward, policy action has been stepped up dramatically, with more measures likely," wrote Maury Harris and Jim O'Sullivan, economists for UBS, who were among the few economists who saw this coming.

The Federal Open Market Committee meets Tuesday and Wednesday to consider the impact of what they've done and what they'll try next. Interest-rates are as low as they can go, so the FOMC will put its full attention on the non-traditional measures it's employed to thaw out the credit markets.

The conventional wisdom is that nothing has worked, but that's not really accurate. First off, governments in the developed world have made it clear that they won't allow the financial system to fail, which has lessened the fear of a systemic collapse. If what they've tried so far doesn't work, there are other things that can be done, including nationalization of the banks as a last resort.

There are signs of improvement already, especially in the short-term funding markets, where the Fed has concentrated its efforts lately. Credit spreads between government debt and the London interbank offered rate, commercial paper and mortgages are falling, although they certainly aren't back to normal levels.

Yes, the days are cold and dark, but spring will come. It always does.
