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January 2010

Special Foodservice Economic Viewpoint

“The stream of increasingly positive news can explain why managers at many American firms are optimistic about growth in 2010. Nevertheless, a tough road lies ahead.”

The Outlook for 2010

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Overview

Aggressive government intervention since 2008 bolstered the global economy, and significantly reduced depression fears from the market. As a result, economic output turned up in 3Q 2009 and stock indices have rallied as much as 70 percent since bottoming out at the height of the financial crisis.¹

The stream of increasingly positive news can explain why managers at many American firms are optimistic about growth in 2010. Nevertheless, a tough road lies ahead. Although emerging economies such as Brasil, China, India, and Indonesia will support the global economy with an average of 7 percent growth in the coming year, **we expect only modest 2 to 3 percent growth in the United States and other developed economies over this period.** These tepid numbers fall below post-recession growth rates that we typically observe in the United States **and should persist until consumers deleverage and accumulate a sufficient savings buffer.**

In this broad overview, we examine the perspective of firms, consumers and government entities and how it will impact the U.S. foodservice market.

Firm Outlook: Feeling More Optimistic

Economies can either grow through the private investment of firms, consumer spending growth, exports, and/or government expenditure. Although actual firm investment was down 20 percent in 3Q 2009 from a year before, 54 percent of recently surveyed American managers expect at least some increase in productivity this year due to an upturn in the inventory replenishment cycle. Further, strong corporate balance sheets, lower input prices, and costs of capital suggest that firms are well-positioned to meet demand. In our view, **corporate health represents a bright spot in the economy** because lasting stagnation will ultimately force more innovation on the market. But this transition will take time: the majority of firms surveyed indicate plans to re-hire, albeit very slowly, in the next 12 to 18 months.

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¹ MSCI World Index, December 2009

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The Consumer Situation: Deleveraging Continues

Firm investment will undoubtedly contribute to a long-term economic recovery, however virtually every economic recovery since World War II has relied on consumer spending in the American market. Unfortunately, household balance sheets look considerably worse than corporations as individuals continue to face highly competitive labor markets, wage freezes, slashed benefits, underwater mortgages and personal debt in 2010. **These factors will push low-income households toward default, while middle- to high-income households will maintain conservative spending postures for at least another 18 to 24 months.**²

Employment Confidence Up, but Job Mobility Isn't. As we anticipated last year, unemployment continues to lag behind output and will remain close to 10 percent in 2010.³ Although consumer confidence in own job stability rose significantly since last year, this optimism has not yet translated into increased willingness to spend. Those individuals who report a need to cut back or postpone major purchases (37 percent) have not improved since last year.⁴ Much of this is likely due to the lowest job mobility figures in a decade and an “underemployment” rate that approaches a staggering 22 percent.⁵ Finally, as unemployment falls in 2011, policy makers will need to take a look at the trend of people who permanently migrate to disability rolls after long spells of unemployment. Although the Census Bureau will provide a much-needed 1.2 million job boost in mid-2010, given even the most optimistic job growth scenarios, **it is hard to anticipate anything less than a sobering 7 to 8 percent unemployment rate for the next decade.**

Consumer Debt is a Major Anchor. Consumer spending typically bounces back from recessions quickly when employment stabilizes. However, the balance sheets of American households are in poor shape, with consumer debt reaching 96 percent of GDP in 2008. Consumer debt grew nearly six-fold between 1980 and 2009. Recent surveys suggest that the average, American household currently carries \$5,100 in credit card debt on average that some estimate may take as long as 4 years to pay down. Reported year-over-year growth in disposable personal income (DPI) is entirely attributable to tax cuts/government transfers while growing household savings rates (5 percent) are due to precautionary savings by the rich. **As middle-class households deleverage and are forced to save more, we anticipate that savings rates will revert to historical norms of 7 to 9 percent over the next 2 to 3 years.**

Housing Prices. Economists appear somewhat mixed about housing price trends. Although price-to-rent ratios and home inventories are falling, they nevertheless continue to gravitate above historical values.⁶ Furthermore, recent government interventions in the form of new home buyer tax credits, nationalization of Fannie Mae and Freddie Mac, and massive Federal Reserve purchases of mortgage-backed securities (MBS) continue to prop up a substantial segment of the market. Although tax credits have been extended and expanded into 2010, subsidies of this type are not fiscally sustainable in the long-run **and could produce as much as a 10 percent reduction in real prices when they are removed.** Credit in the form of home equity will be non-existent for the foreseeable future.

² Haver Analytics

³ Wall Street Journal Economic Forecasting Survey, December, 2009.

⁴ University of Michigan

⁵ Bureau of Labor Statistics (U6 + est. workforce dropouts)

⁶ Case-Shiller Index, Census & National Association of Realtors

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Changing Preferences. Limited budgets and economic stress have also promoted a significant change in consumer culture since 2007. Holiday sales increased unevenly in 2009, despite extended promotions and discount periods. Bulk and discount-oriented outlets such as Costco, Sam's, TJ Maxx and Ross saw 10 percent increases in sales while traditional retailers stayed flat. In foodservice, we are seeing decreases in both traffic and, more significantly, check average. This is also consistent with trends toward substituting entertainment expenditures with inexpensive experiences (e.g., museum/park visits, personal hobbies and recreation, socializing/volunteering).⁷ These attitudes will persist into 2010, suggesting that firms will continue to rely on promotions-oriented strategies and creating truly differentiable experiences in order to drive traffic.

Government continues to keep the economy on life support

If the outlook for the American consumer is poor in 2010, then who (or what) can take its place? Many look to demand from emerging markets such as Brasil, China, and India to fill the gap. Although these economies will continue to play an increasingly important role in the economic world order, emerging markets would have to double their already torrid pace of growth to account for consumption lost from the American economy.

The U.S. economy remains in a precarious state and will continue to rely on government spending to bridge the demand gap in 2010. Although deficit management is a long-term concern, expansive government policies will need to remain in place until 2012. In the final section of this outlook, we discuss the significant impact that government policy will have on economic growth for the next 18 to 36 months.

Monetary Policy, Inflation, and Interest Rates. The aggressive monetary interventions of the Federal Reserve in the wake of the financial crisis propped up the global economy but also introduced fears of long-term inflation. However, weak demand and spare capacity in the United States will keep the focus squarely on fighting deflationary pressures in 2010. In deference to long-term concerns, purchases of mortgage-backed securities and long-dated Treasuries are being dialed back this year. In re-nominating Chairman Bernanke to a second term, the administration appears to endorse a continuation of a 2-3 percent inflation growth target.⁸ However, current resistance to his reappointment in the Senate introduces uncertainty in the form of a new, potentially more aggressive inflation management scheme. Stay tuned.

Fiscal Stimulus. The government will continue to play a heavy role in propping up the economy through 2011 as the original stimulus package (American Recovery and Reinvestment Act) is estimated to pump twice the dollars into the economy (\$400 to \$500 billion) in 2010 as it did in 2009. Although longer planning horizons allow for more efficient allocation and distribution of 2010 funds, the investment return of these, and proposed supplemental expenditures is a serious long-term concern. For example, the \$175 billion "jobs bill" recently passed by the House to supplement the stimulus allocates \$50-\$60 billion in new investment projects while the remainder merely extends unemployment benefits, health care (COBRA) provisions, and subsidies for children and the poor.

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⁷ Department of Labor Time Use Survey, December 2009.

⁸ FOMC Meeting Minutes, January 2009.



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Health Care Policy. Congressional leaders continue to reconcile the relatively liberal House version of the health care bill with the more conservative version approved in the Senate. Although we expect Democrats to pass some version of health care before mid-term elections, recent shifts in the political winds currently point to a scaled-back plan that lacks controversial provisions such as coverage for pre-existing conditions. Initial health care proposals were greeted by the corporate sector with skepticism and uncertainty. Perhaps an incremental approach will allay some of these fears and make several elements of legislation less susceptible to politically-motivated concerns. Again, stay tuned.

Finance Sector Reform. Although bank bailouts (TARP) and the subsequent “stress tests” were important to stabilizing the economy, real financial sector reform remains elusive. Current proposals to prohibit specific investment activities and limit executive compensation are arbitrary, untenable, and full of political frictions. One important policy note is that the financial reforms being proposed don’t really address any of the fundamental issues of systemic risk in the economy. So from the point of view of a foodservice decision-maker, one still needs to keep a bit of an eye on the health of the financial sector in order to make sure that other potential hazards aren’t forming in the economy.

Other Considerations

Dollar Strength and Input Prices. Dollar strength and input prices are much like asset prices: tricky to predict at best. As risk appetites increase and markets are saturated with U.S. Treasuries, there is some sense that the dollar will continue to fall. A weak dollar means more competitive imports but potentially more expensive input prices. From a demand-side perspective, consensus forecasts suggest that stagnant growth in developed markets will leave prices of critical inputs flat for the coming year.⁹ Assuming no supply-side shocks (hurricanes, political upheaval), we tentatively believe that limited demand pressures should outweigh dollar weakness. In the medium term, firms will need to keep note of the resource-intensive infrastructure plans driving stimulus activities in emerging markets. These activities could increase global input prices before the developed economies turn around.

Conclusions

The coming year brings welcome stabilization after a significant downturn. Although the economy will benefit from strong firms, inventory replenishment, and recovering asset markets, households are in the midst of a deleveraging period which could last for the first half of this decade. Unemployment will begin to fall this year, but the pace of job growth will remain sluggish in the foreseeable future.

Fortunately for foodservice providers, input prices (labor, food stuffs) should remain in check, but concerns about the long-term effects of government intervention will need to be addressed between 2011 and 2013. Whether the government will be able to manage the delicate switch from expansionary policy to relative austerity in the midst of significant demographic change remains to be seen.

⁹ We should note that consensus forecasts of commodity prices are somewhat less reliable than other forecasts such as growth and unemployment.