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Providing periodic insights to food suppliers and operators

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SPECIAL MACROECONOMIC OUTLOOK

Understanding the Consumer, the Economy and Policy During Unprecedented Times

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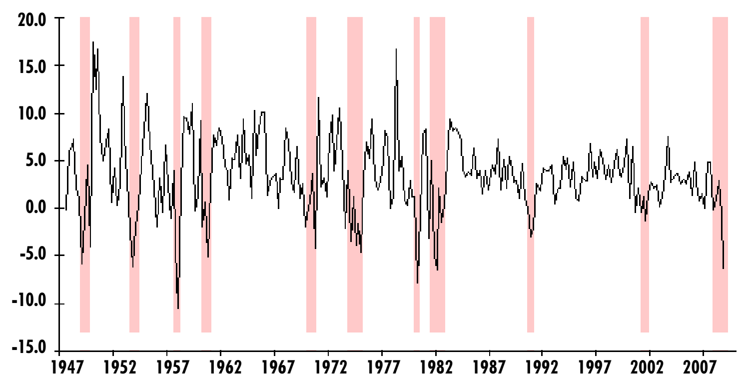
I. INTRODUCTION

As little as eight months ago, consumers were concerned about creeping inflation and the ever-rising cost of energy and basic commodities. How quickly times change: stresses in the financial sector have dropped aggregate consumer demand to its lowest levels since the end of World War II. Losses in employment, home prices and equity investments have left even those who historically spent within their means with the fear that a lifetime of prudent behavior may have been for naught. Finally, market volatility continues to keep well-capitalized firms and consumers from safely deploying their resources in the market. With GDP growth falling off at roughly a 6 percent annualized rate, we are undoubtedly in the midst of a recession (See Figure 1) that is far worse than what we experienced in 1981-1982.

Figure 1. Quarterly Growth in Real GDP at Annual Rates, Percent



Note: Shaded areas indicate recessions.

So where do we go from here? In our multi-part series on the state of the economy and its effect on the foodservice industry, we will develop an analysis that will **help foodservice decision-makers assess whether we can expect a return to the recent status quo or whether the time has come to adjust to a fundamental long-term shift in the American economy.** To understand the true gravity of the current situation, we need to put this recession in the context

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of those since the end of World War II. We focus on this issue in this first paper of our series. This will set the groundwork for deeper analysis that will assess:

- The state of consumer finances and sentiment.
- The effectiveness of proposed policy efforts to revive and reform the financial system and to stimulate long-term growth.

II. THE CURRENT ECONOMY IN THE CONTEXT OF PAST DOWNTURNS

Depression-like economic indicators. With an economy that is highly dependent on sustained American consumption, it is not surprising that a downturn in the United States is having a tremendously negative effect across the world. High-level aggregate measures of industrial output, global equities, and changes in global trade indicate that the current downturn is tracking like a "Depression-level" event in both depth and scope.

Dismal employment outlook. Current domestic employment figures tell an equally unsettling story. Job losses in the current recession now track even beyond losses incurred during the 1981–1982 down turn, regarded as the worst since World War II (See Table 1)[1]. Furthermore, two factors associated with today's recession are particularly troublesome to companies like restaurants that depend on capturing disposable consumer income. First, in recent times, unemployment has been peaking farther and farther past the end of prior recessions (See Figure 2, recessionary periods shaded).

Next, the economy has taken increasingly longer to return to pre-recession levels of employment (See Figure 3). If this represents a long-term shift in employment trends (which even the Obama Administration acknowledges), **we will not reach peak unemployment until mid-2010.** This will put significant strain on the foodservice industry, since disposable personal income is so highly correlated with employment.

Table 1. Major Recessions since World War II

Recession	Peak Unemployment (%)	Unemployment (% Change)	Length (Mo.)
1957-1958	7.3	3.4	14
1974-1975	8.8	3.3	9
1981-1982	10.8	3.6	17
2007-April 09	8.5	3.4	15
2007-2010 (CEA Est.)	8.8	4.1	36

Note: Changes to disability laws since the 1980s have prompted many individuals to take disability rather than shift into unemployment. When accounting for this, current unemployment levels match those since 1981-1982.

Low quit rates equal long job recovery. Taking the job loss and job recovery trends together suggests a bleak scenario in which employment levels will take another 30 to 40 months to reach pre-recession levels. Other indicators also indicate a Depression-level event: Quit levels in firms across all sectors of economy have dropped to zero percent, a level far lower than any seen during the 2001 recession.

[1] *We should note that for all intents and purposes, the recession during this period took place between 1980 and 1984, with a short period of growth in 1983.*

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A recent Manpower hiring survey further suggests that between 60 and 80 percent of firms will not make hires this year while those which do will be roughly offset by those planning layoffs. Given that managers are not very likely to report prospective layoffs, job loss will continue to outpace hires through the end of 2009. We also note that the job loss trend over time will be large, long and gradual rather than sharply-peaked. In this setting, individuals will find it difficult to anticipate the end even when it happens, further prolonging a risk-averse consumption mindset. This means that foodservice consumers will be reluctant to indulge and will continue to seek out value-oriented menu items and venues.

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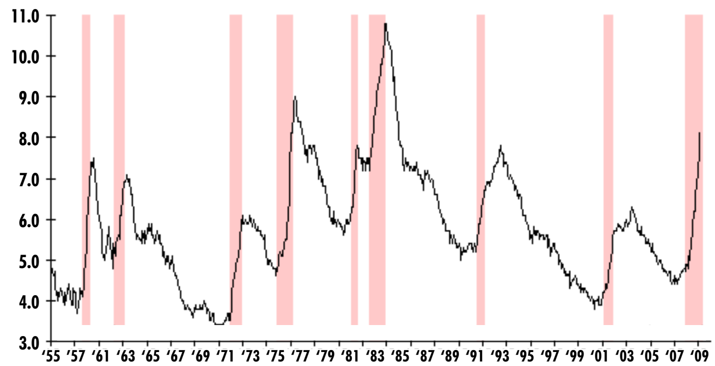
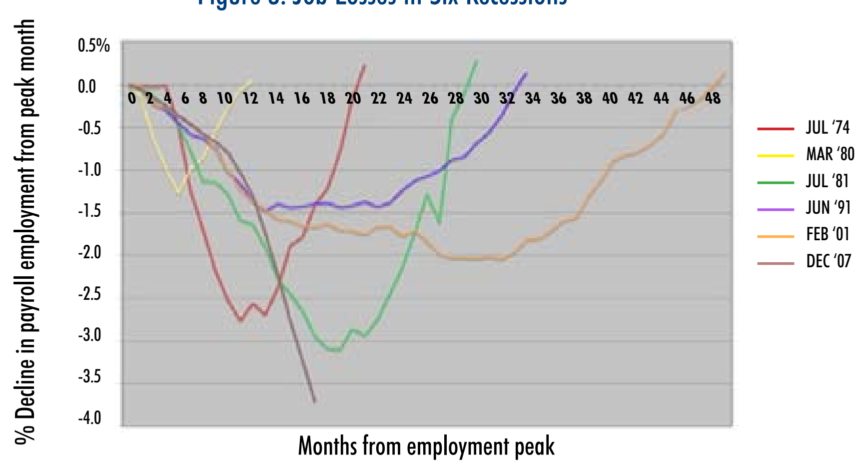
Figure 2. Unemployment Rate, Civilian Labor Force: SA



Note: "SA" refers to seasonally-adjusted figures.

Figure 3. Job Losses in Six Recessions



Source: Bureau of Labor Statistics; compiled by Justin Fox.

Underemployment may produce structural change. Unemployment statistics also mask a pernicious problem that is very difficult to quantify: underemployment. Higher-skilled, higher-paid workers who get laid off remain unemployed or shift into part-time temporary labor for longer periods than less-skilled workers.[2] According to an April 3 report from the Labor Department, the unemployment rate including involuntary part-time workers and those who have not looked for work in at least 12 months is at 15.6 percent, the highest proportion ever recorded since records were first collected in 1994.

2 *Research on job searches for higher income workers shows that while workers are sometimes willing to trade down, employers are actually reluctant to hire them because of the expectation that they will quit faster than a lower-skilled worker.*

Time will tell exactly how many individuals will fall into this category, but the pattern is well-known: individuals will eventually settle for wages at rates that are considerably less than what they were being paid in previous jobs. Further, those who experience these types of downward shifts usually do not return to the higher income strata after a recovery. As a result, **foodservice must closely monitor the number of these types of individuals and can expect the following changes to consumer behavior**:

1. **Downgrades.** Consumption of major luxuries associated with large expenditures (e.g., vacations) will be sharply curtailed. To the extent this increases the amount of disposable income, this trend could paradoxically benefit foodservice.

2. **Maintenance of previous social status in day-to-day life.** Consumers will try to maintain the quality of previous experiences, but will cut back on foodservice occasions.

3. **Changing ordering patterns.** In an attempt to economize, foodservice consumers will increasingly choose less expensive entrees, reduce orders of appetizers, desserts and alcoholic beverages, and share portions.

III. SOME FACTORS POTENTIALLY POINT TO A WAY OUT

No return to the Great Depression. Although these numbers currently trend in line with the Great Depression, several factors assure that the suffering will not be as dramatic in scope. Economies can recover faster today than in years past because of significant managerial, technological, and financial innovation. Most importantly, the vast majority of people in the United States are doing “ok.” They are still employed, keeping up with their bills, and will most likely remain employed.[3]

The problem, of course, is that no person can perfectly predict whether they will be among the one in ten across society who will actually lose their job. This uncertainty produces a widespread rollback in spending that will only subside when employment seems relatively assured. Meanwhile, other key consumers in the economy may be adjusting their spending to losses in paper wealth (e.g., home values, retirement), even though they do not intend to sell their home or draw on retirement for many years. In both scenarios, consumers who can spend are staying on the sidelines and represent the real source of the drop-off in consumer demand that is affecting foodservice and virtually all other industries.

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Improved economic management. Another reason why this downturn will not reach Depression-era levels is because policy makers have learned how to avoid many of the consequences of the Great Depression when addressing current crises. For example, agencies such as the Federal Reserve have learned how to better manage inflation volatility which in the past added uncertainty and transaction costs to consumers and managers’ decisions. They have also developed tools to boost liquidity and access to credit while at the same time using government spending to replace lost consumption in the private market. If handled properly, these approaches can help to jumpstart a stalled economy.

[3] *Consumers did fall behind on car, credit-card and home-equity loans at the highest level in 15 years during the fourth quarter, according to an American Bankers Association survey. Although the absolute numbers are still relatively low, we will continue to follow this trend in future reports.*

IV. THE *RIGHT* WAY FORWARD

A long hangover. Our main premise is that players in the economy will need time to respond to major structural shifts. Poorly monitored activities in the banking sector in the early- to mid-2000s pushed housing price growth well past 1 to 2 percent historical averages. The supply dynamics of the housing market virtually assure that growth rates above this level are unsustainable in the long-run. In fact, previous busts suggest that housing prices will continue to decline in real terms for as long as a decade.

This means that the days of easy credit are over and those who racked up debt will need time to pay it off the old fashioned way. In the absence of additional spending vehicles, savings rates will also likely rise among these households because they will require a security cushion after the debts have been paid down. In short, consumers are paying now for a period of heavy consumption in the past. Foodservice will feel the consequences of this correction for the foreseeable future.

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Asset market growth is key. The economy cannot make a recovery until those with the means to spend actually choose to start spending. Individuals who currently have stable incomes need to see a stable resurgence of the asset markets. As their net worth improves, these consumers will spend more and stimulate aggregate output. As output grows, layoff threats will subside and employers will slowly start to rehire. When spending by higher-income individuals restarts the economy, the foodservice segment will be among the first to experience those benefits. For the large group of lower-income workers, however, the long-term outlook looks dire.

V. THE REALITIES

The banking system is being stabilized... In the previous section we placed a great deal of faith in the capabilities of policy-makers to choose the right set of interventions to prompt a turnaround. In our view, stabilization of the banking system is required to revive asset markets. Up to this point, the Treasury and the Fed have done a good job working in concert to keep deflationary pressures in check by providing enough liquidity to the financial markets to stave off Depression-like deflation for the moment. To this point, major indicators of trading uncertainty and banks' ability to lend the have started to show signs of stability after reaching alarming levels in late 2008. Although the Fed could overshoot and produce 7 to 8 percent inflation when the economy takes an upturn, their long-term inflation appear to be very conservative today. Equities growth could also help to hedge inflation to a degree.

… but stimulus measures will be less effective and carry long-term costs. While we give policymakers passing marks on banking, we take a more critical view of the unprecedented $800 billion stimulus package passed in an effort to bolster the economy and employment. Congressional Budget Office estimates suggest that the stimulus will increase its baseline GDP forecast between 1.4 and 3.8 percent by the fourth quarter of 2009 and between 1.1 and 3.4 percent by the fourth quarter of 2010. We view this forecast as mildly optimistic.

Three factors drive our view: first, while programs to assist the unemployed and poor will be very helpful, the great uncertainties that consumers face in this recession mean that they are more likely to **pocket a tax cut rather than spend it immediately**. Next, **a significant portion of money allocated to state and local governments will be used to pay past-due bills rather than stimulate growth**. Finally, and perhaps most worrisome, **the fiscal stimulus will produce uncertainties and distortions to long-term economic growth that are very difficult to undo**. Impractical time-limits on when states and local governments must allocate funds leaves little room for forward thinking and more room for politically-driven uses for expenditures (bridges to nowhere, etc.).

Given the existing levels of U.S. debt, the effects of the fiscal stimulus on the economy may create a fiscal nightmare if sufficient cost-savings and productivity gains are not realized. Such a scenario would involve a flight from the dollar and higher interest rates across the board as foreign investors seek safety in other parts of the world.

VI. THE BOTTOM LINE

Consumers will only begin to relax their spending postures when their jobs feel relatively safe and personal asset values show some sign of recovery.

Overall, while we do not anticipate a significant deepening of economic turmoil, output measures will not stabilize and turn around by the end of this year. Consumers will only begin to relax their spending postures when their jobs feel relatively safe and personal asset values show some sign of recovery**.** We expect job loss to continue through mid-2010 with quit rates remaining low well into 2011 because many people with negative home equity may find it difficult to relocate.

Based on this outlook, we suggest that the foodservice industry climate will remain challenged for the next 12 to 18 months. While conditions are likely to improve from the recent past, **we are unlikely to see any real growth in consumer spending until 2011**, even with a reasonable resurgence in asset markets. This means that industry participants have to be increasingly focused on differentiation, cost savings, productivity enhancement and customer satisfaction.

LEARN MORE

This issue of The Technomic Viewpoint *marks a departure from prior editions and a move to expand our thought-leadership role to the foodservice industry by providing timely and noteworthy macroeconomic insights. In partnership with the author, Arjun Chakravarti, Ph. D of the University of Chicago Booth School of Business, future position papers in this series will delve further into the state of consumer finances and sentiment, the effectiveness of efforts to stimulate growth and revive and reform the financial system, and other vital topics. We believe that sharing these insights is an important facet of fulfilling our commitment to our clients—helping you make smarter decisions regarding the challenges you face, especially during these turbulent economic times.*

If you have questions or comments about the material presented here, or if we can provide further assistance to your organization, please contact Bob Goldin, Executive Vice President, at 312-506-3936 or rgoldin@technomic.com.

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