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US Economics

The Employment Conundrum

What's New: The mix of growth and inflation has again turned less favorable. And the dichotomy between weak output and firm labor markets raises critical questions about the outlook: Will job and income gains sustain consumer outlays? Has potential output growth declined? If so, will it prolong the whiff of stagflation? And will slowing growth and rising unit costs squeeze profit margins?

Conclusions: Consumer retrenchment is unlikely although the housing recession is far from over; strong global growth likely will sustain both output and employment. Amid uncertainty about productivity's trend, we still think inflation has peaked, but inflation risks are rising again. Margin compression implies that profit growth likely will stall in 2007.

Market Implications: This mix likely will reinforce the Fed's conviction that they must wait patiently for inflation to decline. Rising uncertainty about the outlook and reduced forward-looking guidance from the Fed imply that term and other risk premiums will rise further, the yield curve will steepen irregularly, and TIPs may outperform.

Risks: The risks for investors are rising with crosscurrents swirling around the outlook for growth, inflation, profits, and monetary policy. That markets have defied these uncertainties lately does not give us comfort because we see neither a rapid improvement in growth, a quick decline in inflation, nor relief from the Fed.

Recent Reports

Corporate Profits: Downside Risks Richard Berner	April 5, 2007
Perfect Storm for the US Consumer? Richard Berner	April 2, 2007
Oil Price Spike: Sharp but Temporary Richard Berner & Eric Chaney	March 30, 2007

Forecast at a Glance

	2006A	2007E	2008E
Real GDP	3.3%	2.0%	2.9%
Inflation (CPI)	3.2	2.5	1.9
Unit Labor Costs	3.1	3.0	2.7
After-Tax "Economic" Profits	22.5	1.1	5.3
After-Tax "Book" Profits	19.4	1.1	2.6

Source: Morgan Stanley Research
E = Morgan Stanley Research Estimates

The Employment Conundrum

Rising uncertainty has become the defining characteristic of the economic outlook over the past two months. We argued in our forecast update a month ago that uncertainty was rising, but if anything, developments since have widened the confidence band around our baseline prognosis, and the mix of growth and inflation has again turned less favorable (see “Despite Uncertainty, Fed Ease Still Unlikely Until 2008,” *Global Economic Forum*, March 12, 2007).

Once again, we’ve marked down our forecast for growth, reflecting still-higher energy prices, a deeper housing recession, and additional weakness in capital spending. Over the first three quarters of 2007, we now see growth at a 1.8% annual rate compared with 2.6% in our March update; that’s a full percentage point below our prognosis of two months ago. With growth below trend and operating leverage fading, margins are flattening and earnings growth will be weaker. And once again, reflecting higher prices for energy, food, imports, and medical care, we’ve marked up our outlook for headline and to some extent core inflation.

But simply marking down the growth forecast and raising the inflation outlook is the easy part. Although we’ve long expected that job gains will remain firm, the strength of labor markets in the face of a decelerating economy has surprised us. Indeed, the dichotomy between weak output and firm labor markets raises critical questions about the fundamentals in the outlook: Can strong job and income growth continue to sustain consumer outlays? Has the trend in productivity and potential output growth declined? Even if the productivity slowdown is cyclical, will it push up inflation and prolong the whiff of stagflation? And will slowing growth and rising unit costs squeeze profit margins?

We don’t pretend to have all the answers, but here are our guesses: Job gains have already slowed, and payrolls will continue to decelerate, but not fast enough to undermine consumer wherewithal. The housing recession is far from over, but strong global growth likely will sustain both output and employment. The productivity slowdown is cyclical, but the trend may also have slipped. We still think core inflation has peaked, but inflation risks are rising again. And margin compression implies that profits likely will stall in 2007. That combination will likely leave the Fed on hold and steepen the yield curve. Importantly, however, neither those conclusions nor the weaker baseline presented here imply serious trouble for the economy. Details follow.

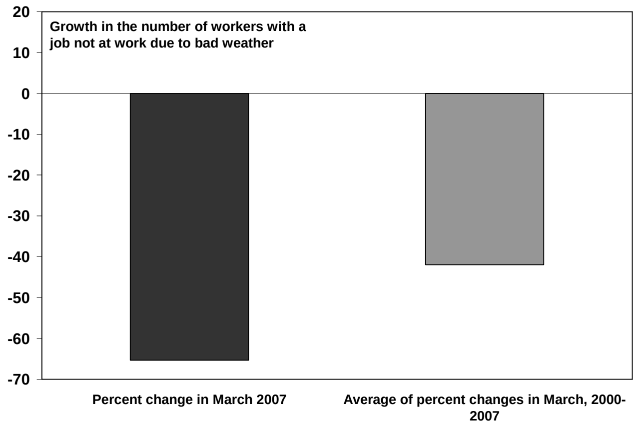
There’s no mistaking the weakness in incoming data and the fundamentals that point to downside risks in three key areas. First, the housing recession continues to deepen. Although housing starts bounced by 9% in February, we think that increase simply represents noise in the data (see “Does Volatility in Housing Data Mark a Turning Point?” *Global Economic Forum*, March 23, 2007). Indeed, we believe that the 10% plunge in new single-family home sales in January-February (although depressed by brutal weather) and a new cycle high for new home inventories point to a tepid spring selling season and aggressive further cuts in supply to realign supply with demand. And the incipient further tightening in mortgage lending standards in the wake of the subprime mortgage meltdown will likely delay until 2008 any meaningful recovery in demand (see “Subprime Will Hurt, But Affordability Is the Key”, *Global Economic Forum*, March 23, 2007). Consequently, we now forecast that the level of housing starts in the summer quarter will be about 5% lower than we expected a month ago — and that was already the second-lowest forecast in the Blue Chip Economic Indicator Survey — and to levels last seen in 1992.

Second, the weakness in capital goods bookings and shipments now points to a second consecutive quarterly contraction in real equipment and software outlays, for the first time in four years. Back then, the bust in telecom equipment and post-9/11 cutbacks in airplanes and rental fleet outlays accounted for much of the downturn. Today’s weakness appears to be more widespread. Deliveries of construction equipment and heavy truck shipments (as new emissions requirements took effect) have plunged — by a stunning 76% and 68% annualized over the three months ended in February, respectively. In addition, CFOs generally appear to be both disciplined and cautious, and still more focused on buying capacity through deals than building it themselves. Also, past investment incentives borrowed from today’s demand (see “The Capex Conundrum,” *Global Economic Forum*, March 9, 2007).

Finally, rising energy prices are again hobbling the consumer. Moreover, higher quotes for food are now adding to the squeeze in discretionary spending power. In fact, we estimate that the latest surge in energy and food prices may drain more than $100 billion (at an annual rate) from consumer purchasing power over the first half of 2007. Inflation-adjusted consumer spending has already slowed and likely will remain sluggish for a while. We estimate that real outlays will rise by just 1.7% annualized in Q2, following an estimated 3.0%

advance in Q1 and the sharp 4.2% jump seen in Q4. Nonetheless, we believe that these pressures will eventually abate and that even a more protracted slowdown does not necessarily mean outright consumer retrenchment (see “Perfect Storm for the US Consumer,” *Global Economic Forum*, April 2, 2007).

Exhibit 1
March's Payroll Pickup Was Weather Related



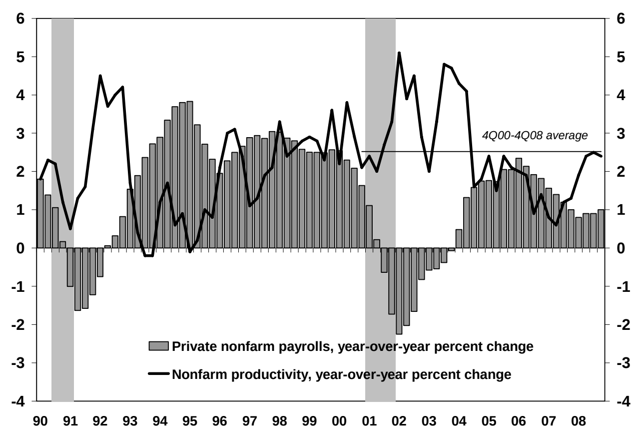
Source: Bureau of Labor Statistics

The key reason: Income gains and the job growth fueling them likely will continue to provide powerful support for the consumer. Indeed, we have long maintained that over time, real income growth will be sufficient for consumers both to defend lifestyles and gradually rebuild saving. While job gains are gradually slowing, this hearty job dynamic is evident in incoming data. Nonfarm payrolls jumped by 180,000 in March, and together with upward revisions to prior months, have averaged 152,000 over the first three months of 2007. That’s 20% slower than last year’s average, but coupled with a firmer workweek and a 3.6% annualized gain in average hourly earnings over the quarter, it is still enough to imply a 5¼% annualized gain in wage and salary income. The jump in energy and food quotes will turn that into a real gain roughly matching the one in outlays.

But — given the yearlong economic slowdown — surely this pace isn’t sustainable. We think that job gains will continue to slow, but despite tepid output gains, not by enough to undermine consumer confidence or wherewithal. Among the reasons: While significant job losses are likely in housing-related industries, the ‘two-tier’ economy, evident in the benefits of strong global growth for exports and output, likely will sustain employment. Job opening rates, which hit a new cycle high of 3.2% in December and sustained that level in January, suggest that companies are still looking to fill the ‘pent-up’ demand resulting from the hiring discipline of the first three years of this expansion. And the tightening of labor markets, evident in the decline in the jobless rate to a new cycle low of 4.4% in March, hints that employers’ anecdotal complaints about the difficulties in finding skilled workers have some validity.

However, the slowing in productivity growth, to 2.1% over 2005 and 1.4% over 2006, raises questions of whether trend productivity and thus potential output are lower than previously thought. As we see it, trend productivity growth is roughly 2½%, which is good news for long-run inflation prospects. Indeed, we think that a below-trend, cyclical productivity undershoot is underway as job growth finally catches up with the economy, and we forecast a return to 2½% productivity growth in 2008.

Exhibit 2
Productivity Undershoot: Cyclical or Secular?



Note: 1Q07-4Q08 values are Morgan Stanley estimates.
Sources: Bureau of Labor Statistics, Morgan Stanley Research

Such a cyclical undershoot is typical, but in this expansion, both the overshoot and undershoot have taken longer to play out. Corporate America’s hiring discipline, aimed at correcting the hiring excesses of the 1990s, yielded a 3.1% average annual gain in productivity in the first three years of this expansion — or 0.6% above the trend. In our view, the current undershoot is showing up in the productivity performance of years 4-6, averaging 1.7% — or about 0.8% below the trend. Shifts in the mix of output and employment may contribute to declining output per hour, if, for example, companies are now hiring less-skilled workers. And the plunge in housing may have trimmed nearly a percentage point from productivity growth over the past year: Although real housing outlays have tumbled by an estimated 16.3% over the past year, builders have cut residential construction payrolls by a mere 3.3%.

Nonetheless, there is also evidence suggesting that the slowing in productivity growth has a significant *secular* or trend element. Business capital spending has been subpar, implying slower growth in the stock of business capital; that may have reduced gains in labor efficiency. Some have found evidence of slower growth of total factor productivity (TFP) in recent years, reflecting less rapid technological advances in both IT and low-tech industries (see "Reassessing Trend Growth: The Role of Total Factor Productivity in the Recent Slowing of Labor Productivity," Macroeconomic Advisers, March 22, 2007). Many have thus revised down their estimates for trend labor productivity growth to 2¼% or a bit less. That's logical, but the cyclical story also makes sense. Perhaps the truth lies in a blend of the two. Perhaps too, annual revisions will show that current data understated growth in output over the past three years.

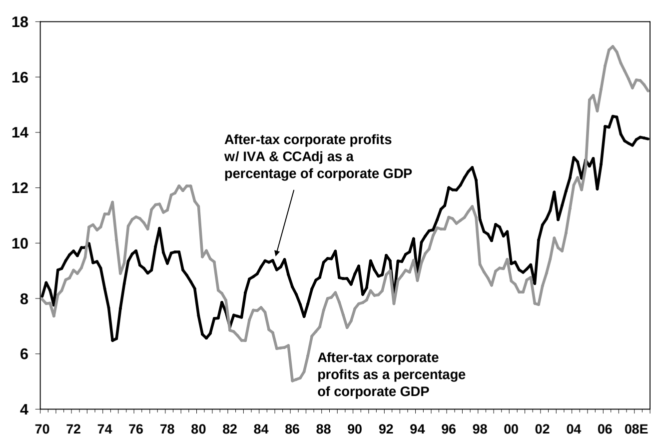
Even if the productivity slowdown is entirely cyclical, it may act temporarily to push up unit costs and inflation. We still think that core inflation has peaked but that the dispersion of inflation risks has risen and declines will come slowly. The housing recession should help. Rents and owners' equivalent rents, which account for 38% of the core CPI, likely will decelerate as would-be home sellers put houses up for rent (decelerating rents will reduce the personal consumption price index (PCEPI) by less since they account for 17% of the core rate). Increased economic slack will also help. We estimate that GDP growth will average just 2.1% over the six quarters ended in the third quarter of 2007, below anyone's estimate of potential growth. Such subpar growth is exactly what the Fed was aiming at to help reduce inflation pressures. "Speed" effects also matter; inflation tends to move in sympathy with the change in operating rates as well as their level. Just as rising operating rates boosted inflation between 2003 and mid 2006, so too will falling operating rates trim it. Still, a looser and less-certain relationship between slack and inflation implies that inflation will recede slowly. And the employment conundrum complicates the analysis; tight labor markets hardly evince growing slack.

Moreover, some factors imply that inflation risks are rising again. The news on longer-term inflation expectations has tuned mixed. The 5-10 year median inflation expectation measure from the University of Michigan's consumer sentiment survey has edged lower, moving to an average 2.9% over the past three months. But distant-forward inflation compensation (5 year, 5 year) has moved up by about 15 bp over the past month, although at 243 bp are well below their mid-2006 peaks of 270 bp.

Increases in prices for imports, medical care, food and energy are also plaguing the near-term inflation outlook. The acceleration in non-auto consumer import prices to a 1.4% rate in February has just started to show up in consumer inflation gauges, especially in prescription drugs and household appliances. The former may simply reflect a rebound from falling drug prices in the first several months of 2006, while the latter seems unsustainable in the face of the housing slump. The 3% February jump in doctors' fees — the biggest one-month gain in the 48-year history of the data — won't be repeated, but alone added 0.1% to core inflation measured by the PCEPI. Overall food prices rose at a 3.1% rate in the year ended in February — and could feed through to inflation expectations. The jump in animal feed quotes has begun to hike beef and poultry prices following flat to declining prices last year. A California freeze also hiked citrus quotes and damaged orchards. But the perceived inflation threat from soaring food prices may be overblown and temporary (see "Yet Another Whiff of Stagflation?" *Global Economic Forum*, March 19, 2007).

Energy quotes have soared this spring, with crude jumping by $8-10/bbl the past two months. At work were OPEC's production cuts, cold winter weather, refinery downtime and rising geopolitical risks. We think that the price spike is transitory, because these factors should fade and the increase in non-OPEC supply will allow prices to drift lower. (see "Oil Price Spike: Sharp But Temporary," *Global Economic Forum*, March 30, 2007). And while it won't cause lasting damage to the economy or inflation expectations, the 55-cent per gallon leap in gasoline prices since mid-January isn't over, and could filter through to higher core readings.

Exhibit 3
Profit Margins: Headed Lower



Note: 1Q07-4Q08 values are Morgan Stanley estimates.
Sources: Bureau of Economic Analysis, Morgan Stanley Research

Will slowing growth and rising unit costs squeeze profit margins? Our long-standing caution on earnings is starting to pay off. Following 18 quarters of double-digit gains, S&P 500 operating earnings rose at an 8.9% annual rate in the fourth quarter, and the bottom-up consensus forecast for Q1 S&P operating earnings has been slashed to just 3.8% — a bar probably set low enough so that results will almost surely beat those reduced expectations. Don't bet on a rapid rebound; even if top-line growth begins to improve later this year, as I expect, I still think that the risks for earnings lie to the downside. Earnings are highly leveraged to growth. Continued sluggish domestic growth likely will promote margin compression as operating leverage fades. Pricing power seems to be cooling as operating rates have leveled off. And credit quality is deteriorating, suggesting pressure on earnings at lenders (see "Corporate Profits: Downside Risks," *Global Economic Forum*, April 5, 2007).

Fed officials adopted language aimed at giving them more monetary policy flexibility at their meeting two weeks ago. The change made sense. Inflation is below its peak, and downside risks to growth have increased. Thus, the Fed's previous warnings of a possible policy tightening appeared inappropriate. Conversely, the Fed made it clear that inflation remains a concern. Balancing those risks, we still think the Fed will remain on hold for the remainder of 2007 as officials patiently wait for inflation to drift lower. The combination of hearty job gains, the decline in the jobless rate to a new cyclical low, uncertainty about the trend in productivity growth and unfavorable inflation readings likely will reinforce the Fed's resolve. However, the easing moves we expect in 2008 will clearly depend on the inflation outlook, not on the calendar.

For market participants, a second Fed change also matters. For the first time in four years, the Fed will henceforth provide less forward-looking guidance about prospective policy moves. The FOMC now agrees that characterizing risks to the outlook is the best way to indicate policy guidance, and that it should use explicit forward-looking language about the policy path only in "unusual circumstances." We think that the combination of rising uncertainty about the outlook — especially for inflation — and reduced forward-looking guidance from the Fed imply that term and other risk premiums will rise further, the yield curve will steepen irregularly and TIPs may outperform.

The risks for investors are rising with crosscurrents swirling around the outlook for growth, inflation, profits and monetary policy. That markets have defied these uncertainties lately does not give us comfort because we see neither a rapid improvement in growth, a quick decline in inflation, or relief from the Fed.

US Economic and Interest Rate Forecast

Real GDP and Related Items, 2006A-2008E — *Forecast Date: April 9, 2007*

	Year over Year			4th Qtr/4th Qtr Percent Change			Percent Change from Prior Quarter*					
	2006A	2007E	2008E	2006A	2007E	2008E	4Q06A	1Q07E	2Q07E	3Q07E	4Q07E	1Q08E
Real GDP	3.3	2.0	2.9	3.1	2.1	3.1	2.5	1.4	1.7	2.3	3.0	3.2
Final Sales+	3.1	2.2	2.9	3.3	2.1	3.1	3.7	1.3	1.6	2.2	3.1	3.2
Personal Consumption Expenditures	3.2	2.8	2.5	3.6	2.5	2.5	4.2	3.0	1.7	2.4	2.9	2.6
Business Fixed Investment	7.2	3.1	6.1	6.1	4.5	5.9	-3.1	-0.6	6.3	6.5	6.1	6.1
-- Structures	9.0	8.1	6.6	11.2	7.7	5.9	0.8	6.9	10.3	6.5	7.3	6.4
-- Equipment	6.5	0.9	5.8	4.0	3.1	5.8	-4.8	-3.7	4.5	6.5	5.5	6.0
Residential Investment	-4.2	-18.3	-3.1	-12.8	-16.6	4.4	-19.8	-19.4	-20.4	-19.6	-6.1	1.7
Exports	8.9	7.4	7.6	9.4	7.3	6.9	10.6	2.9	10.0	9.2	7.4	7.4
Imports	5.8	2.9	3.8	3.3	4.0	4.0	-2.6	5.1	3.4	3.4	4.3	3.3
Federal Government	2.0	2.5	1.2	2.4	2.3	1.0	4.6	5.3	1.1	1.2	1.7	1.5
State & Local Government	2.1	3.2	2.5	2.8	3.3	2.3	2.7	4.6	2.4	2.6	3.7	1.8
Business Indicators++												
Net Exports of Goods & Services	-$618.0	-$576.4	-$545.2				-$582.6	-$596.9	-$580.7	-$566.3	-$561.8	-$552.2
Current Account as a % of GDP	-6.5	-5.7	-5.0				-5.8	-5.8	-5.9	-5.7	-5.5	-5.2
Change in Real Nonfarm Inventories	40.6	25.7	29.1				20.0	25.3	25.5	27.7	24.2	25.9
Housing Starts (Thous)	1,817	1,270	1,280				1,559	1,433	1,225	1,187	1,235	1,236
Light Vehicle Sales (Millions)	16.5	16.3	16.2				16.3	16.6	16.2	16.2	16.2	16.1
Industrial Production (Pct Chg)	4.0	3.1	4.8				-1.2	3.1	4.6	4.5	4.6	4.9
Civilian Unemployment Rate (Percent)	4.6	4.8	5.2				4.5	4.5	4.7	4.9	5.1	5.2
After-Tax "Economic" Profits**	$1,140.7	$1,153.6	$1,214.7				$1,172.2	$1,168.7	$1,143.5	$1,148.2	$1,154.1	$1,187.7
-- Percent Change from Prior Year	22.5	1.1	5.3				21.0	5.1	2.5	-1.2	-1.5	1.6
After-Tax "Book" Profits	$1,336.0	$1,350.0	$1,385.1				$1,361.4	$1,377.5	$1,351.9	$1,342.1	$1,328.6	$1,371.5
-- Percent Change from Prior Year	19.4	1.1	2.6				16.0	7.3	1.2	-1.6	-2.4	-0.4
Real Disposable Personal Income (Pct Chg)	2.6	3.6	5.0				5.3	3.7	1.8	5.2	5.9	5.6
Personal Saving Rate	-1.1	-0.5	2.0				-1.2	-1.0	-1.0	-0.3	0.4	1.2
Prices and Costs (Percent Change)												
GDP Chain Price Index	2.9	2.5	2.0	2.5	2.3	2.0	1.7	3.8	2.7	1.5	1.4	2.5
Consumer Price Index	3.2	2.5	1.9	1.9	2.8	2.0	-2.1	4.1	5.6	1.0	0.7	2.0
CPI ex Food & Energy	2.5	2.5	2.2	2.7	2.4	2.1	1.9	2.6	2.7	2.3	2.2	2.2
PCEPI ex Food & Energy	2.2	2.2	2.0	2.2	2.3	1.9	1.8	2.4	2.5	2.2	2.0	1.9
Market-Based PCEPI ex Food & Energy	1.9	2.0	1.9	1.9	2.1	1.8	1.6	2.3	2.1	2.1	1.9	1.8
Crude Oil Price (WTI, $/bbl)	$66.1	$62.8	$57.1				$60.1	$58.1	$66.8	$64.8	$61.3	$58.7
Producer Price Index	2.9	2.6	0.4	0.3	2.7	1.1	-3.1	7.3	8.0	-2.0	-2.2	0.6
Compensation Per Hour	4.8	4.0	5.1	4.9	4.5	4.9	8.3	1.3	6.7	5.1	5.1	5.0
Productivity	1.6	1.0	2.3	1.5	1.3	2.4	2.0	0.5	0.4	1.8	2.5	2.8
Unit Labor Costs	3.1	3.0	2.7	3.4	3.2	2.4	6.2	0.8	6.2	3.3	2.6	2.2

*Annualized percent change from prior period, unless noted
**Including inventory valuation & capital consumption adjustments
E = Morgan Stanley Research Estimates, A = Actual

+GDP less inventory change
++Billions of dollars; real in billions of chain-type 2000 dollars

Interest Rate Outlook

	Fed Funds		LIBOR	Treasury Yield Curve					
Date*	Target	Prime	3-Mo.	3-Mo.	6-Mo.	2-Yr.	5-Yr.	10-Yr.	30-Yr.
April 09, 2007	5.25	8.25	5.35	5.02	5.09	4.73	4.66	4.75	4.92
07Q2	5.25	8.25	5.35	5.05	5.08	4.70	4.65	4.75	4.93
07Q3	5.25	8.25	5.35	5.10	5.10	4.80	4.78	4.90	5.06
07Q4	5.25	8.25	5.33	5.08	5.09	4.75	4.77	4.90	5.06
08Q1	5.00	8.00	5.20	4.95	4.90	4.65	4.71	4.80	4.95
08Q2	5.00	8.00	5.15	4.90	4.85	4.60	4.66	4.75	4.93
08Q3	4.75	7.75	5.00	4.75	4.68	4.50	4.61	4.75	4.93
08Q4	4.75	7.75	4.95	4.70	4.65	4.50	4.61	4.75	4.93

*All forecast values are for the end of the designated period.

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