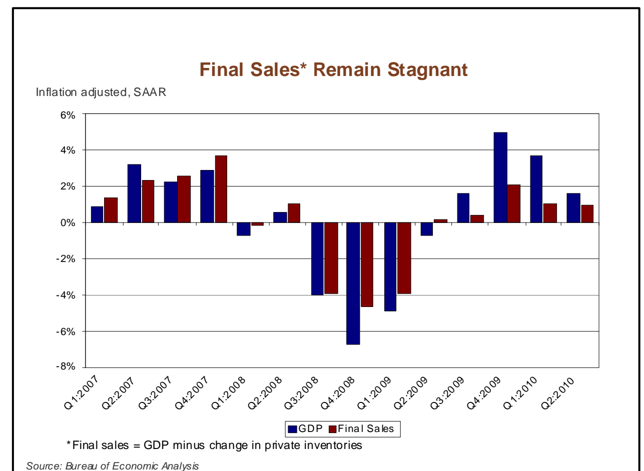
The Economy Maintains a Sluggish Growth Path

We have consistently referred to the current economic recovery, which we believe to have begun in the second quarter of 2009, as “modest.” It appears now that the modest recovery has turned into an “extremely modest” recovery, a term recently used by Federal Reserve Bank of Chicago President Charles Evans. Sluggish consumer spending in the spring and the emerging European sovereign debt crisis have cast doubt on the durability of the U.S. economic recovery, causing businesses to slow their pace of hiring. Recent economic data have softened substantially and much previously released data were revised substantially lower. Real (inflation-adjusted) gross domestic product (GDP) growth in the second quarter was revised downwardly to an annualized pace of 1.6 percent from an initial projection of 2.4 percent. This was a marked slowdown from the 3.7 percent pace of the first quarter and 5.0 percent pace of the fourth quarter of last year.

The downward revisions were primarily the result of an upward revision to imports and downward revisions to inventory investment and exports. While there were upward revisions to consumer spending and business investment in equipment and software, they were too modest to counteract the negative revisions. On net, growth in final sales, measured as real GDP minus changes in inventories (and the key to a self-sustaining economic recovery) was revised lower from 1.3 percent at an annualized pace to just 1.0 percent, virtually unchanged from the prior quarter.



The barrage of weak incoming data and mark-downs of previously released economic data prompted us to further downgrade the outlook for economic growth in the second half of the year to less than 2.0 percent, versus 2.5 percent in the August forecast. For all of 2010, we expect growth to come in at 2.2 percent, before gradually strengthening just modestly during the course of next year to 2.5 percent in 2011.

The deteriorating economic outlook gives credence to concerns of a double-dip recession, although the better-than-expected employment report for August has assuaged such concerns in the near term. Clearly, the recovery is losing momentum. By nature, economic recoveries are uneven at times and a temporary loss of momentum is not uncommon. It is very rare that an economy coming out of recession would slip into another downturn after one year. The only time that has happened since the end of World War II was in July 1981, when the economy slipped back into recession following a recovery that started in July 1980. We believe that, despite the sharply slower growth in the second quarter, the odds still favor a continuing, albeit anemic, recovery. However, the odds of a double-dip recession have elevated, as economic growth is so weak that it is vulnerable to any large shock to the economy, especially with monetary and fiscal policy options very limited at this point.

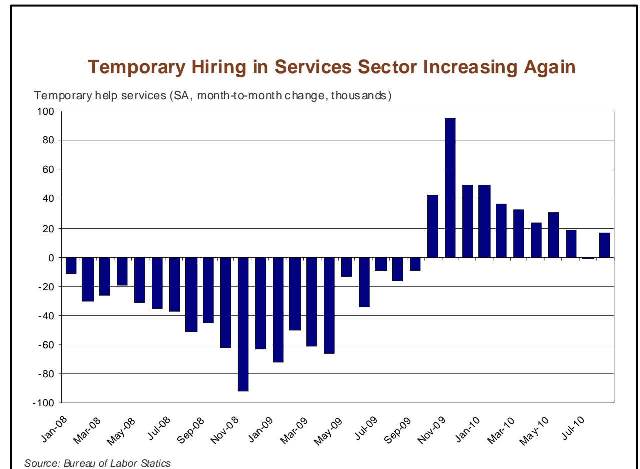
The labor market beats grim expectations

In the July forecast, we lowered our growth projection for the second half of 2010 as it became more evident that the labor market had started to lose momentum. Data that have come in since then have confirmed expectations that the labor market is slowing rather than gaining pace. To be sure, the August labor report turned out to be better than feared—the fear that gripped the financial markets following the jump in initial jobless claims in mid-August to more than 500,000 and a report from ADP, a private firm that surveys private payrolls, showing private sector job losses.

Total nonfarm payrolls fell 54,000 in August following the same drop in July and marking the third consecutive monthly decline, driven by layoffs of Census workers. There were still more than 80,000 Census workers left at the end of August and they will likely be laid off in September, which would result in a decline in total nonfarm payrolls in the third quarter after two positive quarters of gains. Private payrolls rose 67,000 following a rare upward revision of previous employment data showing a gain of 107,000 in July. Viewed in isolation, average monthly job gains of this size—100,000 or less per month—is not something to cheer about, as it is generally too small to absorb the increased number of people joining the labor force. But given the dismal performance of the past several months, this report, along with its upward revision, was a welcome, rare upside surprise.

The average workweek was unchanged at 34.2 hours. It is one of the leading indicators of hiring as businesses generally increase hours of existing workers before they consistently add to payrolls. The workweek has been little changed since April, suggesting that robust hiring is unlikely in the near term. The report offers positive news on earnings: average hourly earnings increased 0.3 percent, which bodes well for August personal income. Another encouraging piece of news was that temporary help services employment, another leading indicator of the labor market, resumed its uptrend after experiencing a decline in July for the first time in ten months.

The unemployment rate, calculated from a separate Household Survey, edged higher to 9.6 percent from 9.5 percent. While more people found jobs, more were looking for them. Most of the gains in household employment came from part-time workers, likely looking for full-time employment but settling on part-time employment for economic reasons. The broad measure of unemployment, which includes those who work part-time but would like to work full-time and those who have stopped looking for work, rose to 16.7 percent from 16.5 percent in July.



Overall, the labor market appears to have lost momentum after a strong showing in the spring but continued to create private jobs, albeit at a modest pace, throughout the summer. The improvement in the labor market has been slow and gradual following the massive loss suffered in the recession. During the first eight months of this year, job creation in the private sector totaled 763,000, compared with a loss of 4.042 million during the same period last year.

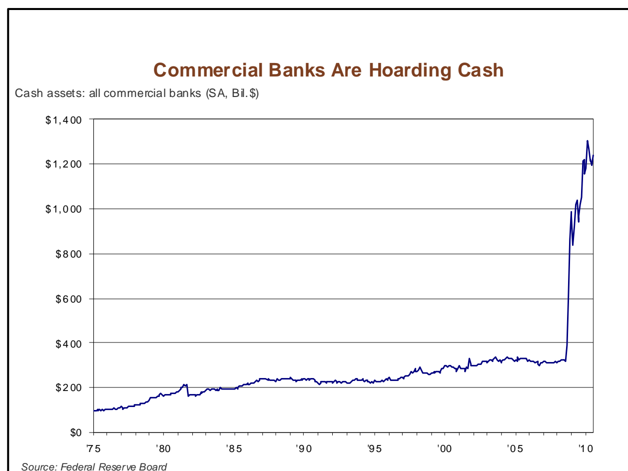
Consumer spending remains soft

Real consumer spending picked up modestly at the start of the third quarter, supported by a rebound in July auto sales, which was driven by strong fleet sales rather than by strength on the retail side. It appeared consumer spending did not get a boost from auto sales in August, however, as sales fell during the month.

Real personal income was flat in July, the worst showing since the drop in January of this year. After taxes, the situation worsened, as real disposable income fell, amidst a fading fiscal stimulus. Growth in transfer income from the government (e.g., social security payments and unemployment benefits) has declined significantly during the last several months, while tax payments have begun to increase. Going forward, strength in income will have to be derived from more traditional sources such as wage and salary income. While the employment report suggested decent wage and salary income growth in August, developing a robust trend will be challenging. Unless income growth strengthens substantially, consumers will likely remain cautious, resulting in modest consumer spending growth. Other support to consumer spending includes wealth. While household net worth has rebounded, it remains well below its peak, suggesting that consumers will continue to focus on saving and rebuilding their balance sheets. The saving rate, the ratio of saving to disposable income, dropped 0.3 percentage points in August to 5.9 percent, remaining at high levels by recent standards.

Encouraging signs for lending activity

The zero interest rate Fed policy has helped commercial banks to recapitalize following the massive evaporation of capital resulting from the unprecedented decline in residential real estate prices. The recapitalization of banks has helped improve the health of their balance sheets and put them in a better position to resume credit creation, which is an essential driver for a robust economic recovery. So far, banks have been reluctant to lend despite being flooded with liquidity, resulting in a sustained contraction of bank credit. It is true that the demand for credit has been anything but brisk; however, the extent of the contraction in bank credit is unprecedented.



Source: Federal Reserve Board

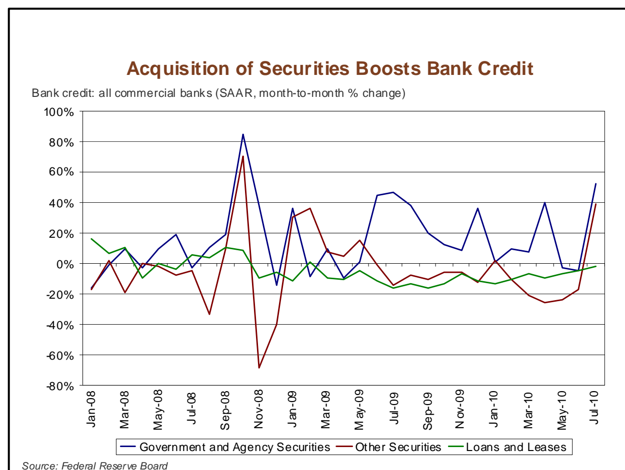
Since late 2008, commercial banks have increased their holdings of cash: cash assets have increased from $319.5 billion in August 2008 to a peak of $1.30 trillion in February 2010 before trending down modestly to $1.24 trillion in July.

Cash hoarding has helped keep short-term interest rates low. For example, three-month LIBOR (London Interbank Offered Rate), the rate at which banks lend each other money on a short-term basis, has fallen to its lowest level since early April, before the height of the European debt crisis. LIBOR is normally used as a gauge for market stress but now it may be reflecting banks' caution and the lack of demand for credit.

Banks have been reluctant to make new loans or acquire securities other than Treasury or agency securities, as these actions will incur a charge to risk-based capital for banks. There are several reasons why banks are reluctant to commit their capital to new loans and investment. For example, a double-dip in housing could induce renewed declines in residential house prices, or there could be a large amount of commercial real estate loans on banks' books that has not yet been written off. These could cause some banks to become undercapitalized. In addition, banks are cautious as they are uncertain as to the extent of the required capital that they will need to raise as a result of financial reform.

There are some signs that credit conditions and lending activity are marginally improving. In July, commercial banks' total credit (largely loans and securities) posted a large gain, marking only the second increase in the last 21 months. While it is too early to see if this is a one-off event or a turnaround for bank credit, the robust increase is encouraging. Although the increase in credit was driven by a huge increase in banks' acquisition of Treasury and agency securities, acquisition of other securities increased for the first time in five months, indicating some increase in banks' risk appetite.

The Federal Reserve Survey of Senior Loan Officers on Bank Lending Practices covering the May-July period supports the notion that credit conditions are improving slowly. The latest survey showed further easing of lending standards for commercial and industrial (C&I) loans for large and medium firms. More importantly, lending standards for small firms were eased for the first time since the fourth quarter of 2006. On the demand side, banks reported increased demand for C&I loans from large firms for the first time since the second quarter of 2006, while demand from small firms continued to be weak. For consumer loans, standards for credit cards and for other consumer loans both eased, while demand for consumer loans continued to decline, although the pace of decline appeared to be slowing.



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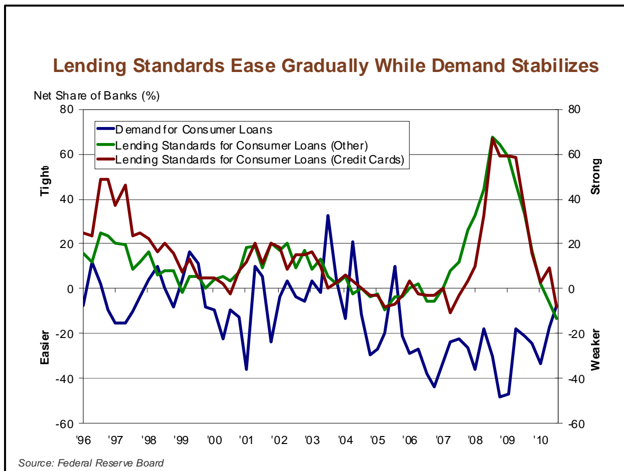


Residential mortgage lending also experienced easing standards and improving demand.

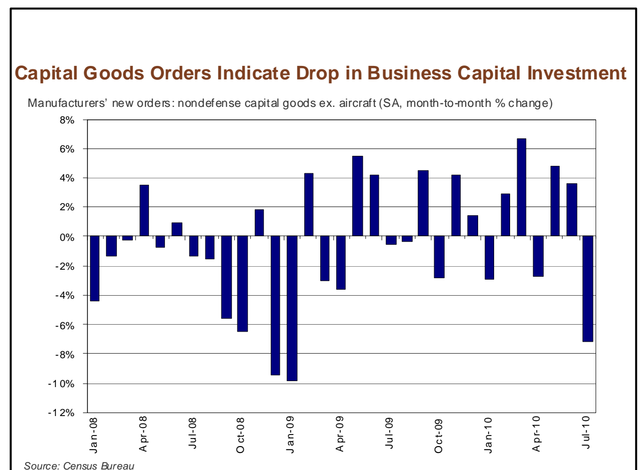
In contrast, commercial real estate saw further tightening of standards, albeit at a slower pace, while demand for loans was little changed.

Overall, the Fed Survey showed improving credit conditions across several loan categories. Demand has increased in a few key loan categories, which suggests that businesses and consumers are becoming more responsive to easing lending conditions. If this trend continues, it should help support consumer spending by next year, as consumer balance sheets will have improved materially by then, allowing consumers to be in a more comfortable financial position to accelerate their spending.

Bright spots poised to grow dim

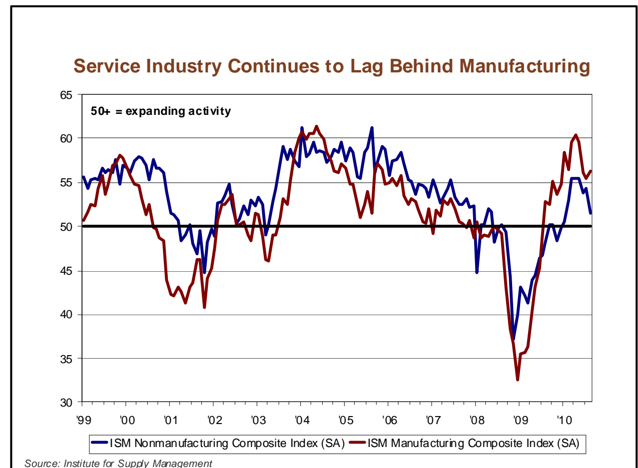
Manufacturing activity has been a bright spot in the economic recovery, propelling growth in its early stages thanks to inventory rebuilding, strong business investment to replenish worn-out capital, and healthy exports. Activity will likely moderate somewhat in coming months. The inventory cycle has run its course: the contribution of inventories to economic growth in the second quarter was 0.6 percentage points, down substantially from more than 2.5 percentage points in the prior two quarters.

Until now, business investment in equipment and software has been an engine of economic growth in this recovery, eclipsing consumer spending. Since the fourth quarter of 2009, the contribution to real GDP from business investment in equipment and software has exceeded that from consumer spending. However, the July durable goods report suggests a sharp moderation ahead. Overall orders for durable goods increased modestly, supported by a large increase in orders for civilian aircraft. Core capital goods (nondefense capital goods excluding aircraft), a component of orders that has a direct bearing on near-term business investment in equipment and software, posted the biggest drop since the beginning of 2009, largely reversing robust gains exhibited during the prior two months. The drop suggested a sharp deceleration in real business investment in equipment and software in the third quarter from the strong pace of approximately 25 percent in the second quarter.



Not every report on manufacturing activity was bearish. One popular survey-based indicator of manufacturing activity, the Institute for Supply Management (ISM) manufacturing survey, pointed to strengthening activity in August. The ISM manufacturing index advanced unexpectedly for the first time in four months, indicating a faster pace of expansion of activity, which started a year ago according to this survey. Details of the survey were not as upbeat as the headline suggested, however, due to a continued decline in the forward-looking components, suggesting a slowdown in activity in coming months. New orders fell in August for the third consecutive month to the lowest reading since June 2009. Meanwhile, the inventories index continued to rise for the third straight month. The gap between the indexes for new orders and inventories, a leading indicator of factory output, has been trending down sharply from more than 20 points in May to less than two points in August. The downward trend in these forward-looking indicators points to slowing activity ahead in the factory sector.

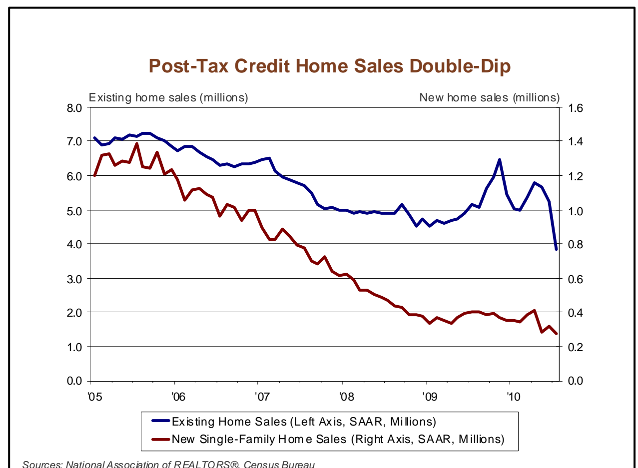
The recovery in the rest of the economy appears to be slowing down currently. The service industry, representing approximately 90 percent of the economy, has underperformed the manufacturing industry during this economic recovery. Service activity slowed unexpectedly sharply in August, according to the ISM nonmanufacturing survey (which includes the construction industry). The gap between the two ISM surveys widened by the most since November 2008. While the ISM manufacturing index rose surprisingly in August, the ISM nonmanufacturing index fell to the lowest level since January of this year, although it has still remained in expansionary territory. The details of the ISM nonmanufacturing index are troubling as the new orders index fell sizably and the employment index dropped to a level indicating contracting employment. Since the beginning of the year, the employment index has indicated expanding employment in the service industry only twice. The performance of the nonmanufacturing index suggests that the recovery will remain moribund in the near term.



Housing bottom proves elusive

There is no let-up in a long string of grim housing data after the expiration of the tax credits, and housing is searching for a trough. Existing home sales plunged 27 percent in July to a new cycle low, while new home sales fell to a fresh record low during the month, breaking the previous record low just set in May.

Single-family starts fell in July for the third consecutive month to a 14-month low, and single-family permits fell in July for the fourth straight month suggesting further drops in near-term starts. Dismal sales, slow traffic, and low expectations of sales during the next six months continue to depress home builders' confidence, which fell to a 17-month low in August.



Another indicator showing the impact of a withdrawal of government support was construction spending, which dropped in July for the third consecutive month to the lowest level in ten years. June and May figures also were revised sharply lower, adding to the risk that economic growth in the second quarter could be revised lower again. Private residential construction spending fell for the third straight month, driven by declining single-family construction and home improvement. Private nonresidential spending rose for the first time since March 2009, thanks to spending on electric power plants.

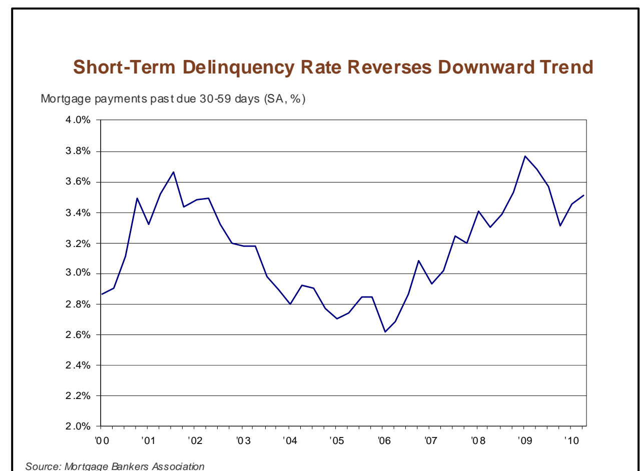
Public sector spending dropped after an increase in June. Going forward, there remain several obstacles to a rebound in construction spending. The fiscal stimulus, which has helped support public construction spending during the past year, is expected to end during the first half of 2011. Given tight budgets for state governments, public construction spending will likely drop off next year. Private construction spending will not improve materially until excess supply has been worked off and asset values stop declining. We expect residential investment to subtract from economic growth this year for the fifth consecutive year—an unusual phenomenon compared with past economic recoveries when housing acted as a strong boost to economic growth. Nonresidential investment in structures is expected to be a drag to growth through 2011.

While current housing market conditions seem dire with ample room for improvement, leading indicators suggest that a free-fall is behind us but that a strong rebound appears unlikely. After falling steadily by 42 percent between the end of April and early June, the purchase mortgage applications index has stabilized and has moved sideways through the end of August. Given weaker-than-expected housing activity in the second quarter, we lowered our projection of housing starts

and home sales for the rest of year, as well as for coming years. We expect housing starts to increase in 2010 by about four percent from an annual record low level in 2009, versus a gain of about 17 percent projected in the previous forecast. Total home sales this year are projected to decline by about seven percent from 2009 versus a slight increase in the August forecast.

Various home price measures paint a mixed picture of home prices in June following some boost or at least flattening of prices in April and May, thanks to the homebuyer tax credits. For example, the Case-Shiller Home Price Index posted a robust gain while the CoreLogic Home Price Index and the FHFA Home Price Index saw declines. The large pullback in home sales after the tax credits' expiration suggests weakening home prices in the third quarter.

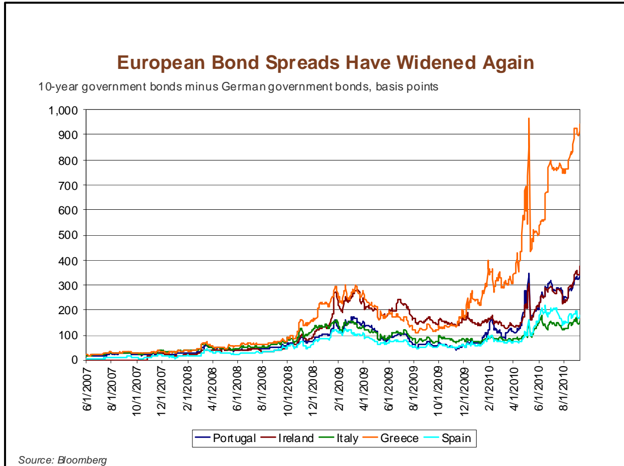
Finally, the latest figures from the Mortgage Bankers Association National Delinquency Survey show a mixed picture of credit quality. It appears that recent modification efforts have been successful in converting some of the seriously delinquent loans (those that are 90 days or more past due or in the foreclosure process) into performing loans, as the seriously delinquent rate fell to 9.11 percent, the second consecutive quarterly drop. The inventory of homes in the foreclosure process dropped for the first time since the first quarter of 2006. One piece of discouraging news was the increase in short-term delinquencies (30-59 days past due) for the second straight month, following three consecutive quarterly drops. Since job loss is the main reason that borrowers become delinquent, it appears that the recent deterioration in the labor market has led to rising short-term delinquencies. The reversal in the improving trend bears watching, as it may drive the seriously delinquent rate up down the road.



Continued drop in mortgage rates helps spur refinance activity

Long-term Treasury yields have tumbled during the past few months as concerns have grown that the economic recovery may have lost traction due to the impact of the fiscal stimulus fading. The yield on the 10-year note, the benchmark for consumer and corporate borrowing, has plunged more than 150 basis points after rising briefly above 4 percent in early April. While the August employment report pushed the 10-year yield higher by about 20 basis points, we expect that the increase will be temporary. We project the yield to hover around 2.5 percent in coming quarters, keeping mortgage rates at approximately 4.2 percent through most of next year. This projected level is low enough to entice well-qualified borrowers who had refinanced during the past two years to refinance again. As a result, we revised higher our projected refinance originations in the fourth quarter of this year and early next year.

Low mortgage rates are not expected to boost purchase activity as long as the labor market remains weak. Purchase originations are projected to be lower than in the prior forecast, given the deteriorating outlook for home sales. For all of 2010, total mortgage originations are projected to decline to $1.5 trillion from an estimated $1.9 trillion in 2009, with a refinance share of 65 percent. Total single-family mortgage debt outstanding is projected to decline by 2.1 percent, compared with a 1.9 percent decline in 2009.



European debt dials up investor angst

Market concerns with the contagion of debt solvency from Greece to other countries in the European Union (EU), including Ireland, Portugal, and Spain, have recently intensified rather than subsided. Despite the establishment of the European Stabilization Fund, a mechanism that guarantees the sovereign debt of the EU nations, progress seems to be slipping. A credit-rating cut by Standard & Poor's on Ireland's government bonds raised renewed concerns about the euro zone's fiscal problems and its banking system. Spreads on Greek, Irish, Portuguese, Spanish, and Italian debt have returned to levels near those reached at the height of the crisis this spring.

In his remarks at the Kansas City Fed meeting in Jackson Hole, Wyoming in late August, Fed Chairman Ben Bernanke pledged to do what it takes to stimulate the economy should it deteriorate substantially. He laid out several options for the Fed to implement but, most notably, he indicated that the Fed could resume its asset purchases and expand the size of its balance sheet again. Bernanke acknowledged that the impact of another round of quantitative easing on long-term interest rates is uncertain and may be less effective then the first round. In addition, he acknowledged that more asset purchases could complicate the Fed's task when it needs to start tightening monetary policy The minutes of the Federal Open Market Committee (FOMC) meeting indicate disagreement among the committee members about the decision to reinvest repayments of principal of agency debt and mortgage-backed securities. Given the caveats of the impact of another round of asset purchases and the reported dissent in the FOMC on the decision to reinvest repayments of principal of agency debt and mortgage-backed securities, it likely would take a significant deterioration in economic activity for the Fed to pursue additional measures of quantitative easing.

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