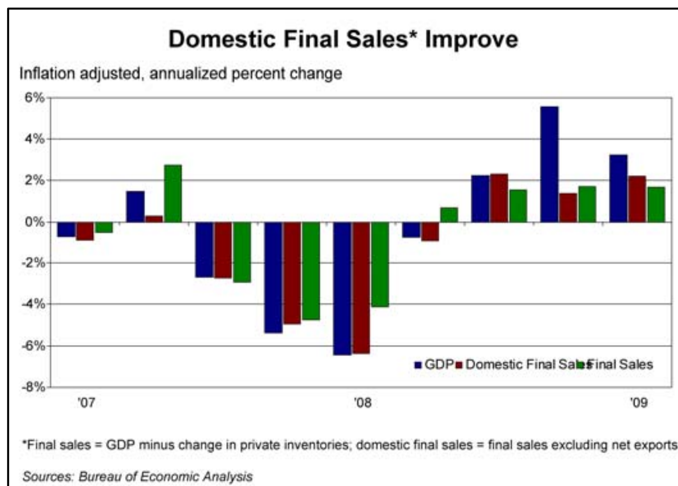
Near-Term Outlook Brightens As Self-Sustaining Momentum Develops

Downside risks increase

Economic growth posted a solid annualized pace of 3.2 percent in the first quarter of 2010, slowing from the 5.6 percent pace in the previous quarter. A pickup in employment and stronger than expected consumer spending contributed to growth which modestly exceeded the consensus. We have revised up our projected economic growth for the rest of the year based on strong momentum coming out of the first quarter and an improving job market, but our expectations for continued softness in housing, following the expiration of homebuyer tax incentives, stay in place. At the same time, new events have emerged in the form of continued threats of sovereign defaults in Europe and an oil spill off the southern U.S. coast which increase the downside risks to the base forecast.

Growth strengthens

Private inventories accounted for about one-half of the growth reported in the first quarter, decelerating substantially from the fourth quarter. Final sales, key to a self-sustaining economic recovery, grew at about the same pace as the previous quarter. Measured as real (inflation-adjusted) gross domestic product (GDP) minus changes in inventories, they appeared to have strengthened at the end of the quarter, setting the stage for an increase in the current quarter. More encouraging is the growth in domestic final sales (excluding net exports), which accelerated in the first quarter, thanks to a strong increase in consumer spending.



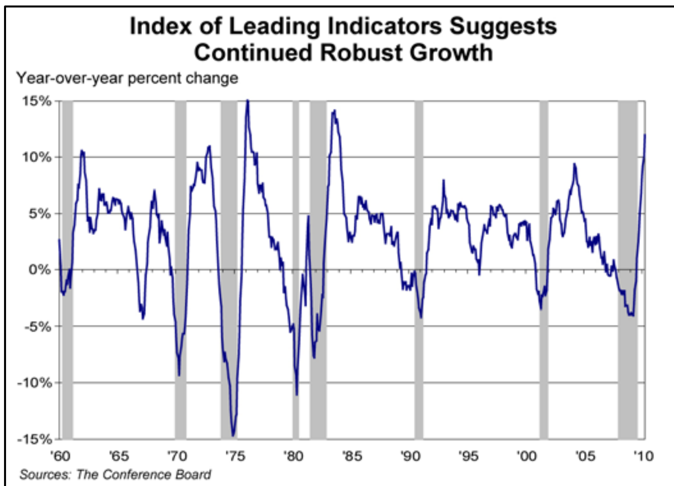
*Final sales = GDP minus change in private inventories; domestic final sales = final sales excluding net exports

Sources: Bureau of Economic Analysis

Consumer spending was the biggest contributor to growth in the first quarter, surpassing but followed by inventory adjustment which led fourth quarter 2009 growth. Trade subtracted from growth in the first quarter, reversing its role in the previous quarter. Government also continued to subtract from growth, as the cutback in state and local spending outweighed an increase in federal spending. Business investment roughly offset the drag from residential and nonresidential investment in structures.

The boost to growth from inventories will continue to diminish in coming quarters and any impact of the federal fiscal stimulus will fade in the second half of 2010. Thus, for the economic expansion to be durable, final sales must strengthen to replace waning contributions from inventories and fiscal stimulus. We believe that the expansion will be sustained. Positive April employment data and upward revisions to previous months' employment, wage, and salary income support a more upbeat outlook. For the current quarter, we expect final sales to strengthen substantially, supported by continued strong consumer and business spending as well as a rebound in residential investment from a double-digit annualized drop in the first quarter. For all of 2010, we expect the economy to grow at a 3.5 percent pace, breaking away from the narrow range of 3.0 to 3.2 percent held since last September.

One indicator with a good track record of gauging economic growth three to six months out is the Conference Board Index of Leading Indicators. It advanced in March for the 12th consecutive month. In the first quarter, the index rose 10.5 percent from a year ago, the largest increase since the first quarter of 1984. We do not see the pace of growth rivaling the pace seen in the early 1980s economic recovery but the trend in the index gives us some comfort that sustainable growth will continue in coming quarters.

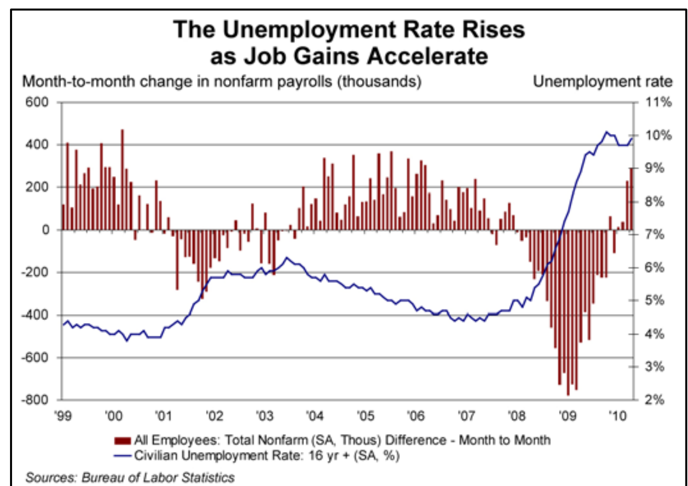


However, concerns over European sovereign debt have overshadowed news of improving U.S. economic activity. The potential fallout from the crisis in Greece poses a considerable downside risk to our longer-term outlook, as the situation in Europe is potentially much more serious than the 1997 Asian crisis. At the time of this writing, the announcement of a major package of financial support to the peripheral nations of the European Union (EU) has resulted in sharply lower borrowing costs for these countries. Nonetheless, this package serves to treat the short-term market turmoil and it is far too early to tell whether the underlying issues of relative costs and fiscal deficits will ultimately be addressed in a satisfactory manner. Our current outlook for the U.S. economy in 2010 assumes the debt crisis in Greece can be resolved in a manner that will not lead to contagion to other peripheral European countries. If the financial crisis spills over to Ireland, Italy, Portugal, and Spain, compromising the European financial system, the U.S. economic recovery could be jeopardized. Thus, the uncertainty around this forecast has widened considerably.

Jobs are coming back…

The April payroll data from the Establishment survey was a game changer, supporting the view that the recent pick-up in economic activity will generate the momentum needed to carry us into the second half of the year. Nonfarm payrolls jumped by 290,000. Even excluding temporary Census workers, payrolls posted an impressive 224,000 job gain. Revisions to previous months were positive, with March and February now showing a net gain of 121,000 jobs. Manufacturing jobs increased for a fourth consecutive month. Construction jobs posted a second consecutive gain. Businesses also added hours to existing workers, lengthening the average workweek.

A few dark clouds persist. The Household Survey reported that the unemployment rate moved higher, to 9.9 percent from 9.7 percent, reflecting a huge increase in the labor force that substantially outpaced the increase in employment. An increase in the unemployment rate is not uncommon at the same time labor market conditions start to improve as discouraged workers re-enter the workforce looking for jobs again as market conditions show signs of improvement. The broad measure of the unemployment rate, which includes those working part-time because they cannot find full-time jobs and those not looking for work but who want to work and are available for work, also increased, rising to 17.1 percent from 16.9 percent in March. The number of workers unemployed for at least 27 weeks rose to 6.7 million—a record-high 45.9 percent of all unemployment.



…and so is consumers' appetite

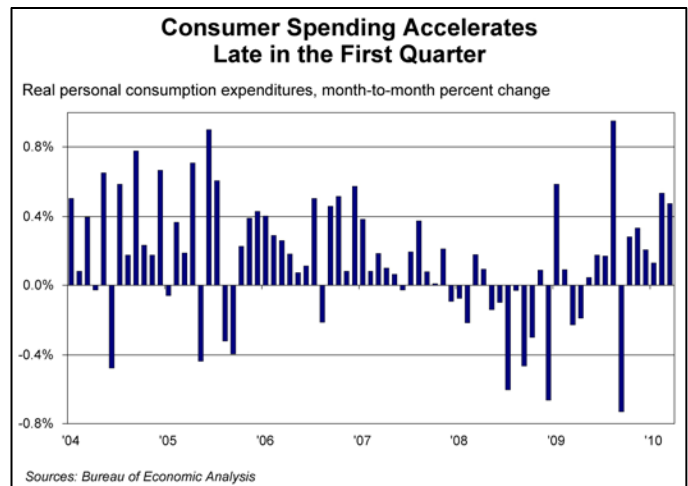
Consumers had an impressive showing during the first quarter, with real consumer spending growth accelerating to a 3.6 percent annualized rate—the fastest pace in three years. The increase in consumer spending was widespread across goods and services. Growth in spending on durable goods was the strongest in four years, except for the third quarter of 2009, when the "cash for clunkers" program temporarily boosted auto sales.

Earlier data made it appear that consumer spending had gotten ahead of improvement in consumer confidence and underlying fundamentals. While measures of consumer confidence have rebounded, they have remained near the levels

seen during the 1990-91 and 2001 recessions. The April job report will likely lift confidence substantially going forward. In addition, the job report, with its upward revision of employment showing year-to-date payroll gains of 573,000, suggests that wages and salary income was much larger in the first quarter than previously reported and will likely boost income in the second quarter more than previously expected.

Monthly data on consumer spending show that real consumer spending increased in March at a robust pace for the second consecutive month. Expectations that consumers will try to increase their savings to repair their damaged balance sheets have not yet been realized, as the saving rate fell to 2.7 percent in March, the lowest reading since September 2008. The saving rate in the first quarter will likely be revised higher, albeit modestly, in response to upward revisions of payroll data. There is potential for a bigger revision when the three-year revisions of GDP data are released in July.

One favorable factor supporting consumer spending in the first quarter may turn negative in the current quarter. The bullish stock market, which helped boost household wealth, turned bearish by mid-April, starting with concerns over Goldman Sachs and then shifting to the European sovereign debt crisis. Jitters in the financial market may dampen consumer optimism and moderate improving labor market conditions.

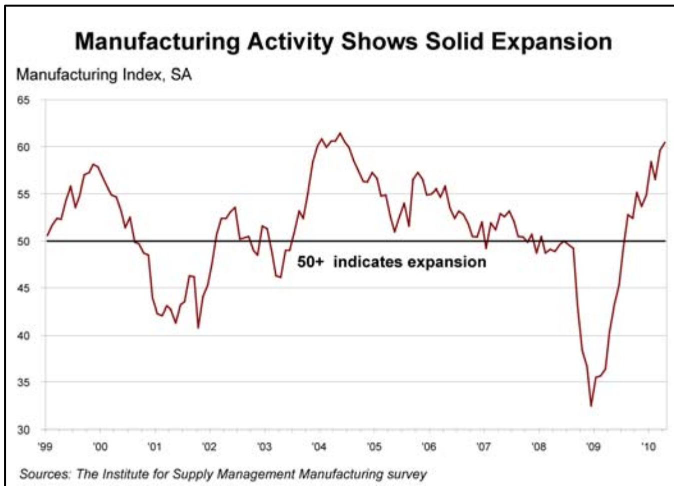


In the previous forecast, we noted that real consumer spending growth would likely move lower from the projection of more than three percent in the first quarter to below three percent in coming quarters. The strength in consumer spending late in the first quarter sets up positive momentum into the second quarter, calling into question our view that consumer spending growth would be below three percent. Thus, we have revised higher our projected consumer spending growth in the near term.

There are many factors that convince us that the strength projected in the first half will slow in the second half. Besides developments in the stock market, the income support to consumers from the fiscal stimulus will dissipate. Currently, personal income continues to be supported by the government, largely in the form of unemployment insurance benefits, which were extended to 99 weeks from 53 weeks. This benefit is expected to expire for about one million jobless during the next few months. The labor market, which appears to be turning the corner, is crucial in assessing the durability of a rebound in consumer spending. We expect consumer spending to slow only moderately in the second half of the year to a solid 2.5 to 3.0 percent gain. Another positive for consumer spending is easing lending standards for consumer loans, according to the Federal Reserve's Senior Loan Officer Opinion Survey. On the non-mortgage consumer credit side, banks are now easing standards during the first quarter for non-credit card loans to households for the first time since early 2007.

Manufacturing marches on

The factory sector continued to gain momentum in the first quarter. While industrial production barely increased in March, this was attributable to a large drop in utility production. Manufacturing production actually surged during the month, showing broad-based improvement, and increased for the third consecutive quarter following a string of six consecutive declines. The capacity utilization rate increased steadily to 73.2 in March from its record of low of 68.3 in June 2009. Manufacturing should continue to gather steam in the current quarter. The Institute for Supply Management (ISM) manufacturing index rose in April into firm expansionary territory, with the index rising above 60 for the first time since June 2004.



The sector has received support from a rebound in business investment. Investment in equipment and software has proven to be a solid source of support to domestic demand, posting a double-digit gain during the last two quarters, albeit from a very low base.

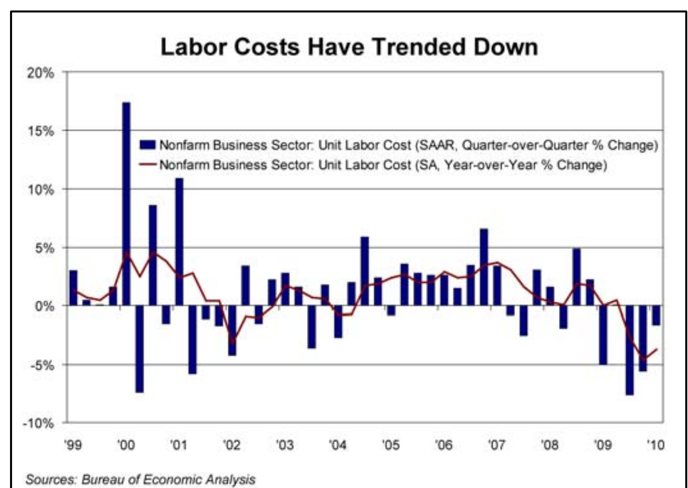
We expect nonresidential investment in equipment and software to make a bigger contribution to GDP for the rest of the year—compared to the 0.8 percentage point contribution in the first quarter)—given incoming data on durable goods orders and shipments. Orders of nondefense capital goods excluding aircraft—a proxy for future equipment and software spending—surged in March following an upward revision in the February figure.

Inflation is a no show

Recent price data indicate declining inflation measures for the next several quarters. The deflator for personal consumption expenditures excluding food and energy, the Fed's favored measure of inflation, was up at an annualized rate of just 0.6 percent in the first quarter—a record quarterly low since the series inception in 1959. The Fed's target for this measure over time is believed to be 2.0 percent.

In addition, there have been no wage pressures. The employment cost index rose 0.6 percent in the first quarter, led by above-trend benefit costs. Wages and salaries were up only 0.4 percent on the quarter. Labor costs adjusted for productivity changes have been declining. With a solid increase in productivity growth in the first quarter, unit labor costs—a key gauge of inflationary pressures—fell for the third consecutive quarter. Declining unit labor costs imply that productivity gains continue to outstrip increases in compensation. With labor costs constrained, profit margins will remain elevated this year. Rising profit bodes well for continued increases in business investment and later increased hiring.

The lack of inflation and wage pressure, as well as the stubbornly high unemployment rate, supports our view that the Fed will not start hiking the fed funds rate this year from its current 0–to-25 basis point range. This leaves the Fed able to keep monetary easing in place for some time, indicating that inflationary expectations remain well contained.



Residential investment poised to rebound…not so fast for nonresidential investment in structures

Total construction spending increased in March for the first time in five months, thanks to a surge in public spending. Private residential construction spending dropped for the second consecutive month while private nonresidential construction spending continued to decline for the twelfth consecutive month.

Private residential construction spending has trended down since the end of last year, though it remains above its trough reached in mid-2009. A steep decline in multifamily construction was the culprit. Single-family construction has been increasing, albeit at a slow pace since mid-2009. Despite the setback, private residential construction continues to perform relatively better than private nonresidential construction. The downturn in commercial real estate has continued even as the economic recovery appears to have taken hold. Spending on utility structures has been the only construction

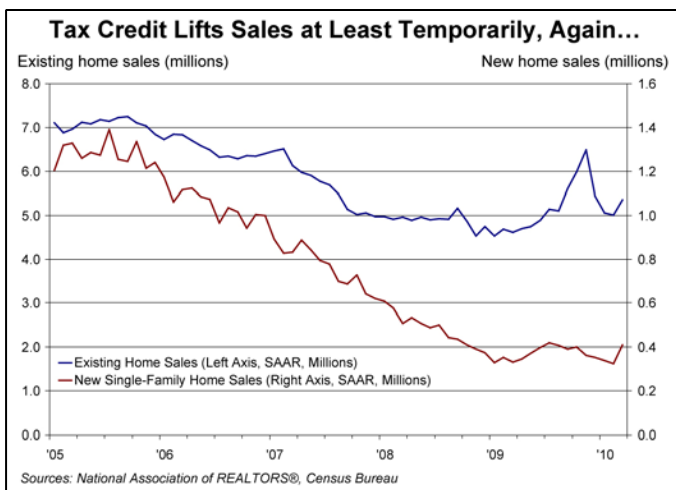
category that has not been seriously affected by the recession. Spending on office construction, manufacturing, and commercial structures has steadily declined to very depressed levels.

As expected, residential investment fell in the first quarter after gaining in the third and fourth quarters of last year. We expect a rebound in the current quarter and a continued uptrend going forward. For all of 2010, we expect residential investment to add just 0.1 percentage points to GDP. We expect nonresidential investment in structures to be a drag on GDP through most of 2011.

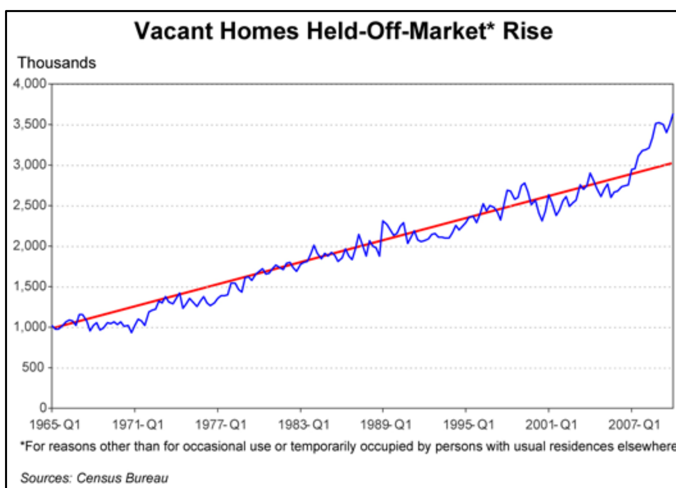
Home sales surge (at least temporarily)

Data on home sales confirmed that the second homebuyer tax credit will give a lift to sales, although the increase will likely be temporary. New home sales jumped in March, presumably from buyers rushing to sign contracts before the deadline at the end of April. The surge in new home sales was the second biggest percentage increase in the series' history but it came on the heels of record low sales in February. New home sales, which are recorded at the time of contract signing, are likely to see a further increase in April.

Existing home sales posted a robust increase in March as well. Because existing home sales are recorded at closing, we expect sales to increase further in coming months. For homebuyers to claim the tax credit, sales contracts must have been signed by the end of April and closed by the end of June.



Sources: National Association of REALTORS®, Census Bureau



*For reasons other than for occasional use or temporarily occupied by persons with usual residences elsewhere

Sources: Census Bureau

Leading indicators of home sales confirm rising sales in the coming months. March pending home sales, which measure existing home sales at the time of contract signing, posted a sizable gain for a second consecutive month. In addition, the Purchase Index in the Mortgage Bankers Association's weekly survey of mortgage applications has shown a rising trend during the past two months.

The increase in home sales in the second quarter will help boost residential investment as real estate commissions count as part of residential investment. We continue to believe that the recovery in homebuilding activity will be gradual this year, given the excess supply of housing and a significant amount of shadow inventory. Both the homeowner vacancy rate, which measures the share of housing units that are typically owner-occupied but are vacant and for sale, and the rental vacancy rate edged down only 0.1 percentage points in the first quarter of this year from historically high levels in the fourth quarter of last year. Furthermore, the number of vacant homes held off market for reasons other than for occasional use or temporarily occupied by persons with usual residences elsewhere increased sizably during the quarter.

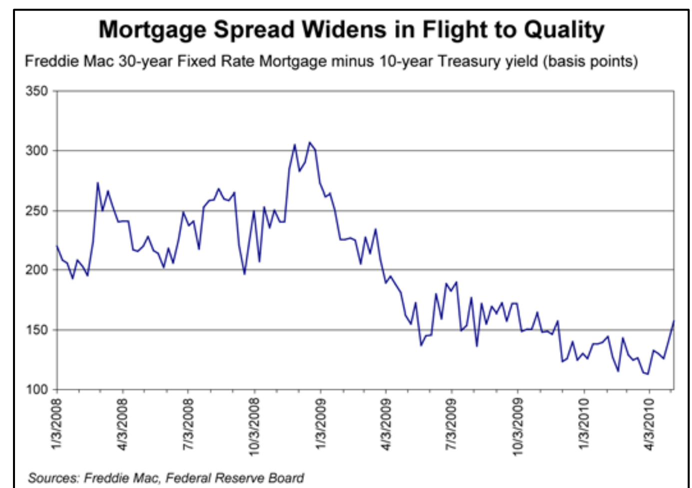
The number of such vacant units has trended up during the years. However, since 2005, the rate of increase accelerated significantly. These units do not represent an excess supply of housing as they are not available for sale. They represent a shadow supply of housing as they could potentially be put on the market as housing market conditions improve. It is possible that some of these units are held off market because they are in very poor condition and are likely to be demolished but no estimate of the magnitude of this effect is available.

Our forecast of housing starts and home sales is little changed from the April Outlook. Incoming data support out projection of an uptick in activity in the second quarter. We continue to project a pullback in total home sales starting in July as the tax credit will likely pull sales forward into the second quarter. Improving signs in the labor market support our view that sales should pick up again by the end of the year, despite the withdrawal of the policy support and the projected moderate rise in mortgage rates. For all of 2010, we expect total home sales to increase by about 5.5 percent.

Purchase mortgage production rebound bodes well for FHA

Concerns about the euro-zone's debt crisis continued to support the Treasury market. Our view of mortgage rates was little changed from the previous forecast as the decline in the benchmark 10-year Treasury yield was largely offset by the widening mortgage spread. Decreased risk appetites due to market volatility have led to a flight to quality and a sharp drop in Treasury yields. Additionally, the global stock market slumped and corporate and mortgage spreads widened, although the new package of support to the peripheral nations of the European Union have improved sentiment and market performance, at least temporarily.

We expect 30-year fixed mortgage rates to rise by about 50 basis points by the end of the year from their current level of about five percent, which should continue to support home buying activity. Much of the purchase mortgage activity will benefit FHA. According to the Mortgage Bankers Association weekly survey of mortgage applications, the government (largely FHA) share of applications for purchasing a home accounted for about half of all purchase applications in recent weeks. It appears that the extension and broadening of the homebuyer tax credit has continued to be supportive of FHA activity in the purchase mortgage market.



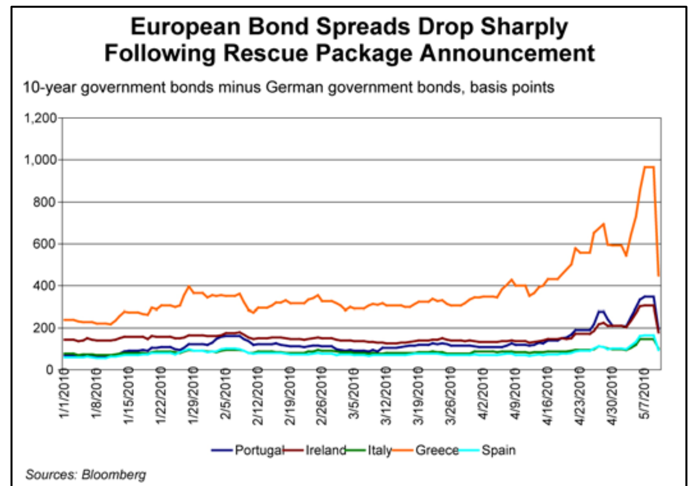
Without a significant change in projections of mortgage rates and home sales, our forecast of mortgage volume remains close to the previous forecast. We expect purchase originations to increase and refinance originations to continue to drop off sharply. For all of 2010, total mortgage originations are projected to decline to $1.28 trillion from an estimated $1.92 trillion in 2009, with a refinance share of 45 percent. Mortgage debt outstanding for 1-to-4 single-family properties is projected to drop 1.5 percent in 2010, moderating from a 1.9 percent decline in 2009.

European debt crisis poses significant risk to the forecast

Greece has commanded center stage of the capital markets since late April, when Standard and Poor's (S&P) lowered its rating of Greek government bonds to junk status. The financial markets initially shrugged off sovereign default concerns as signs continued that the U.S. economic recovery was gaining traction. However, the situation grew more tenuous in the face of heightened uncertainty regarding the extent and structure of support from the EU, leading to broad expectations of debt restructuring. S&P also downgraded the ratings of Spain and Portugal government bonds, stirring fears of contagion to the other peripherals. Investors have been more risk-averse, putting their funds into German government bonds, considered the safest among European government securities. The spread of the 10-year Greek bond over its German counterpart widened to nearly 1,000 basis points on May 9. The spread for Portugal and Spain government bonds also climbed.

At the time of this writing, officials in Europe have announced a massive (nearly $1 trillion) loan plan and the European Central Bank has announced its intention to purchase public and private debt. Spreads have plummeted as a result, although they remain elevated by historical standards.

Nonetheless, the path forward remains murky. The new proposals treat the symptoms of underlying structural problems (relative cost structures, fiscal deficits) that have yet to be adequately addressed. Whether peripheral economies have the political will to institute draconian fiscal measures, or if their banking systems could survive them, remains far from clear. Once the short-term market correction has occurred, uncertainty will continue to overhang the markets, with lingering concerns of another seizure in the global capital markets. As a consequence, substantial challenges and risks to the global financial sector lie ahead.



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