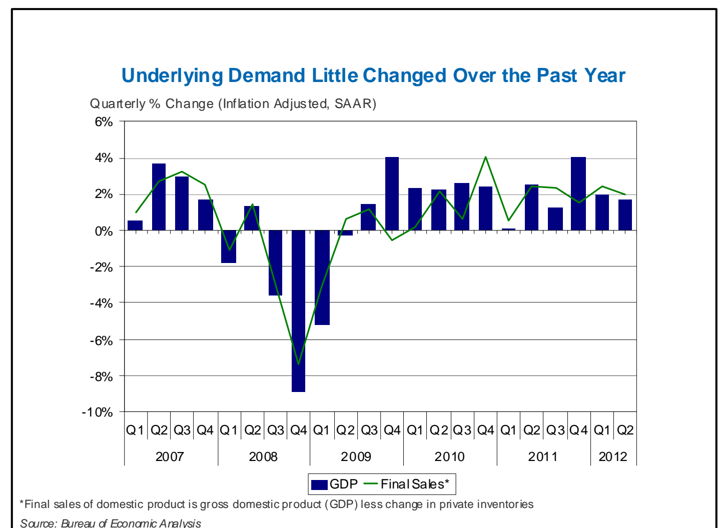
Economy Struggling to Maintain Lackluster Growth

The overall tone of economic data over the past month suggests continued slow growth in the second half of the year from the modest pace of the second quarter. While there were some shifts in the performance of a few economic sectors, the improvements in some sectors were offset by the declines in others. Our view continues to be that downside risks outweigh possible upside surprises, as the economy limps along.

Revisions to gross domestic product (GDP) for the second quarter caused a slight upgrade in economic growth to 1.7 percent annualized – still a deceleration from the subdued pace of 2.0 percent in the first quarter. While revisions were minor in aggregate, they made the composition of growth more favorable, as they showed that inventories subtracted 0.2 percentage points from GDP instead of adding 0.3 points as initially reported. As a result, final sales – defined as real (inflation-adjusted) GDP minus the change in inventory investment and a gauge for the economy's underlying demand – grew 2.0 percent, accelerating sizably from the initially reported rate of 1.2 percent. Despite an improving picture of final sales reported for the second quarter in the revised report, growth in final sales has been little changed over the past year.

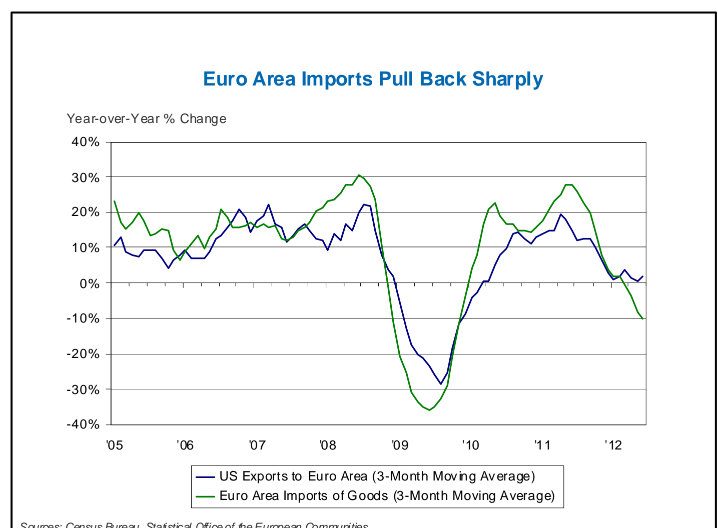
We continue to project weak growth in the second half of the year, supported somewhat by consumer spending and, to a lesser extent, business and residential investment. Federal, state, and local governments will continue to be a drag. Economic growth will be restrained by trade declines, reflecting a slowdown in global economies, especially in the euro area and China. The recession in Europe has led to a slump in imports, which posted a sharp decline from a year ago, helping to cool off global trade, especially in China, its major trading partner. U.S. exports to the euro area also have slowed substantially over the past year but have been offset to some degree by improved trade to Mexico, a major U.S. trading partner.



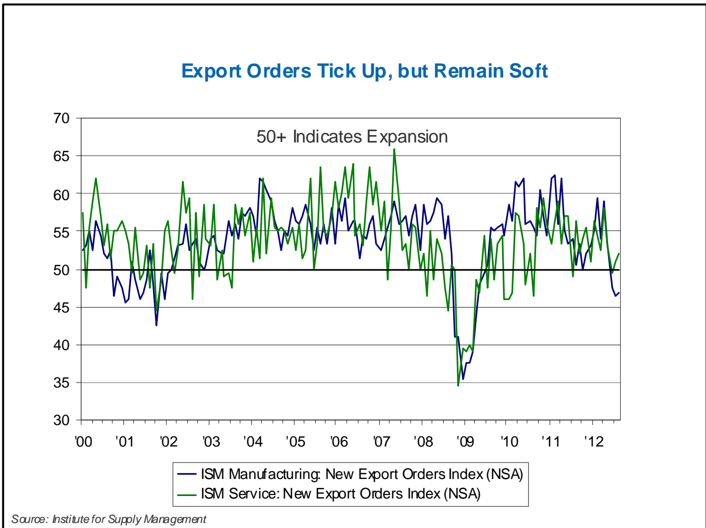
*Final sales of domestic product is gross domestic product (GDP) less change in private inventories

Source: Bureau of Economic Analysis

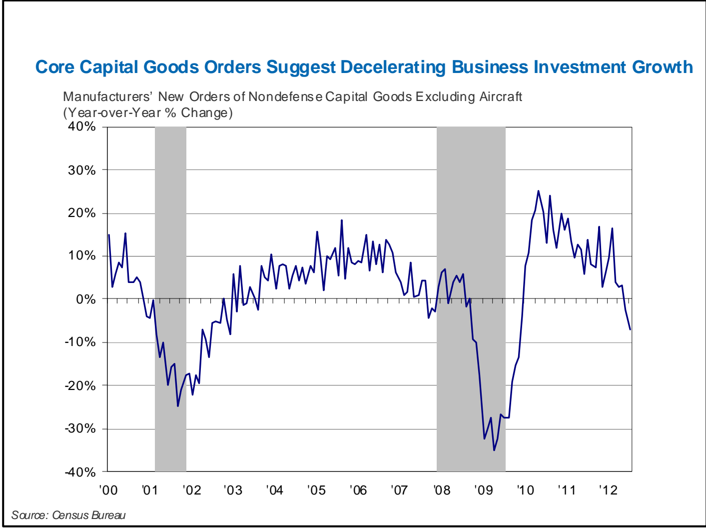
Weaker export demand as well as reduced domestic demand has slowed the U.S. manufacturing industry. The Institute for Supply Management (ISM) manufacturing survey showed that manufacturing activity contracted in August for the third consecutive month, driven by declines in both the new orders and production components. While the new export orders component ticked up, it also remained in contraction territory for the third straight month – a rarity in an economic expansion. Service activity fared relatively better, with the ISM non-manufacturing index rising during the month. However, the key new orders index – a forward-looking indicator – fell for the month, suggesting some weakness going forward. The new exports orders index for the service industry rose for the second consecutive month after slipping into contracting territory in June, but remained well below the levels witnessed earlier this year. Overall, both surveys suggest U.S. exports growth will soften substantially during the second half of the year.



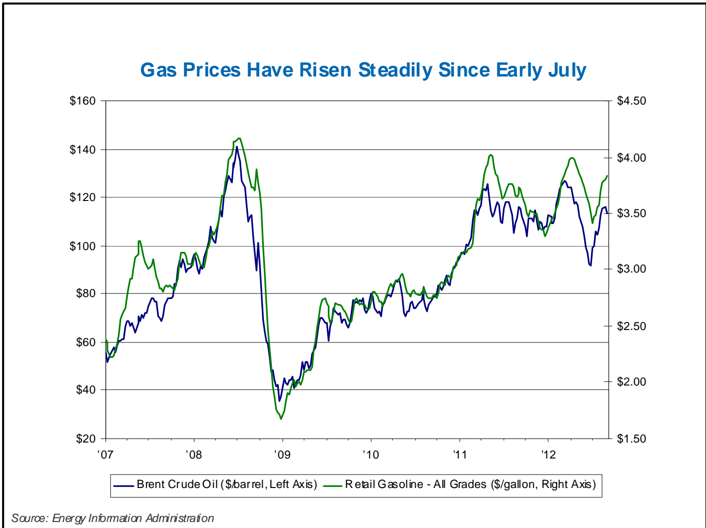
Sources: Census Bureau, Statistical Office of the European Communities



Source: Institute for Supply Management



Source: Census Bureau



Source: Energy Information Administration

Meanwhile, U.S. imports are likely to remain weak, in line with the moderate growth rate of domestic demand. Thus, we expect that net exports, which were a slight boost to growth in the second quarter, will be a marginal contributor to GDP in the second half of this year.

Another factor that is expected to keep domestic demand subdued for the remainder of 2012 is business investment in equipment and software, which showed a marked slowdown this year. Business capital investment was a big boost to economic growth in 2011, rising more than 10 percent. However, its growth slowed to just half that pace during the first half of this year. It appears likely that the deceleration in investment spending will continue through the rest of 2012, according to the recent trend in its leading indicator – core capital goods orders (i.e., nondefense durable goods orders excluding aircraft), which fell sharply in July. This marks the second consecutive monthly drop as well as the second straight year-over-year decline. Businesses appear to be increasingly skeptical about whether the pace of demand going forward warrants continued increases in capital expenditures.

We expect investment in nonresidential structures to grow modestly in the second half of the year, as high vacancy rates and limited financing will continue to restrain the sector.

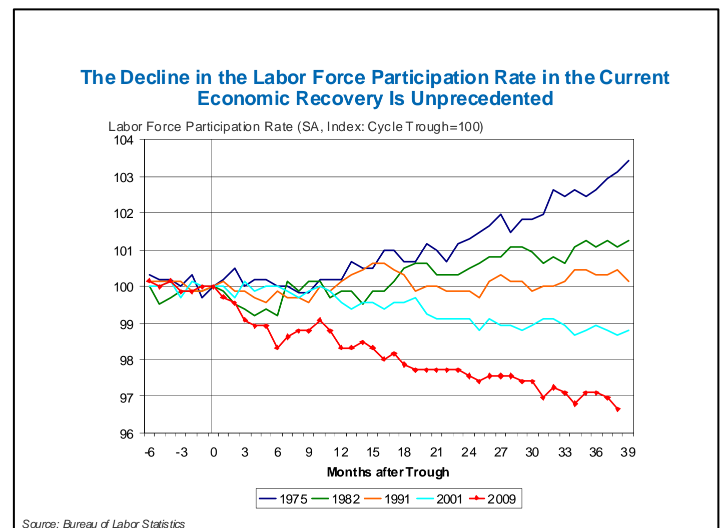
Consumer spending will remain the primary, albeit moderate, driver of economic growth. The July report on personal income and spending indicated that consumers started the current quarter on a firm note. Both nominal income and nominal disposable income increased 0.3 percent while nominal consumer spending rose 0.4 percent in July. As a result, the saving rate ticked down to 4.2 percent, remaining 1.0 percentage point higher than the rate recorded just last November. Real consumer spending increased 0.4 percent – the biggest rise since February. Combined with a jump in August auto sales, which lifted the two-month average of the third quarter above the second-quarter sales pace, consumer spending is expected to pick up in the current quarter.

However, counter balancing the auto sales increase is the increase in gasoline prices, which have steadily trended up since early July. There are several reasons why crude prices and thus gasoline prices have risen in recent months, including increased tension in the Middle East, temporary shutdowns of pipelines in refineries in the Midwest, and a reported huge decline in stockpile inventories from the Department of Energy. In addition to rising gas prices,

severe drought conditions throughout much of the U.S. will likely boost prices for crops, such as corn, soybeans, and other agricultural commodities, adding to the rise in the headline inflation and stifling real spending growth.

The August jobs report also suggests less support for consumer spending in the near term, as both hours worked and average hourly earnings were flat. The report was disappointing in every aspect, with nonfarm payrolls growing just 96,000, and previous months' gains revised lower by 41,000. Private payroll employment rose 103,000 in August, moderating sharply from a 162,000 gain in July. Manufacturing employment fell for the first time in almost a year, posting the biggest drop in two years. Part of the August drop may be attributable to a giveback in the auto sector as a result of the postponed July plant closures. The hiring pace has clearly lost momentum in the spring and summer months this year: In the six months ending in August, payroll increases averaged 97,000 – less than half the average monthly gain attained during the prior six months.

The seeming improvement in the household survey showing the unemployment rate falling from 8.3 percent to 8.1 percent masks bearish labor market conditions, as the drop was driven by a plunge in the labor force that outweighed a decline in household employment. The labor force participation rate – the share of the adult population that is employed or looking for jobs – dipped 0.2 percentage points to 63.5 percent, the lowest rate in more than three decades. The extent of resource under-utilization in the labor market in the economic recovery is worrisome, as the decline in the labor force participation rate in the current recovery is unprecedented.



The weak labor market supports our prediction in the August forecast that additional Fed easing will soon be forthcoming. The minutes of the July 31-August 1 Federal Open Market Committee (FOMC) meeting noted that "many members" assessed that additional monetary easing would be warranted "fairly soon" unless the economy shows an appreciable gain in strength, which seems unlikely in the near term. In his speech at Jackson Hole at the end of August, Fed Chairman Ben Bernanke remarked that the healing of the labor market has been "painfully slow," and that it is a "grave concern...because of the enormous suffering and waste of human talent it entails." Given the downbeat August jobs report, the Fed will likely extend its low-rate guidance to mid-2015 from the current late-2014 date and initiate a new round of asset purchases including agency mortgage-backed securities at the next FOMC meeting, which will occur shortly after we complete our September forecast.

Our outlook for the second half of the year was little changed from the previous forecast, with growth expected to remain below 2.0 percent. For all of 2012, the economy is projected to grow at a 1.8 percent pace, slightly slower than 2011, and downside risks predominate. Uncertainty surrounding the looming fiscal contraction at the beginning of next year is expected to weigh on businesses and consumers as we approach the end of 2012. The impact of the fiscal contraction – spending cuts and tax increases – on the economy in 2013 is very difficult to assess, particularly ahead of the November elections. If the full fiscal contraction scheduled under current law is allowed to occur, the drag on economic growth is estimated to be approximately 4.0 percentage points, which will be more than enough to send the economy into recession. Our forecast continues to assume just slightly more than a 1.0 percentage point hit to the economy (see detailed assumption in the August commentary).

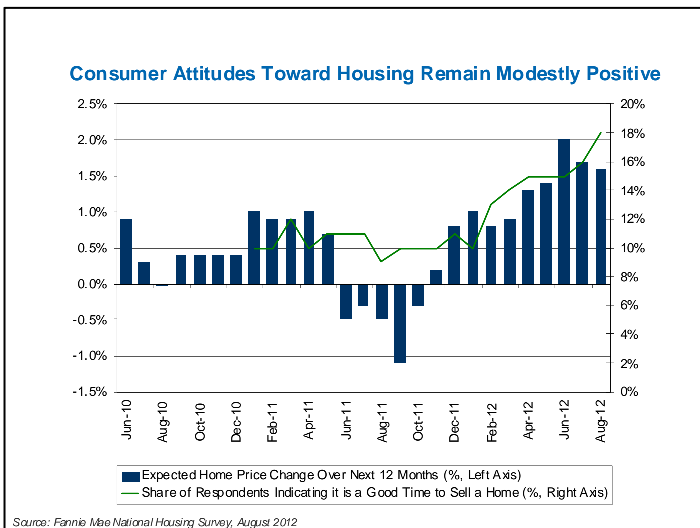
Meanwhile, tail risk from Europe appears to be receding following the announcement from the European Central Bank (ECB) of potentially unlimited sovereign bond purchases, without a preferred creditor status for the ECB. While this effort is unlikely to solve the sovereign debt crisis in the euro area in the long term, it lessens the immediate risk that any particular euro-area country will face a destabilizing market-driven run on liquidity in key markets, for example Italy and Spain.

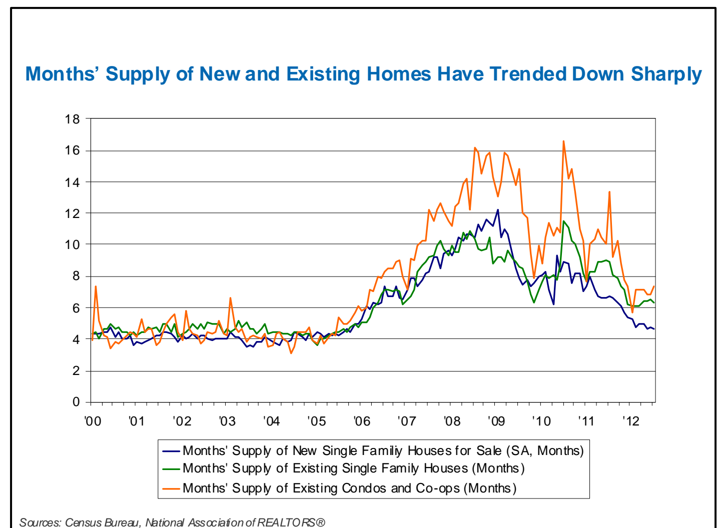
One domestic risk factor emerging during the second half of the year is the impact of the drought on farm inventories. New estimates from the Department of Agriculture indicate that this summer's drought will result in a sharp reduction in farm output in the second half of the year. Combined with businesses' worries about future demand amid various headwinds, which deter them from building inventories, total business inventories could decline by more than we expect, becoming a bigger drag to growth this year. In any case, the impact of the drought on inventories will only be temporary and should reverse early next year. Because of crop insurance and expected price increases for agricultural commodities, the drought is likely to affect farm income much less than farm output. Thus, the second round impact from the drought on consumer spending will likely be muted.

Housing: Sales and Building Activity Turning the Corner, with Prices Soon to Follow

Despite the challenging backdrop of the overall economy, we expect the housing recovery to persist. The August Fannie Mae National Housing Survey showed that consumer attitudes toward the housing market remain modestly positive, amid signs of increased concerns over the direction of the overall economy. The number of respondents who believe the economy is headed in the wrong direction ticked up 2.0 percentage points to 60 percent – the third consecutive rise and the highest reading since January. At the same time, the share of consumers who say now is a good time to sell a home continued to trend up to the highest level since the survey's inception in June 2010. In addition, home price expectations over the next year remained positive for the tenth consecutive month.

Housing activity has improved substantially over the past year, with better alignment of housing supply and demand, as measured by the months' supply or the inventory-sales ratio. The months' supply of new homes has been declining rapidly for the past three years, falling below its long-term average, while the supply of existing homes also has trended down but remains somewhat elevated compared to its normal levels.



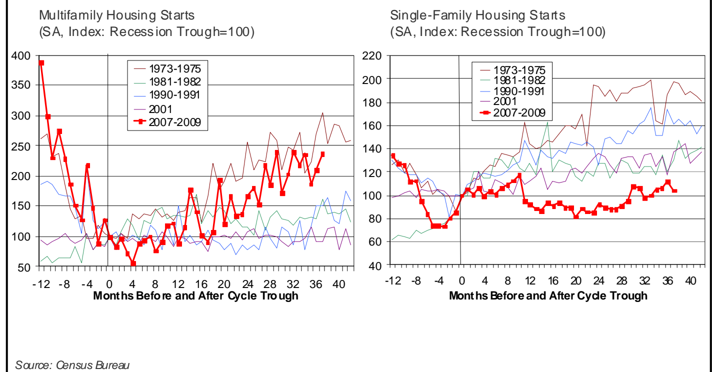


However, a more balanced market has been driven largely by a drop in new housing supply, reflecting several years of an extraordinarily slow pace of homebuilding activity, gradual processing of foreclosures, and increased modification efforts, rather than through robust housing demand. Increased construction activity over the past several years has been concentrated in the multifamily segment. Construction of multifamily homes during the current recovery compares favorably to most previous recoveries, spurred by strong demand for rental housing units, driven by elevated distress in residential loans, credit tightening for mortgages, and declining homeownership rates. However, the pace of multifamily starts this year averaged just 60 percent of the peak during the housing boom of slightly more than 350,000 units. (For more information on multifamily market conditions and data demonstrating that multifamily construction is gaining steam, read the September 2012 *Multifamily Market Commentary*).

The healing of the labor market has been painfully slow, resulting in depressed wage growth and presenting an obstacle for a strong rate of household formation and housing demand. Real aggregate wages across all employees declined sharply during the last recession and have yet to regain pre-recession levels, more than three years into the recovery. (For more details on the performance of real wages as well as construction employment in the current recovery versus previous recoveries, read the [September 2012 issue of *Housing Insights*], titled “Stuck in the Great Recession’s Income Slump: Sluggish Job Earnings Impede an Economic Expansion”).

Housing data over the past month were encouraging, as both new and existing home sales posted solid gains in July. Year-to-date new home sales in July were 22 percent above the same period in 2011, when new home sales set an annual record low. Year-to-date existing home sales were 9.0 percent above last year’s pace – the best showing since 2007.

Multifamily Construction Compares Favorably to Most Previous Recoveries, While Single-Family Home Building Fares the Worst

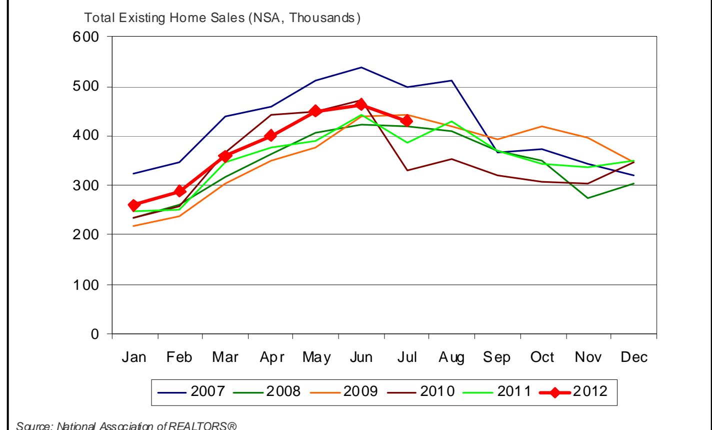


Source: Census Bureau

Home prices continued their upward climb in recent months. During the second quarter, various home price measures posted the best performance since 2005. While price increases are likely to slow going into the fall and winter months, we expect that, if current trends continue, home prices reached bottom in the first quarter of this year.

An improving trend in new home sales, very lean inventories in the new home market, and firming home prices have combined to boost home builders’ confidence, which rose in August for the fourth consecutive month to the highest level since early 2007. While single-family starts pulled back in July, their year-to-date pace remains more than 20 percent above last year. Multifamily starts picked up strongly for a second straight month, with year-to-date starts almost 40 percent above last year’s level. As a result of increased new construction and a healthy rise in home improvement spending, residential investment contributed to GDP during the first half of this year, and we expect continued positive, albeit modest, contribution through the rest of this year.

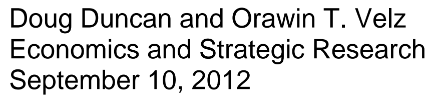
Year-to-Date Existing Home Sales Post the Best Showing Since 2007



Source: National Association of REALTORS®

Housing starts are projected to rise by 23 percent this year from a depressed base in 2011, with a more pronounced gain in the multifamily space. We expect an increase in home sales of about 9.0 percent in 2012, little changed from our forecasts since the start of the year. The expected increase in home sales is modest given extraordinarily low mortgage rates, as lending standards in the mortgage space remain tight, limiting the pool of potential homebuyers, and mortgage insurance premium and guarantee fees have trended up, adding to the cost of obtaining mortgages.

If the Fed goes ahead with another round of quantitative easing as we expect, mortgage rates will continue to provide a support for the housing and mortgage markets for the remainder of this year, especially for refinancing. For all of 2012, total mortgage originations are projected to rise to $1.58 trillion from an estimated $1.36 trillion in 2011, with a refinance share of 69 percent. Total single-family mortgage debt outstanding should decline by an additional 1.2 percent in 2012, marking the fifth consecutive annual drop.



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Economics and Strategic Research
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