EconomicUpdate NATIONAL
Federal Reserve Bank of Dallas

Mixed Data Support a Moderate Recovery

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Recent data point to a mild firming of the underlying pace of final demand growth. However, questions remain as to the sustainability of growth as conventional monetary and fiscal policy stimulus efforts fade over the course of this year. Improving trends in production and employment suggest that job losses might soon give way to modest gains. In light of continued debt deleveraging and tight credit conditions, persistent economic slack will likely continue to constrain inflationary pressures and expectations.

Strong Fourth Quarter GDP

In fourth quarter 2009, real gross domestic product (GDP) grew at a better-than-expected 5.6 percent seasonally adjusted annualized rate, the strongest quarterly growth in more than six years. The final estimate of fourth quarter GDP released by the Bureau of Economic Analysis showed that more than two-thirds of the quarter's growth was attributable to less inventory liquidation. Consumer spending, net exports and business fixed investment were revised moderately weaker than originally estimated. Real final sales, which exclude inventories, grew 1.7 percent—1.4 percentage points from rising domestic demand and 0.3 percentage points from higher net exports. Real final sales has averaged less than 1.9 percent over the past two quarters, indicating that the underlying demand for goods and services is still rather tepid.

Financial Markets Normalizing

Contributing positively to the prospects for renewed economic growth, conditions in short-term and long-term funding markets have largely returned to normal. Moreover, the recent increase in the discount rate from 50 basis points to 75 basis points on Feb. 19 has not led to significantly tighter financial conditions; the move was largely accepted as a technical adjustment in response to improved financial market functioning. Market yields and related spreads for interbank lending, commercial paper, Treasury securities, corporate bonds and mortgages have attenuated over the past several months. Specifically, corporate bond spreads have recovered to levels seen in mid-2008, although the liquidity premium between Treasury securities and corporate bonds remains a little elevated from previous periods of market stability (Chart 1). Money market conditions have been well maintained despite the winding down of several Fed liquidity and asset programs. The process of normalizing the Fed's function as a lender of last resort will proceed as money market strains continue to abate and the private sector reestablishes self-sustaining funding and liquidity.

Chart 1
Corporate Bond Spreads Returning to Normal

SOURCES: Federal Reserve Board; Merrill Lynch; Moody's.

Chart 2
Manufacturing Sector in Expansion

*Seasonally adjusted.
** Philadelphia Fed general business outlook diffusion index recalculated to show 50+ as factory expansion territory.
SOURCES: Federal Reserve Board; Philadelphia Fed; Institute for Supply Management; author's calculations .

Led by Manufacturing, Business Sector Improves

Total industrial production inched 0.1 percent higher in February following January's solid 0.9 percent increase. Industrial production has been steadily improving since June of last year, and growth has been widespread. The Institute February, although it showed some signs of deceleration as it declined 1.9 percentage points to 56.5 percent. Manufacfacturing output also declined in February, and manufacturing capacity utilization remains at a very low level at 69.4 percent. The Philadelphia Federal Reserve Bank's general activity diffusion index, a broad measure of manufacturing conditions, further corroborates the strong rebound in manufacturing, with seven consecutive months of positive growth (Chart 2). The manufacturing sector appears to be expanding strongly from very low levels of resource slack.

Although experiencing less robust growth, the service sector also appears to be expanding. The ISM nonmanufacturing index rose 2.5 percentage points to 53 percent in February, indicating service sector growth for the second consecutive month. While the recovery remains modest, with forward-looking measures still below expansionary index levels, recent gains have been broader-based across the sector. Overall, business sector trends are encouraging for the labor market as the U.S. economy begins to rebound and soak up the economic slack legacy of the last two years.

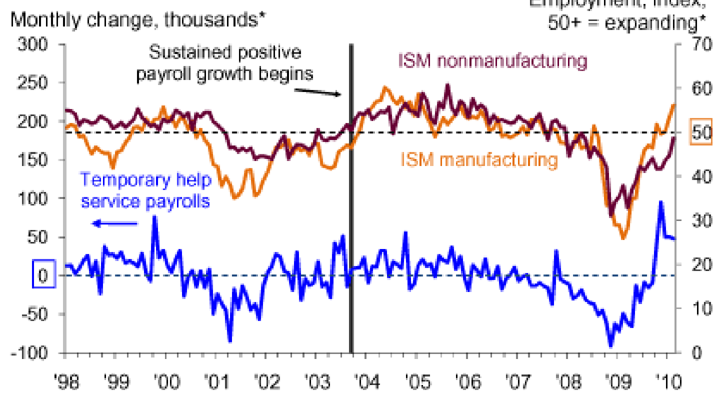
Labor Market Still Weak but Poised for Positive Growth

Labor market conditions are slowly improving, though unemployment remains mired at high levels. Initial jobless claims have trended only slightly lower so far this year, remaining above the approximate 400,000 claim level commonly associated with positive job growth. The February household labor survey continued January's favorable direction as both the labor force and employment expanded for the second consecutive month, leaving the unemployment rate unchanged at 9.7 percent. February's employment situation revealed nonfarm payroll employment fell by 36,000, noticeably better than the Bloomberg median forecast for a decline of 68,000 jobs. Serving as a possible harbinger of overall payroll gains, temporary help service payrolls have posted solid gains since October 2009, increasing an average 57,000 jobs each month. This payroll measure had been in positive territory for five consecutive months in 2003 before overall payroll employment began sustained positive growth later that year. Supporting an outlook for positive payroll gains in the next month or two are the ISM survey employment indexes, which have shown marked improvement over the past several months (Chart 3). Recent employment reports have been generally on the positive side, and the U.S job market may see a somewhat faster pace of job recovery in the quarters ahead.

Consumer Spending Edges Up, Although Households Remain Cautious

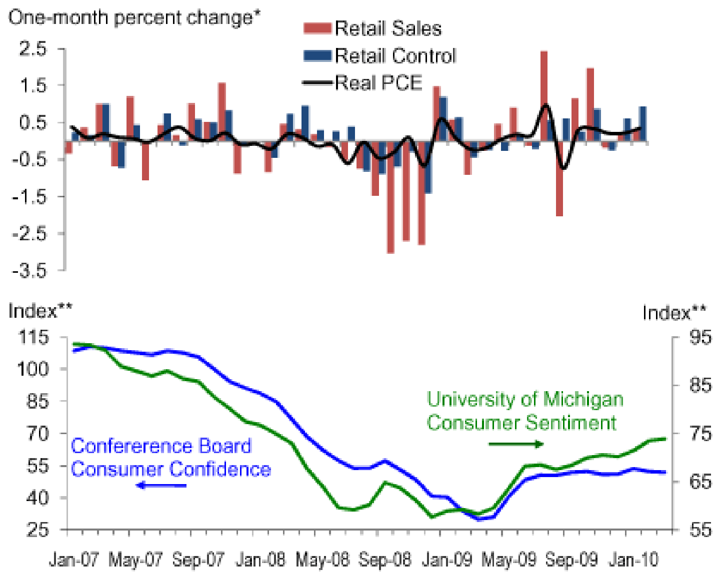
Over the past two months, the pace of consumer spending has improved from very low recessionary levels. Real personal consumption expenditures rose 0.3 percent in February, comparable to the growth realized throughout fourth quarter 2009. Similarly, nominal retail sales rose 0.3 percent, while retail control (retail sales excluding auto, gasoline station and building materials sales) rose 0.9 percent in February. However, recent measures of consumer confidence appear to be stalling out. The University of Michigan's index of consumer sentiment remained unchanged in March, and the Conference Board's index of consumer confidence rose 6.1 points in March after plunging 10.1 points in February. Overall, consumer confidence levels have not changed significantly since last summer, as the three-month moving averages of both indexes suggest that consumers cautiously await better employment and income trends (*Chart 4*). Given the guarded outlook and modest improvement in spending trends, the pace of real consumer spending suggests a moderate overall path to growth compared with previously robust, consumer-led recoveries.

Chart 3
Employment Measures Suggest Job Growth May Be Imminent



*Seasonally adjusted.
SOURCES: Bureau of Labor Statistics; Institute for Supply Management (ISM).

Chart 4
Cautious Consumers Increase Spending Modestly



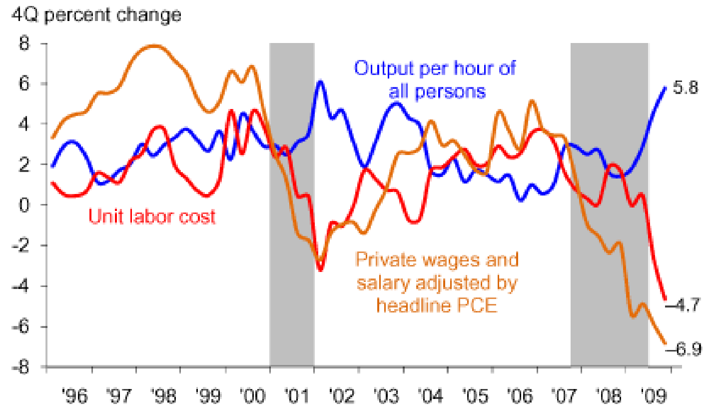
*Seasonally adjusted.
**Three-month moving average.
SOURCES: Census Bureau; Bureau of Labor Statistics; Conference Board; University of Michigan; author's calculations.

Although the housing market has stabilized some in recent months, conditions appear fragile. As the extended expiration date of the first-time homebuyer tax credit approaches, the housing supply overhang resulting from slow demand, overbuilding and a large inventory of foreclosed homes remains a drag on construction spending and household net worth. In part hurt by unusually bad weather in February, housing starts declined 5.9 percent and were joined by a 1.6 percent decline in the housing permit series. Both of these home construction measures remain at very low levels—about 73 percent from their respective January 2006 peaks. Further evidence of the vulnerability of the housing rebound to future negative payback effects has been seen in the continued decline of new- and existing-home sales, which fell 2.2 percent to a record low and 0.6 percent, respectively, in February.

Price Pressures Remain Well Contained

While the manufacturing sector has begun to exhibit strong growth trends, disinflationary producer price tendencies remain in place due to the still-low level of manufacturing activity. Furthermore, recent data indicate continued downward pressure on consumer price inflation. Core consumer prices edged up only 0.1 percent in February, decelerating to a 0.1 percent annual rate over the past three months, and are only 1.3 percent above year-ago levels. Robust core measures like the Dallas Fed Trimmed Mean PCE and Cleveland Fed Median CPI have shown continued deceleration to all-time lows on six- and 12-month bases. Household deleveraging in the face of still weak housing and labor markets has helped push labor costs and wages to record lows while prodding productivity higher over the past several quarters (*Chart 5*). Therefore, in addition to disinflationary pressures from domestic slack, the economy is seeing little upward pressure from wages on overall inflation.

Chart 5
Record Wage Disinflation Breeds Solid Productivity Gains



SOURCES: Bureau of Labor Statistics; Bureau of Economic Analysis; Department of Commerce; author's calculations.

Upside Optimism Tempered by Persistent Downside Risks

Since the January FOMC meeting, financial headwinds continued to subside, the manufacturing sector expanded further and the service sector started picking up. Although economic activity has improved since dire times a year ago, downside risks to robust growth persist as extraordinary labor market and resource slack remain to be worked off in the wake of the recent financial crisis and severe recession. In particular, sluggish employment conditions, low levels of income growth and a slow housing recovery will continue to make it very difficult for consumers to simultaneously increase spending and pay down their substantial debt overhang. As the temporary impetus from the inventory cycle and the effects of federal stimulus wane, the onus of sustained economic growth depends on established job growth and strong private sector demand. Positively, with inflation expectations and pressures well contained thus far, the nation may yet see upside risks to growth from productivity, consumer spending and business sector expansion.

—David Luttrell

About the Author

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