Economic Update

Federal Reserve Bank of Dallas

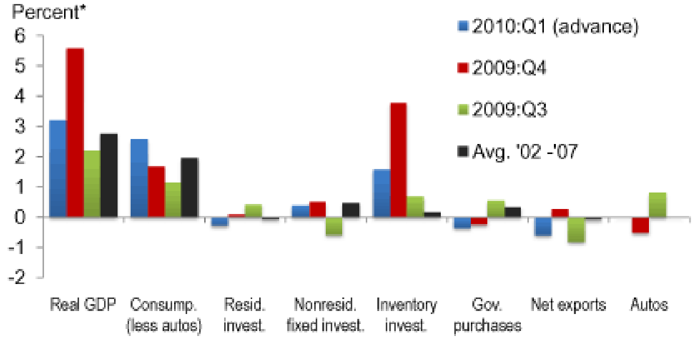
NATIONAL

Heading in the Right Direction

May 3, 2010

In first quarter 2010, real gross domestic product (GDP) grew at a 3.2 percent seasonally adjusted annualized rate, in line with Bloomberg survey expectations for a 3.3 percent increase. The initial estimate released by the Bureau of Economic Analysis showed that half of the growth was attributable to inventory investment, compared with two-thirds the previous quarter. Consumer spending accelerated to its fastest pace in three years, rising 3.6 percent from the previous quarter and contributing 2.6 percentage points to economic growth (*Chart 1*). As a result, real final sales, which exclude inventories, grew 1.6 percent—2.2 percentage points from rising domestic demand and negative 0.6 percentage point from lower net exports (imports grew more rapidly than exports).

Chart 1
Inventory Investment, Consumption Bolster Q1 GDP Growth



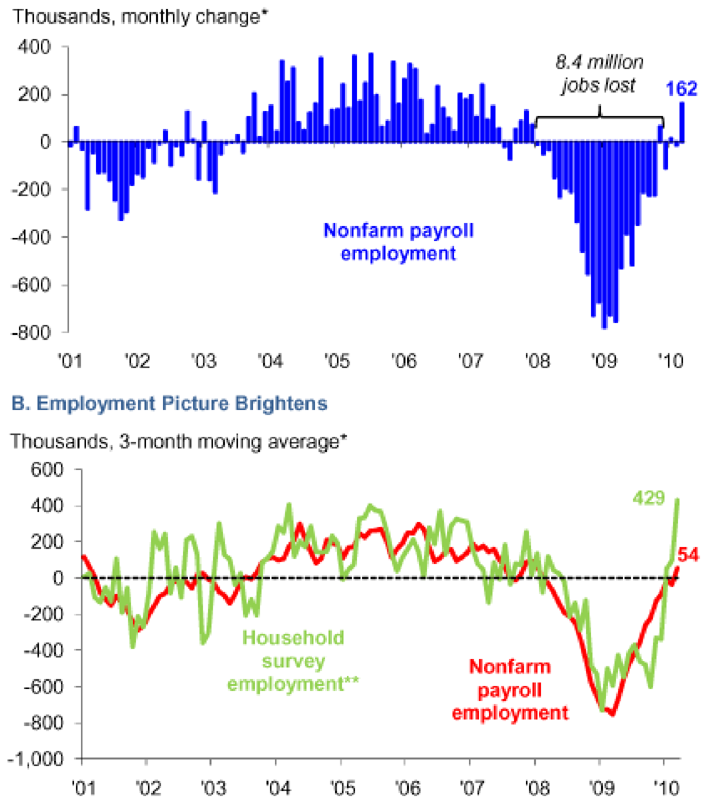
*Seasonally adjusted annualized rate.
SOURCE: Bureau of Economic Analysis.

Positive Payroll Gains

Labor market conditions have shown marked improvement. The March household labor survey found that the labor force and total employment expanded for the third consecutive month, leaving the unemployment rate unchanged at 9.7 percent. In coming months, workers will likely continue to reenter the labor market, keeping the unemployment rate relatively high and enabling employers to limit wage increases. The more comprehensive establishment survey revealed a nonfarm payroll employment increase of 162,000, including 48,000 new Census workers (*Chart 2*). Of the payroll total, 123,000 of the jobs were created in the private sector.

Overall initial claims and their four-week average have remained broadly similar to what they were in March and modestly lower than they were in February. While March employment reports brought welcome news of improvement, considerable labor slack remains. Strong payroll gains are needed for an extended period to work off normal labor force growth and the 8.4 million jobs lost since the recession began.

Chart 2
Labor Market Conditions Improve
A. March Sees Positive Payroll Gains



*Seasonally adjusted.
**Population-smoothed and adjusted to be equivalent with the nonfarm payroll survey.
SOURCE: Bureau of Labor Statistics.

Absent Confidence, Consumption Rising

Despite weak fundamental household finance conditions, the pace of consumer spending recently improved from very low recessionary levels. Real personal consumption expenditures rose 0.5 percent in March and accelerated to a 4.7 percent annual rate over the past three months, stronger than the 3.5 annualized pace seen in the fourth quarter of last year. Nominal retail sales surged 1.6 percent, while retail control (retail sales excluding auto, gasoline station and building materials sales) rose 0.5 percent in March (*Chart 3A*). However, at odds with payroll gains, stronger consumption, and stock market performance, measures of consumer confidence appear to be stalling out. Three-month moving averages of both the Conference

Board's and University of Michigan's measures of consumer sentiment suggest confidence levels have not changed significantly since last summer (*Chart 3B*).

Housing Uncertainties Persist

Although the housing market has stabilized some in recent months, conditions appear fragile. The extension of the first-time homebuyer tax credit to April 30 contributed to new- and existing-home sales rebounds in March. New-home sales surged 26.9 percent to 411,000 units, 23.8 percent above their year-ago level but still 70.4 percent below their July 2005 peak (*Chart 4*). Existing-home sales increased 6.8 percent in March to 5.35 million. Housing starts and permits both drifted higher in March as well but were 72 and 70 percent, respectively, below peak levels. Tempering any housing outlook optimism, construction spending rose just 0.2 percent in March, marking its first increase in the past five months. Construction spending has fallen 30.2 percent since peaking in March 2006, posting declines in 36 of the last 47 months. The housing rebound remains vulnerable to negative payback effects as fiscal programs such as tax credits and mortgage modifications fade.

Manufacturing Boosts Business Sector

The manufacturing sector appears to be expanding strongly from a very low level. Industrial production has been steadily improving, rising at an 8.2 percent annualized pace over the prior nine months. Manufacturing output rose 0.9 percent in March, following a 0.2 percent increase in February and 0.9 percent growth in January. Manufacturing capacity utilization rose 0.8 percentage points to 70.5 percent. Further, the March Beige Book survey indicated that manufacturing activity expanded across most of the country, with increases reported in orders, shipments and production. In April, the Institute for Supply Management (ISM) composite manufacturing index climbed 0.8 percentage points to 60.4 percent.

Although experiencing less-robust growth, the service sector also appears to be expanding. The ISM nonmanufacturing index rose 2.4 percentage points to 55.4 percent in March, indicating service-sector growth for the third consecutive month.

Business-sector trends are encouraging for the labor market and business investment as the U.S. economy begins to rebound and soak up the economic slack of the last two years.

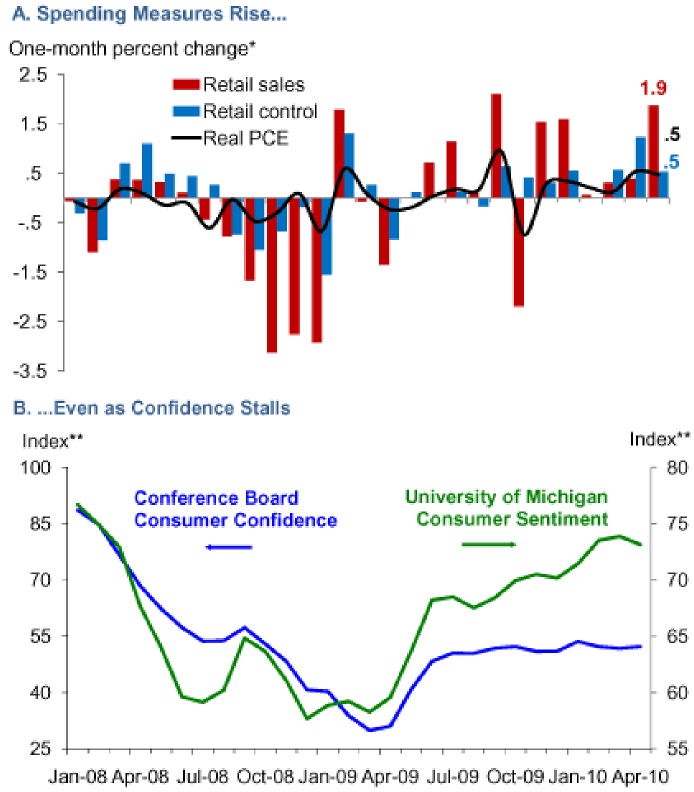
Price Pressures Remain Well Contained

In March, both headline and core measures of CPI were nearly unchanged, as a 0.1 percent increase in services prices was offset by a decline of similar magnitude in goods prices. Over the past three months, headline CPI has risen at an annualized rate of 0.9 percent, while core CPI has declined an annualized 0.2 percent.

An Upward Turn

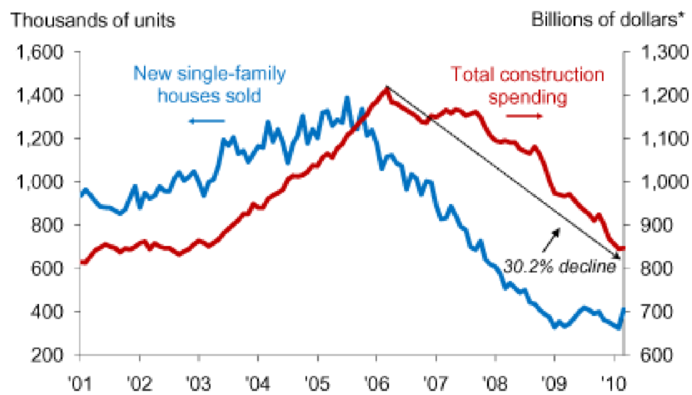
Data released in recent weeks point to a firming of the underlying pace of demand growth. Conditions in short- and long-term funding markets have largely returned to normal, inflation expectations and pressures remain well contained, business-

Chart 3
Consumers Step Up the Pace



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

Chart 4
New-Home Sales at Summer '09 Levels; Construction Spending Still Low



*Seasonally adjusted annualized rate.
SOURCES: Census Bureau; author's calculations.

sector growth continues to expand and the labor market has shown some long-awaited signs of life. Adversely, difficulties persist as households face a paradox of thrift and spending. Low levels of income growth and a slow housing recovery make it difficult for consumers to simultaneously increase spending and pay down their substantial debt overhang.

It remains to be seen whether established job growth and private-sector demand can drive a sustainable economic recovery in the place of diminishing federal stimulus and the temporary impetus of the inventory cycle. The national economy has made a turn in the right direction; however, the trajectory of growth remains unclear.

—David Luttrell

About the Author

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The Dallas Fed's National Economic Update is available online at www.dallasfed.org/research/update-us/.