EconomicUpdate NATIONAL
Federal Reserve Bank of Dallas

Slowing Pace of Growth

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Data released in the past six weeks suggest a slowing pace of growth in the national economy. In second quarter 2010, real gross domestic product (GDP) grew at a 2.4 percent seasonally adjusted, annualized rate—a significant step below first quarter's 3.7 percent pace (*Chart 1*). The advance estimate released by the Bureau of Economic Analysis showed that a full percentage point of growth was attributable to inventory investment, leaving final demand growth at a tepid 1.4 percent. Moreover, the revision to the past several years of national income and product accounts data showed that the contraction in real GDP from late 2007 to mid-2009 was deeper than previously estimated (*Chart 2*). As of second quarter 2010, real GDP now stands 1.1 percent below its fourth quarter 2007 level; in effect, the revisions set the pace of recovery back a full quarter.

Real Spending Shifts Lower and Grows Slower

As with real output, the contraction in real personal consumption expenditures (PCE) is now estimated to have been deeper—a 1.6 percent annualized decline from fourth quarter 2007 to second quarter 2009 versus the earlier estimate of a 1.2 percent annualized decline. Further, the growth rate since second quarter 2009 is now estimated at an average 1.6 percent annualized pace, a full percentage point below the prerevision growth rate (*Chart 3*). The pace of consumer spending has tapered off—real PCE growth over the three months ending in June averaged just a 0.7 percent annualized rate compared with a 2.6 percent annualized rate over the three months ending in March.

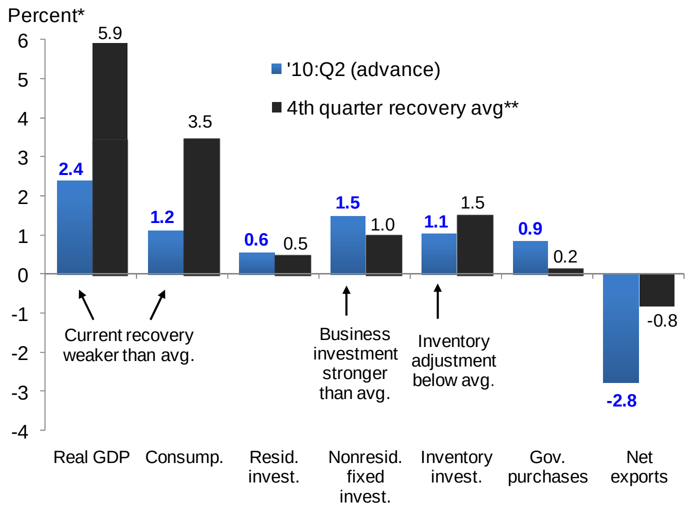
Labor Market Remains Sluggish

One possible explanation for the deceleration in consumption is the still-sluggish labor market. Private nonfarm payroll gains have increased by 630,000 jobs so far in 2010, with two-thirds of the year-to-date increase occurring in March and April. In July, private payroll employment increased by 71,000 jobs compared with June's downwardly revised 31,000 and May's 51,000 jobs. Private sector jobs have increased in eight of the past nine months, generating sustained but modest increases in employment. However, the household survey's unemployment rate remains at 9.5 percent, given three consecutive months of decline in the following measures: employment, labor force participation and the employment-to-population ratio. The labor market has yet to show sustained employment gains suggestive of a robust recovery.

Manufacturing Slows

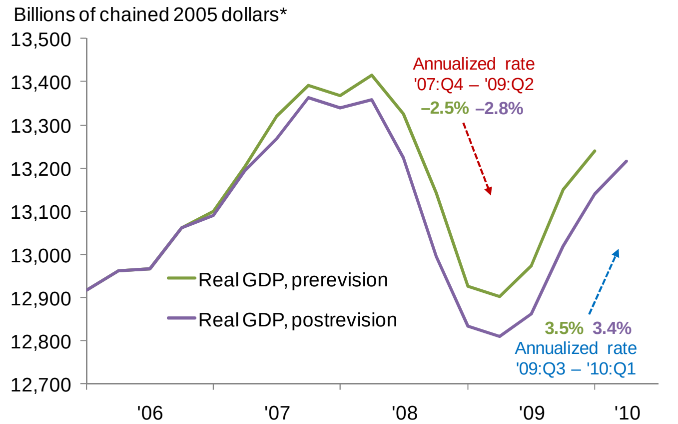
Weak final demand growth and the waning inventory cycle have slowed manufacturing sector growth as producers pare back inventories due to slower shipments. Excluding contributions to growth from inventories, final demand growth has been a modest 1.25 percent in the first half of this year. This weakness is corroborated by June's 0.4 percent decline in manufacturing output, a 4.2 point drop in the Institute for Supply Management (ISM) manufacturing index over June and July, and the slower pace of expansion indicated in the Texas manufacturing and Philadelphia Fed business outlook surveys (*Chart 4*). Buttressed by seven consecutive months of manufacturing employment gains, the manufacturing sector is expanding, but at a slower pace.

Chart 1
Less-than-Robust Recovery Growth



*Seasonally adjusted, annualized rate.
**Components' real GDP contribution in the fourth quarter after NBER-dated recession trough. Average of post-WWII recoveries excluding 1980 recession.
SOURCE: Bureau of Economic Analysis.

Chart 2
A Deeper Downturn Than Previously Estimated

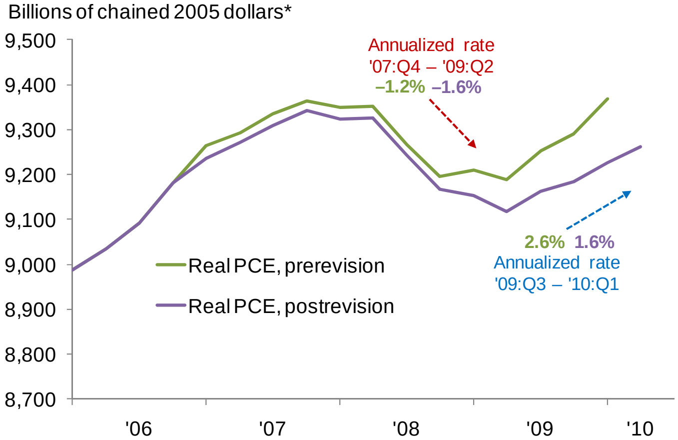


*Seasonally adjusted, annualized rate.
SOURCE: Bureau of Economic Analysis.

Strong Business Investment

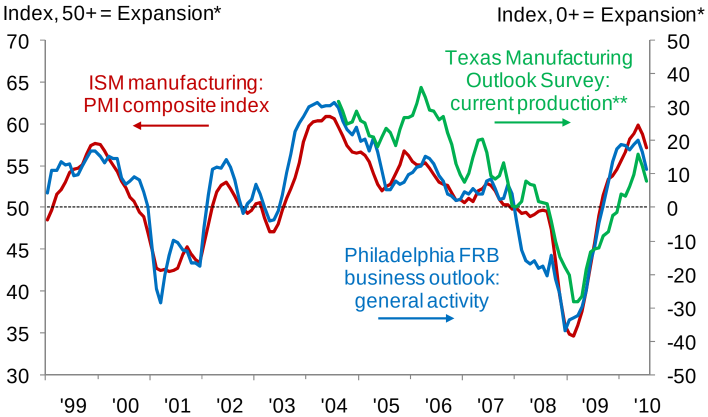
Bright spots in the current GDP release included increased contributions to output from nonresidential fixed investment, government purchases and residential investment (*see Chart 1*). Specifically, the equipment and software category of nonresidential fixed investment increased by more than a 20 percent annualized rate in the first two quarters—the strongest growth rates in a decade. Moreover, business investment seems poised to continue growing in light of recent strength in new orders for core capital goods. Will investment in new capital be the driver for

Chart 3
Real PCE Growth Revised Lower and Slower



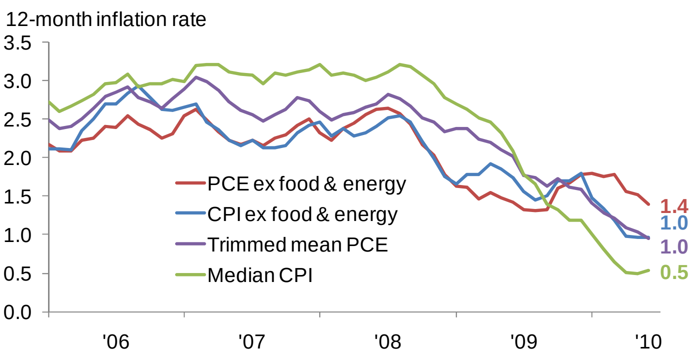
*Seasonally adjusted, annualized rate.
SOURCE: Bureau of Economic Analysis.

Chart 4
Manufacturing Indexes Suggest Slowdown



*Seasonally adjusted, three-month moving average.
**The Texas Manufacturing Outlook Survey begins in June 2004.
SOURCES: Institute for Supply Management; Federal Reserve Bank of Dallas; Federal Reserve Bank of Philadelphia.

Chart 5
Consumer Disinflation Pauses at a Low Level



SOURCES: Bureau of Labor Statistics; Bureau of Economic Analysis; Federal Reserve Bank of Dallas; Federal Reserve Bank of Cleveland.

growth going forward? Optimism should remain tempered, given the size of this component of final demand—just 10 percent of GDP. Furthermore, government purchases and residential investment contributions to growth will likely be constrained as fiscal austerity pressures mount and residential investment tax-incentive programs expire.

Net Exports Plunge

At first glance, the recent release of GDP emphatically lowered optimism regarding net exports leading the recovery. Although subject to large revisions, exports contributed roughly the same to growth as in the previous quarter, while imports *subtracted* a record 4.0 percent from final demand. Net exports are in fact likely to be revised lower, considering June's widening of the U.S. trade deficit. Stronger demand for non-U.S. goods and falling import prices relative to export prices contribute *negatively* to overall output, although such a trend may actually point to strengthening in underlying domestic demand.

Price Pressures Level Off for Now

Falling energy prices have kept headline PCE inflation in negative territory for three consecutive months. Given more recent movements in the price of gasoline, this trend will likely be broken. Meanwhile, core consumer inflation measures appear to be stabilizing (*Chart 5*). This pause in core disinflation reflects a steady pickup in growth rates for rent and owners' equivalent rent so far this year.

Growth Trajectory Slows

The economy remains on track to continue to expand, though the second half of 2010 will likely be characterized by slowing growth and subdued underlying inflation. U.S. households and businesses remain cautious, partly restrained by uncertainty regarding fiscal and regulatory policy. Though immediate financial market frictions appear to have abated with the improved sentiment concerning European sovereign debt and banking issues, the outlook for investment confidence remains vulnerable to a fragile economic recovery. 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.

—David Luttrell and Tyler Atkinson

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About the Authors

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