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Slowly Returning to 'Normal': The Near-Term Outlook Improves

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The outlook for U.S. gross domestic product (GDP) growth has firmed, probably to a 3 to 4 percent range for fourth quarter 2010 and 2011. Upside factors seem likely to outweigh downside factors. Gradual improvements in credit availability, solid consumer spending, moderate job creation and less uncertainty about new regulations and taxes should work to reinforce the economic recovery. Downside risks remain, mostly in the form of drags from housing, state and local finance, and uncertain financial spillover from the euro debt crisis.

Financial Frictions

Unusual financial frictions contributed to the recession and lackluster recovery, but they are abating, as they have done since second quarter 2010. The unusual weakness in the recovery may partly owe to higher risk premiums in securities markets that make direct financing more costly and less accessible than usual. This can be seen in above-normal spreads between interest rates on Baa-rated corporate and 10-year Treasury bonds (*Chart 1*). Prior to the recession trough, this spread was much wider than seen in other recessions, and it is still about 80 basis points above the average for six of the last seven recessions.[1]

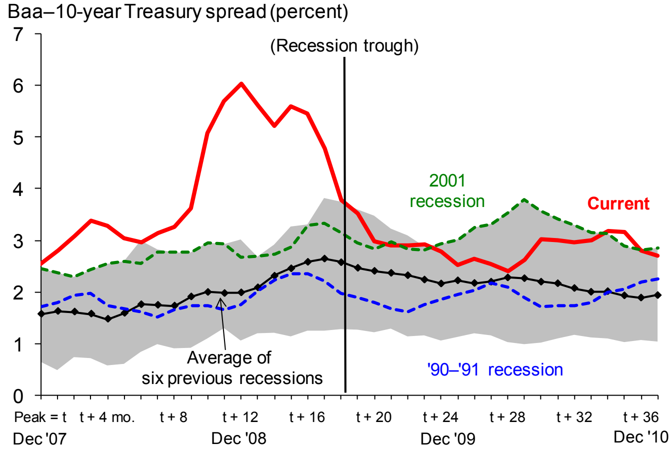
Contributing to the tepid nature of the current recovery, risk premiums in various securities markets remain vulnerable to euro-area debt troubles, though less so than in mid-2010. Stock prices have recovered to levels preceding Lehman's collapse, and various medium- and long-run inflation risk premiums have returned to precrisis levels. Real bond yields and corporate rates have also moved higher. Real rates are returning to ranges that prevailed from the mid-1980s to early 2000s, an arguably more normal time, before the arrival of unusually low risk premiums in the mid-2000s that accompanied the euphoria of the structured finance boom. Revisiting levels associated with a less recession-panicked and stressed psychology may be reflective of expectations that the U.S. economy will return to normal, albeit over a long period.

Some Strength to Build On

Several sectors of the real economy have begun to show clear positive momentum. The underlying pace of consumer spending was healthy at the end of 2010, rising notably in October and November, before the coldest winter since 1985 boosted heating bills and likely deterred even more shopping. Retail sales increased 0.6 percent in December after surging 0.8 percent in November. Excluding autos, sales rose 0.5 percent, following a 1 percent jump in November. This strong growth around the turn of the year should be viewed with the caveat that the data are subject to sizable revisions in December and January due to large seasonal factors, difficulties tracking nonstore retail sales, and the timing of gift card purchases.

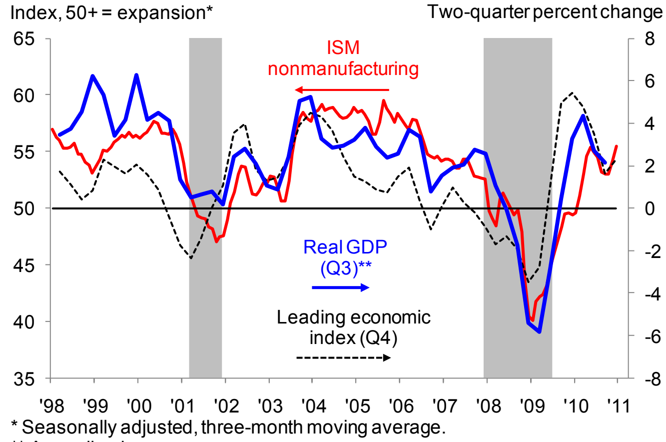
Consumer credit availability has gradually improved, helping bolster underlying trends in consumer durables excluding transportation and aircraft orders.[2] Other data show that GDP growth may be firming. For example, both the Conference Board's index of leading economic indicators and the Institute for Supply Management (ISM) nonmanufacturing composite index point to a near-term pickup in GDP growth (*Chart 2*). However, the leading indicators have been less reliable in the recent cycle, suggesting a more normal downturn and recovery than the decline and subsequent rebound seen in the actual GDP data.

Chart 1
Corporate Bond Premiums Still at Recessionary Levels



NOTE: Shaded area indicates range of previous six recessions, excluding the 1980 recession.
SOURCES: National Bureau of Economic Research; Federal Reserve Board; author's calculations.

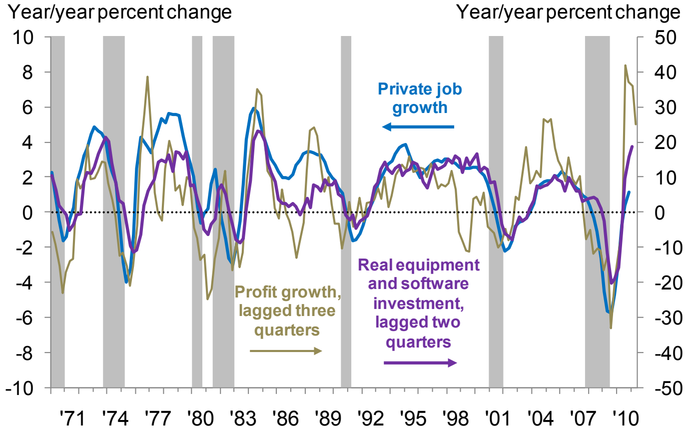
Chart 2
Grounds for Growth Strengthen



* Seasonally adjusted, three-month moving average.
** Annualized.
SOURCES: Institute for Supply Management; Bureau of Economic Analysis; Conference Board; author's calculations.

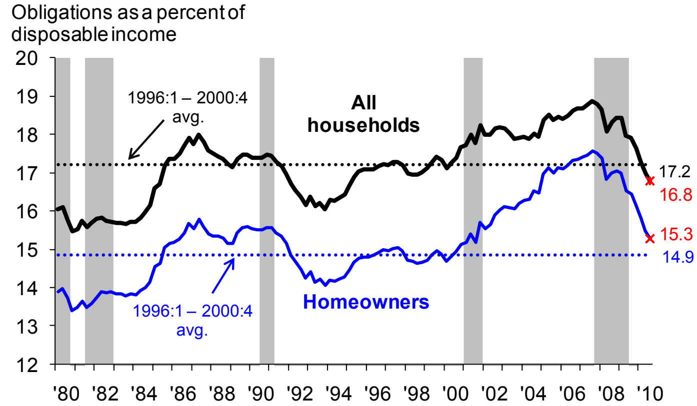
Manufacturing output resumed its 4 percent annualized growth pace in the fourth quarter after nearly stalling out in the third quarter. Industrial production jumped 0.8 percent in December, led by a 4.3 percent surge in utility output associated with the unusually cold winter weather. The

Chart 3
Profits and Investment Surge, Job Growth Lags



NOTE: Gray bars indicate recessions.
SOURCES: Bureau of Economic Analysis; Bureau of Labor Statistics.

Chart 4
Households Continue to Deleverage



NOTE: Gray bars indicate recessions.
SOURCE: Federal Reserve Board.

manufacturing component rose 0.4 percent in December, up from a 0.3 percent gain in November. The ISM manufacturing composite and new orders readings for January confirm the strengthening in manufacturing growth after a summer pause.

The Belabored Recovery

Relative to historical patterns, private payrolls have recovered more slowly on a year-over-year basis than have business equipment investment and corporate profits (*Chart 3*). This deviation may reflect business reactions to uncertainties about future staffing needs emanating from health care reform and globalization trends. In addition to the cyclical behavior of labor productivity, the rise of information technology has encouraged substitution of labor with capital, contributing to this cycle's high excess capacity and labor market slack. A near-term pickup in job growth is likely, though the subpar performance of payroll increases in the early phases of the recovery suggests that the pickup may fail to significantly impact unemployment figures or impart robust output growth.

Remaining Headwinds and Uncertainties

Tighter credit standards and reduced demand have likely both contributed to household deleveraging. Although there are several ways of gauging household debt burdens, the Federal Reserve Board's financial obligations ratio (FOR) is a relatively straightforward measure.[3] The FOR rose notably during the subprime boom but has dropped 2 percentage points since 2007, reflecting lower consumer demand, the write-down of bad loans, tighter credit standards, and regulatory changes. It appears that a large portion of the fallback in the FOR is over, though new regulations and a different credit climate make it unclear when and where the FOR will bottom out (*Chart 4*).

Data released since December's Federal Open Market Committee meeting have generally indicated a weak housing market, with some relative improvement in the trajectory of home sales. During the housing boom, residential construction grew far above the need to replace depreciation and meet population growth. The resulting oversupply of homes and the effect of probable further price declines reveal residential construction as a foundering engine of economic growth.[4]

Other notable downside risks to the economic outlook involve challenges facing government finance. Possible spillover of Europe's debt crisis into U.S. risk premiums, or any type of euro-zone slowdown, might limit U.S. growth. But there are also stresses on government finance within the nation's borders. Exacerbating continued cuts in state and local spending is the pull-forward effect of municipal issuance, given December's expiration of the Build America Bonds program. This program subsidized infrastructure spending, and its expiration may slow municipal spending after 2011 because many states had moved up issuance of these bonds to fund future projects. Further, outsized state budget deficits have led to elevated credit default swap spreads and borrowing costs for states with large budget shortfalls.

Conditions Favor Growth

Recent data indicate that the risks of a double-dip recession and deflation have ebbed. Although the regenerating channels of credit and finance remain vulnerable to shocks, renewed signs of a self-sustaining recovery in consumer and business spending are growing as the underlying factors behind the recession and subpar recovery continue to unwind. While housing, municipal finance and labor market slack continue to detract from a more robust recovery, the near-term outlook has improved.

—David Luttrell

About the Author

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Notes

1. Because of the short cycle after the 1980 recession, it is difficult to make comparisons with the current cycle; therefore, the 1980 downturn is omitted from these calculations.
2. Consumer credit standards have been gradually improving, as seen in the Federal Reserve Board's Senior Loan Officer Opinion Survey and Beige Book commentary. For an interesting methodology of consumer credit availability, see "Credit, Housing Collateral and Consumption: Evidence from the U.K., Japan and the U.S.," by Janine Aron, John V. Duca, John Muellbauer, Keiko Murata and Anthony Murphy, Federal Reserve Bank of Dallas Working Paper no. 1002, May 2010.
3. For more information on the financial obligations ratio, see www.federalreserve.gov/releases/housedebt/default.htm.
4. See "The Fallacy of a Pain-Free Path to a Healthy Housing Market," by Danielle DiMartino Booth and David Luttrell, Federal Reserve Bank of Dallas *Economic Letter*, vol. 5, no. 14, 2010.