EconomicUpdate NATIONAL

Federal Reserve Bank of Dallas

News Is Positive at Home, but Europe Looms

December 16, 2011

Since the November Federal Open Market Committee (FOMC) meeting, the economic recovery has been subject to both positive and negative forces. Fears of deflation and excessive inflation continue to subside, with measures of inflation expectations converging at 2 percent. Home prices appear to have stabilized, and private employment figures have undergone positive revisions. In contrast, real gross domestic product (GDP) growth for the third quarter was revised downward to an annualized 2 percent from the initial release of 2.5 percent, and the economy faces downside risks from the situation in Europe.

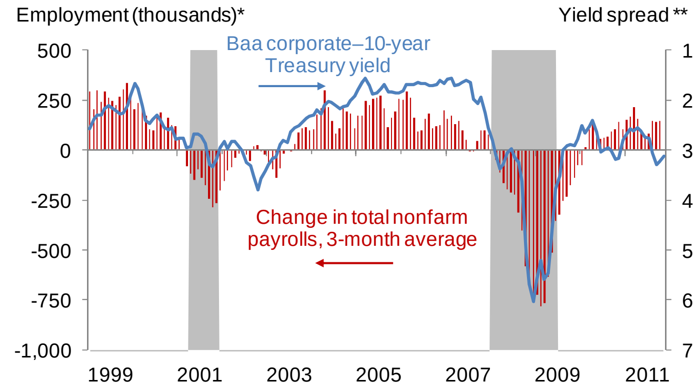
Corporate Bond Risk Premia Slightly Elevated

While the Baa–10-year Treasury spread remains above 300 basis points and payroll growth remains modest, the latest data show improvement. The sustained strong job growth of the mid-2000s coincided with a Baa–10-year Treasury spread of below 200 basis points for an extended period (*Chart 1*). Only when the Baa–Treasury spread falls to around 250 basis points or less is there a tendency for job growth to rise in a manner that brings down the unemployment rate. This spread widened following the first Greek crisis of 2010 and the second flare-up in the summer of 2011. In November, the spread reversed its upward trend. Private nonfarm payroll growth did not gain sustained momentum. Thus, a great deal of economic slack remains.

Negative Revisions to Third-Quarter GDP

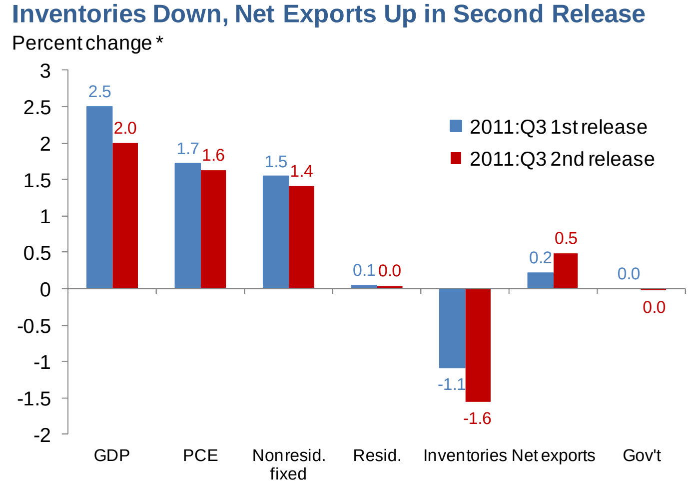
Real GDP growth in the third quarter was revised down from 2.5 percent in the first release to 2 percent in the second (*Chart 2*). Much of the revision stems from inventory investment. Anecdotal information reveals that many firms intentionally destocked inventory in September and October amid heightened uncertainty following the extension of the Treasury debt ceiling and surrounding the economic fallout of the euro crisis. On a positive note, net exports underwent a substantial upward revision. Small downward revisions of about 0.1 percentage points were made to contributions from personal consumption expenditures (PCE) and nonresidential fixed investment.

Chart 1
Yield Spreads and Private Employment Encouraging



* Seasonally adjusted and census adjusted.
** Inverted scale.
NOTE: Shaded areas indicate recession.
SOURCES: Bureau of Labor Statistics; Federal Reserve Board.

Chart 2
Inventories Down, Net Exports Up in Second Release



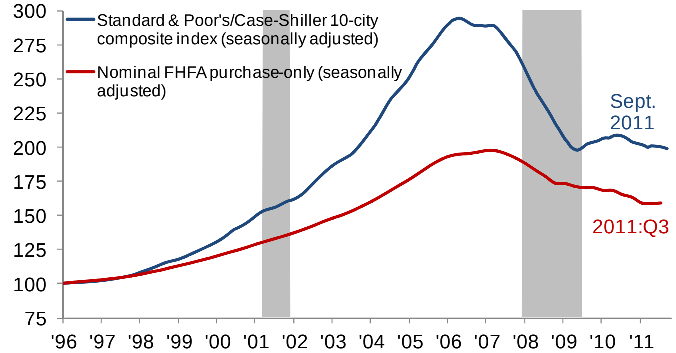
* Quarter/quarter, annualized.
SOURCE: Bureau of Economic Analysis.

House Prices Bottoming Out, Stabilizing Consumption

Recent data suggest we are seeing the first tentative signs of housing-sector stabilization—albeit slow and well below expectations during a recovery. Some seasonally adjusted house price indexes appear to have hit bottom in the third quarter (*Chart 3*). The Federal Housing Finance Agency (FHFA) index seems poised to re-

Chart 3
House Prices Show Signs of Stabilizing

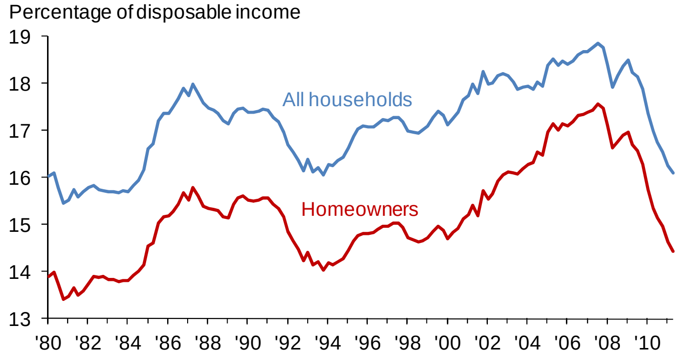
Index, January 1996 = 100



NOTE: Shaded areas indicate recession.
SOURCES: Standard & Poor's, Fiserv and MacroMarkets; Federal Housing Finance Agency.

Chart 4
Financial Obligations Ratios Nearly Back to Post-1979 Lows

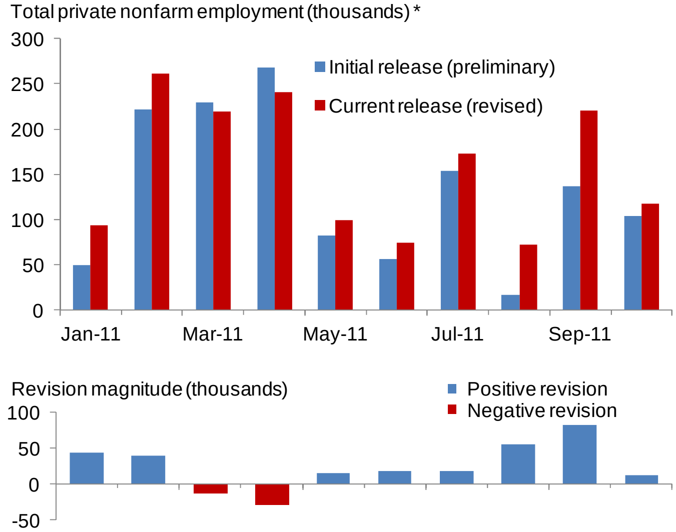
Percentage of disposable income



SOURCE: Federal Reserve Board.

Chart 5
Private Nonfarm Payroll Revisions Positive in Recent Months

Total private nonfarm employment (thousands)*



* Month/month change.
SOURCE: Bureau of Labor Statistics.

verse trend and turn up. The Standard & Poor's/Case-Shiller index is still trending down slightly, but this index is a less-robust measure, based on data from only 10 metro areas. Furthermore, the household sector saw delinquent-loan and early-stage foreclosure rates ebb in mid-2011. Debt-to-income ratios are still elevated; they have been receding, but some of this improvement can be attributed to lenders writing down mortgage debt at unusually high levels. Improvements in household debt burdens positively impact consumer spending by affecting both housing-related consumption and—via net wealth and liquidity effects—overall consumption. In the same vein, financial obligations ratios (FOR) suggest de-levering may be nearing an end, with these ratios nearly back to post-1979 lows (*Chart 4*). The decline reflects increased write-downs on and paying off of mortgage debt, amplified by lower interest rates across the maturity spectrum.

Employment Growth Underestimated

Another positive note is the sustained pattern of upward revisions to payrolls seen in the six months ending in October (*Chart 5*). Private payrolls picked up by 140,000 in November (initial release), leading to year-to-date gains of 1.71 million. Initial claims for unemployment had trended lower to levels consistent with November's mild payroll gains; however, claims remain elevated, and upticks since mid-November might be early signs of drag from the euro crisis. The composition of payroll growth for November shows that a rise in service jobs extended beyond the usual contributors of health, education and temporary services to retail trade, leisure, hospitality and even financial activities.

Core Inflation Recedes; Inflation Expectations More Centered

All three inflation gauges overshot 2 percent in the third quarter on a six-month basis but decelerated and posted notable declines in October. The three major measures of underlying consumer inflation have trended up toward 2 percent from recent lows on a year-over-year basis (core Consumer Price Index, 2.1 percent; core PCE, 1.7 percent; and Trimmed Mean PCE, 1.8 percent). A decline in energy prices partially reversed the larger October jumps in energy and helped lower the overall Producer Price Index. The distribution of expectations of the PCE price index from the Survey of Professional Forecasters (SPF) also has become more centered at 2 percent. This can be seen by looking at how the frequency distribution of forecasts has evolved over the last four SPF surveys, comparing the tails of the distribution in fourth quarter 2011 to the previous quarters (*Chart 6*). When expectations are centered, they are closer to the mean, indicating that fewer forecasters think disinflation or inflation is likely.

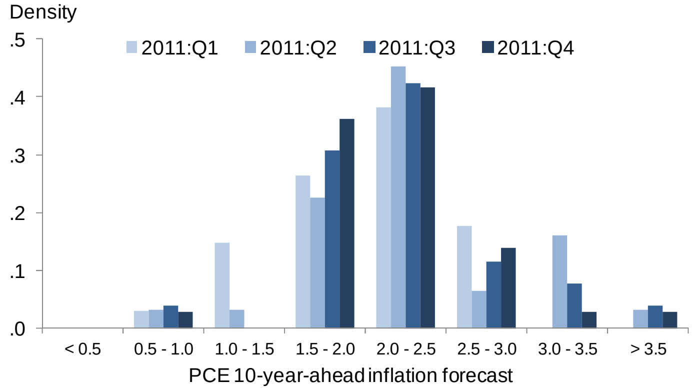
While economic data have been positive on balance since the November FOMC meeting, downside risks remain. One positive sign is that housing markets have shown tentative signs of stabilization. While labor market conditions have been mediocre, the sector has benefited from positive data revisions. On the downside, financial markets have been volatile due to swings in confidence about resolving the widening European debt crisis. Much will depend upon whether the euro area will credibly and quickly resolve the solvency and other structural challenges it faces.

—Christoffer Koch and J.B. Cooke

About the Authors

Koch is a research economist and Cooke is a research assistant in the Research Department of the Federal Reserve Bank of Dallas.

Chart 6
Inflation Expectations Increasingly Centered



NOTE: When expectations are centered, they are closer to the mean, indicating that fewer forecasters think disinflation or inflation is likely.
SOURCE: Survey of Professional Forecasters.