EconomicUpdate NATIONAL
Federal Reserve Bank of Dallas

Tempered by High Oil Prices, Recent Data Encouraging

March 19, 2012

The majority of recent data releases have been positive. Notably, the three-month moving average of the change in U.S. payroll employment is its strongest since 2006. The positive news has improved the outlook for gross domestic product (GDP), which the Survey of Professional Forecasters (SPF) now projects will grow at a moderate rate of 2.3 percent in 2012 and a more robust rate of about 2.7 percent in 2013. Levels of risk appetite have increased as policy uncertainty has fallen. The housing market is bottoming out as nondistressed house prices are stabilizing. Despite the good news, a noteworthy obstacle to growth comes from higher oil prices. Meanwhile, uncertainty associated with the European sovereign debt crisis remains a hindrance to more robust global growth.

Steady Improvement in the Labor Market

The most promising data come from the labor market, where conditions continue to improve even though the unemployment rate remains high. Nonfarm private payroll employment has risen at a moderately brisk pace since November (*Chart 1*). Both the November and December employment numbers were upwardly revised, leading to stronger-than-anticipated employment growth. January employment was strong, coming in at 285,000 jobs, followed by 233,000 jobs in February.

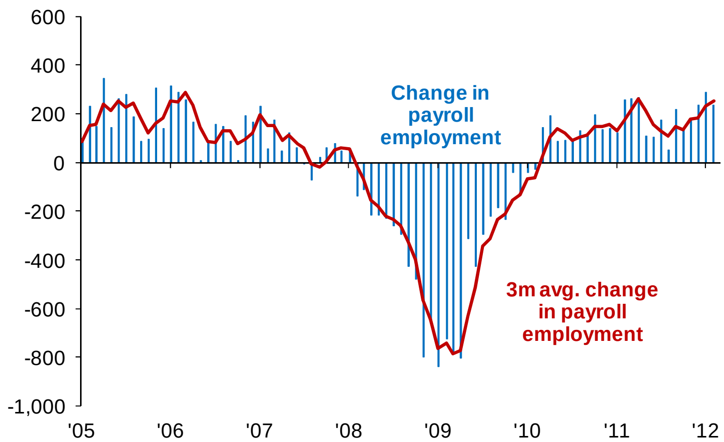
GDP Growth Forecasts Improved

The 1.7 percent GDP growth in 2011, following 3 percent growth in 2010, was "uneven and modest" (see the Semiannual Monetary Policy Report to the Congress by Fed Chairman Ben Bernanke). However, perhaps due to recent strength in the labor market, the SPF and Blue Chip forecasts of growth in 2012 and 2013 are more robust (*Chart 2*). The modest and uneven growth rate in 2011 reflects the Japanese tsunami, the floods in Thailand, the uncertainty surrounding the Arab Spring uprisings and the European sovereign debt crisis. On the domestic front, the debt-ceiling negotiations of late summer also generated considerable uncertainty. In the absence of such adverse shocks, GDP is poised to grow at a more respectable rate the next couple years.

How Will High Oil Prices Affect Inflation?

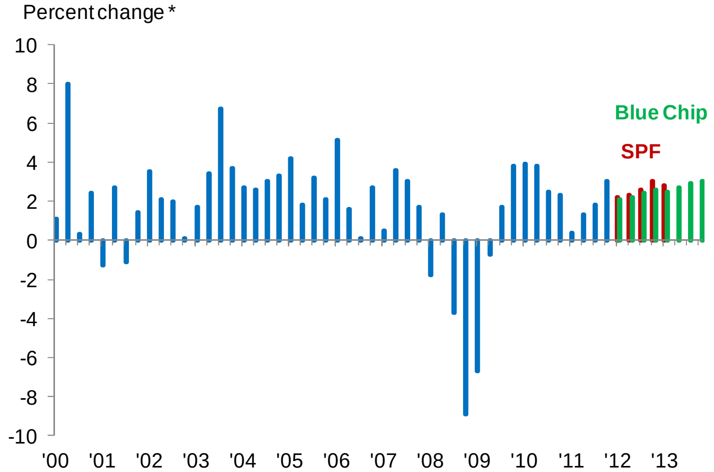
While oil prices have had only temporary effects on headline personal consumption expenditures (PCE) and muted

Chart 1
Nonfarm Private Payroll Employment on Upward Trend



* Seasonally adjusted.
SOURCE: Bureau of Labor Statistics.

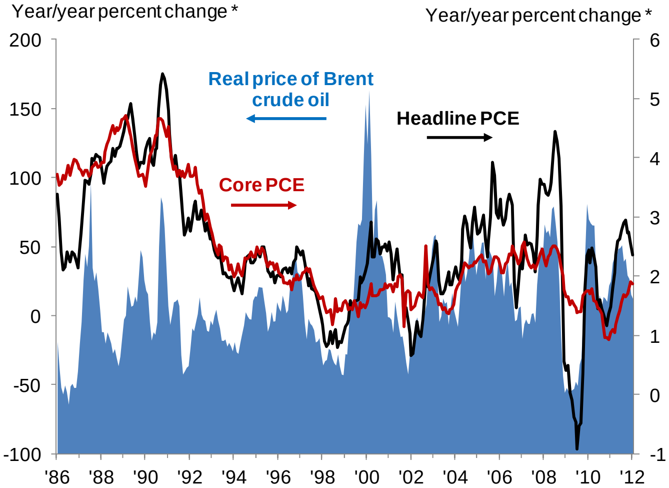
Chart 2
GDP Growth Projected to Increase



* Seasonally adjusted, annualized rate.
SOURCES: Bureau of Economic Analysis; Federal Reserve Bank of Philadelphia Survey of Professional Forecasters (SPF); Blue Chip Economic Indicators.

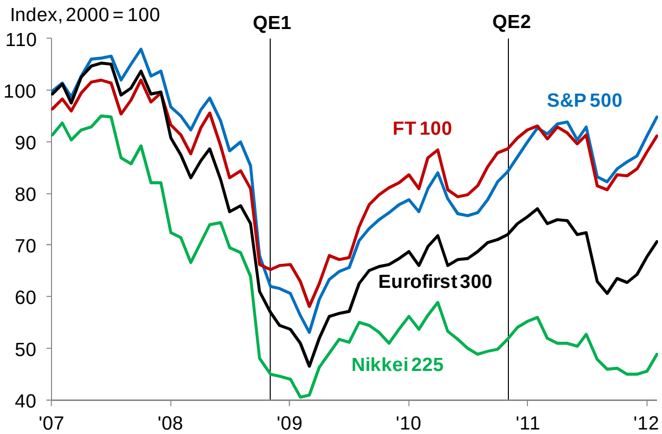
pass-through to core PCE inflation since the Great Moderation (*Chart 3*), oil prices are a concern going into 2012 because sustained high prices would create headwinds for economic growth. Precautionary oil demand shocks, driven by rising geopolitical risks in the Middle East, appear to be the main reason for the recent steep rise in prices. Temporary supply shocks may be playing

Chart 3
Oil Prices Have Little Effect on Core Inflation



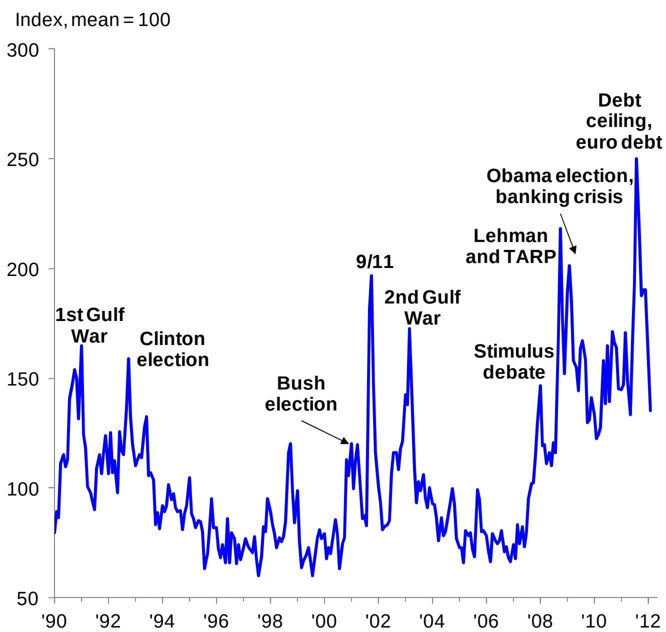
* Seasonally adjusted.
SOURCES: *Wall Street Journal*; Bureau of Economic Analysis.

Chart 4
Stock Market Continues Recent Surge



NOTE: QE1 and QE2 point to the start of the first and second rounds of the Federal Reserve's quantitative easing policy.
SOURCES: *Wall Street Journal*; *Financial Times*.

Chart 5
Index of Economic Policy Uncertainty Is Declining



SOURCE: Stanford University.

a role as well. High energy prices act as a tax hike, lowering consumers' discretionary income. Gasoline prices have gone up by more than 50 cents year to date, and oil prices threaten to jump even higher due to supply constraints. The price hike may directly reduce spending on discretionary items and negatively influence the confidence of households and businesses.

Financial Markets Strong

Despite the sharp rise in oil prices, an overall improvement in sentiment toward the U.S. and euro zone economies has boosted equity prices. The S&P 500 Index has already increased roughly 11 percent year to date, while the Eurofirst 300 Index is up almost 10 percent (*Chart 4*). This improvement in sentiment can be attributed to greater risk appetite. The decline in economic policy uncertainty has also contributed to the equity price surge.

Policy Uncertainty Coming Down from High Levels

Uncertainty with regard to economic policy is still high, but it is declining (*Chart 5*). Economists have long recognized the damaging impact of uncertainty on economic activity and growth. The index of economic policy uncertainty averages several components: the frequency of references to policy uncertainty in the media, the number of federal tax code provisions set to expire in future years, and the extent of forecaster uncertainty over future inflation and federal government purchases. The index suggests that an increase in policy uncertainty as big as the actual change between 2006 and 2011 would portend a large and persistent decline in aggregate economic activity. Index values have been very high in recent years, with clear jumps around the Lehman bankruptcy, the euro zone crisis and the U.S. debt-ceiling dispute. However, the index has declined since peaking in August 2011. The next test may be around the corner as the presidential election approaches in November.

House Prices At or Near Bottom

As the uncertainty in economic policy ebbs, the housing market appears to have finally bottomed out. National house price indexes reflect different home compositions. For example, the Federal Housing Finance Agency (FHFA) index excludes the prices of homes at the upper and lower ends of the market, while the CoreLogic indexes include these prices. The indexes display somewhat different trends recently (*Chart 6*). Unlike the CoreLogic indexes, the FHFA index has leveled off and appears ready to turn up. While prices stabilize, housing starts and sales are beginning to rise slowly.

A steady stream of good news is likely to be tempered by the escalation in oil prices. Because the increase is mainly the result of a precautionary oil demand shock, driven by rising geopolitical risks in the Middle East, the macroeconomic effects of the shock should be short-lived. Despite high oil prices, inflation expectations are well-anchored, implying inflation should run at or below the 2 percent rate targeted by the Federal Open Market Committee. As the labor market, the stock market, policy uncertainty and the housing market continue to improve, a slight pickup in the modest recovery seems to be on the horizon.

—J.B. Cooke

About the Author

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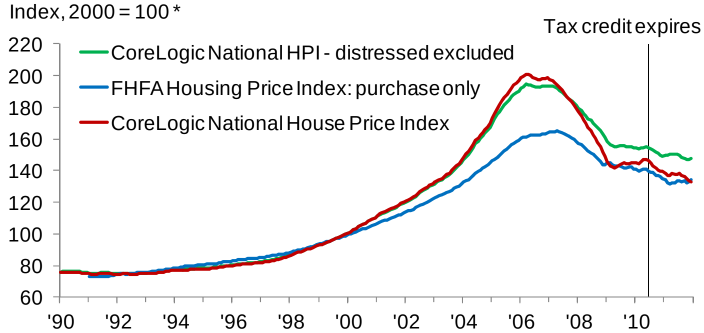
Chart 6
House Prices Preparing to Turn the Corner



* Seasonally adjusted.
SOURCES: Federal Housing Finance Agency; CoreLogic.