DALLASFED Economic Update

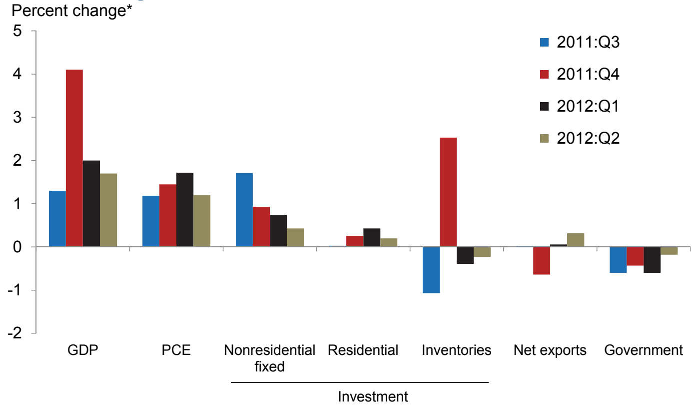
National

Housing Rebounds, but Forward-Looking Indicators Cause Concern

September 17, 2012

Data released since the August Federal Open Market Committee (FOMC) meeting indicate that economic growth may have firmed, but at the same time, forward-looking indicators may portend stalling growth. Real gross domestic product (GDP) grew at a 1.7 percent annual rate in second quarter 2012. Contributors to recent growth have been improvements in housing and slight improvements in the labor market. Although manufacturing production also had picked up, more timely survey data had foreshadowed a decline for a few months. The August manufacturing data exhibited this drop. Inflationary pressures remain subdued.

Chart 1
PCE, Housing Contribute to GDP Growth
Percent change*

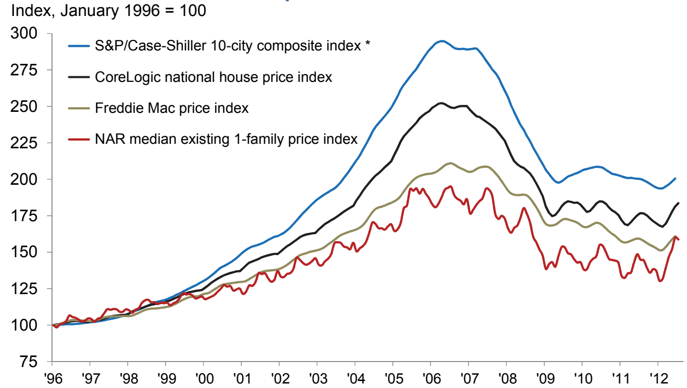


* Seasonally adjusted, annualized rate.
SOURCE: Bureau of Economic Analysis.

Net Exports Drive Upward Revision of GDP Growth

Second-quarter real GDP growth was revised up to 1.7 percent from the advanced reading of 1.5 percent (*Chart 1*). The greatest contribution came from personal consumption expenditures (PCE), coming in at 1.2 percent, supported in part by progress in the housing market. Growth in business nonresidential fixed investment has slowed over the past four quarters, adding 0.4 percent, while an increase in residential investment was offset by a negative contribution from inventories. Net exports contributed 0.3 percent to GDP growth, an upward revision of 0.6 percent from the advanced reading. Government continues to be a drag on the economy, taking 0.2 percent off real GDP growth in the second quarter; yet, this drag has lessened. The upward revision of second-quarter GDP growth can be attributed primarily to the large, positive revision of the contribution of net exports; however, the largest contributor to overall growth, PCE, was largely driven by the noteworthy improvement in the housing market.

Chart 2
House Price Indexes Turn Up in Summer 2012
Index, January 1996 = 100



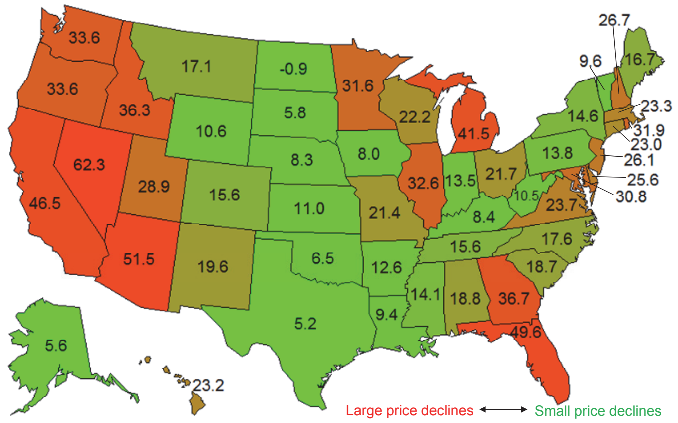
* Seasonally adjusted.
SOURCES: Standard & Poor's, Fiserv, and Macromarkets LLC; CoreLogic; Federal Home Loan Mortgage Corporation; National Association of Realtors.

House Prices Showing Signs of an Uptake

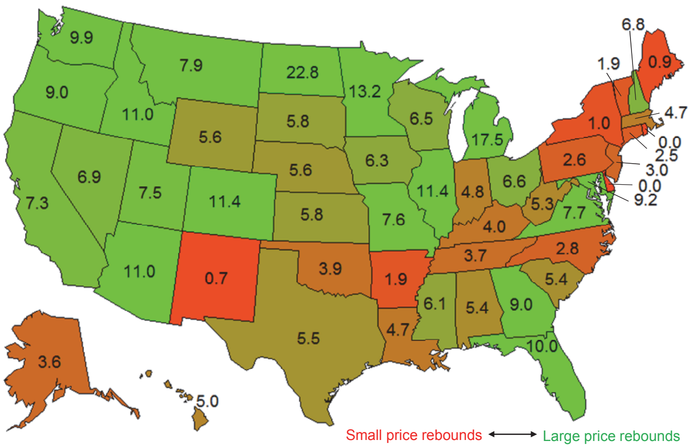
Positive news continues to come out of the housing sector. House prices seem to have bottomed out, posting broad-based gains recently. Major house price indexes flattened at the beginning of 2012 and then increased over the summer, exhibiting year-over-year growth in the most recent readings (*Chart 2*).

Chart 3A displays the peak-to-trough house price decline for each state during the housing bust (note that North Dakota did not experience a house price decline). The five colors denote quintiles, with red states suffering the largest declines and green states being only mildly affected. The declines were concentrated on the coasts, especially in the Southwest and Florida. Many of the red states are now experiencing the greatest house price gains as their housing markets recover. Chart 3B shows the increase in house prices since prices bottomed out in

Chart 3
House Prices Recover, Especially on Coasts
A. House Price Declines (in percent)

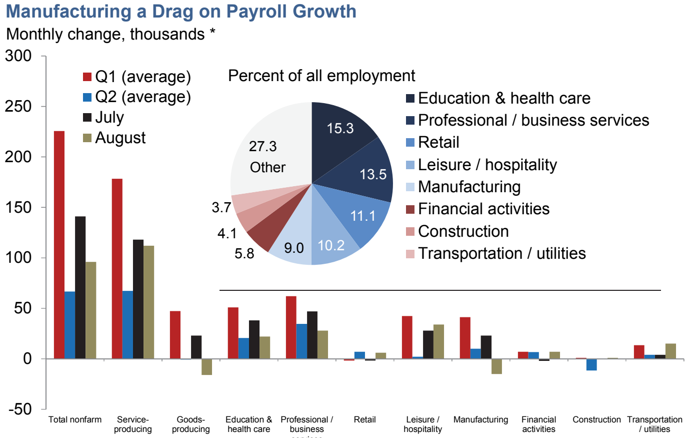


B. House Price Rebounds (in percent)



SOURCE: Federal Home Loan Mortgage Corporation.

Chart 4
Manufacturing a Drag on Payroll Growth



* Average monthly change for the first and second quarter, seasonally adjusted.
SOURCE: Bureau of Labor Statistics.

each state through the June data release. Notably, house prices in Rhode Island and Delaware have yet to bottom out, and North Dakota's large increase follows no decline in house prices. Increases in house prices will improve the balance sheets of households, leading to an increase in spending and a declining unemployment rate. A map of recent changes in the unemployment rate would reveal a correlation between the improvements in unemployment rates and recovery in house prices by state.

Slight Improvement in Nonfarm Payrolls

After a very weak second quarter (average monthly increase of 67,000 jobs) and a positive surprise from the July employment report (141,000 jobs), total nonfarm payrolls increased by only 96,000 jobs in August (*Chart 4*). In private services the biggest employment gains were in leisure and hospitality (34,000 jobs), professional and business services (28,000 jobs), and education and health services (22,000 jobs), which combined to account for three quarters of all gains in service-producing employment. The notable decline in August manufacturing employment in conjunction with recent survey data from the Institute for Supply Management (ISM) were leading indicators of the decline in manufacturing production observed in August.

Manufacturing Production Turning Down

After rising robustly in early 2012, manufacturing production slowed considerably (*Chart 5*) just as the contribution of business nonresidential fixed investment to real GDP growth continued to trend down. The positive July reading temporarily alleviated concern about an immediate, more substantive slowdown; however, a number of red flags had already been raised. Weakness in both the August manufacturing employment data and the ISM manufacturing index were causes for concern; the ISM manufacturing index registered a sub-50 reading for three straight months, indicating below-trend growth. The large drop in manufacturing output that was feared materialized in the August report.

Prices Decelerating Slightly

Price pressures have been subdued in July and August. Core prices have been very stable, though there has been slight deceleration recently. Core PCE measures are below the FOMC's 2 percent target, while the core consumer price index (CPI) inflation reading dipped below this target for the first time in nearly a year (*Chart 6*). Headline inflation has receded, but some increases in food prices will likely manifest in slightly higher headline inflation in 2013. Import prices continue to fall on a year-over-year basis, possibly leading the deceleration in core inflation. Inflation expectations remain well-anchored.

Economic growth may have firmed from a modest starting pace below 2 percent. The trade balance improved substantially, contributing positively to the second-quarter GDP reading. The improvement in the housing market has also been a key driver of growth and looks to continue to be so. The labor market is still operating with high levels of unemployment and underemployment. Nonfarm payrolls have picked up from the slow pace of the second quarter, though August's employment numbers were disappointing following July's report. The outlook for business investment has softened as ISM readings and manufacturing production have weakened. Inflationary pressures remain subdued amid disinflationary risks as core price indexes decelerate. Looking ahead, the central tendency forecast for U.S. real GDP growth for 2012 is between 1.7 and 2.0 percent; the forecast for 2013 improved to between 2.5 and 3.0 percent, according to the FOMC's survey of economic projections.

—J.B. Cooke

About the Author

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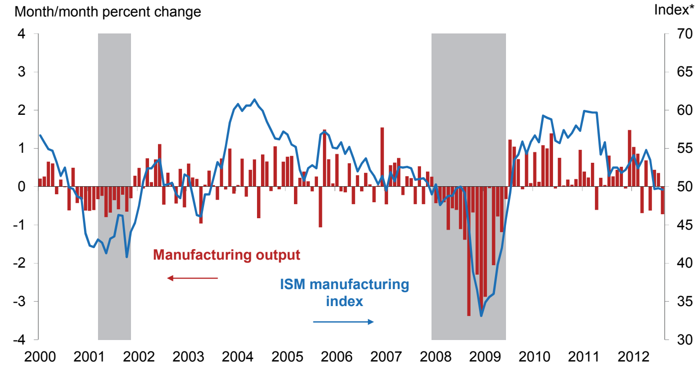
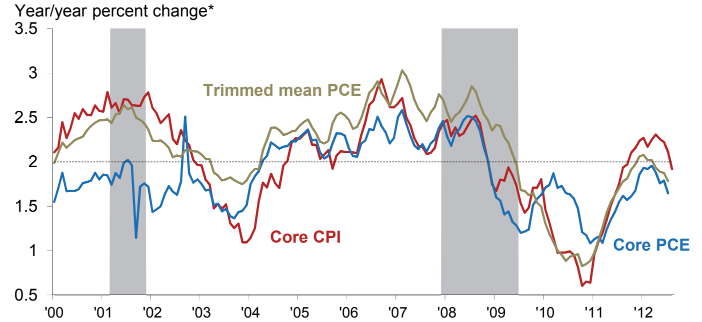
Chart 5
Manufacturing Output Falls Amid Weak ISM Readings



*Seasonally adjusted.
NOTE: Shaded areas indicate recession.
SOURCES: Federal Reserve Board; Institute for Supply Management.

Chart 6
Consumer Inflation Retreating



*Seasonally adjusted.
NOTES: Black line indicates the Federal Open Market Committee's inflation target of 2 percent. Shaded areas indicate recession.
SOURCES: Bureau of Economic Analysis; Bureau of Labor Statistics; Federal Reserve Bank of Dallas.