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## FOMC Acknowledges an End to Recession amidst Mixed Near-Term Data



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Monetary policy is largely unchanged, but the FOMC has essentially conceded that the recession has come to an end. The economic releases this week were mixed, with the two housing reports below expectations and durable goods orders surprisingly weak. On the positive side, however, consumer confidence exceeded expectations and initial jobless claims fell more than forecast. I should point out that the two positive numbers reflect more recent data (the month of September and the week ending September 18, respectively) than do the weaker than expected figures, all of which cover the month of August.

### FOMC leaves policy stance largely unchanged

The Federal Open Market Committee (FOMC) announced this week that it intends to maintain its current policy stance. The committee has essentially acknowledged that the recession is over, but still foresees weak economic conditions. The committee has extended the timing for winding up its purchase of mortgage-backed securities and agency debt.

- The FOMC believes that economic activity “has picked up following its severe downturn,” i.e., that a recovery has begun. This is in contrast with August, when economic activity was “leveling out,” and with previous months when it was still seen as declining. The committee still expects activity to be weak “for a time”; this phrasing was unchanged from August. Nevertheless, it now believes that the combined impact of policy and market forces will bring about both a strengthening of economic growth (instead of just a “resumption” of growth) and a decline in unemployment. This was the first time in this cycle that the statement mentioned the likelihood of reduced unemployment (“higher levels of resource utilization” in FOMC jargon). Including such wording in the statement is a way of preparing markets and Congress for a reversal of monetary accommodation, which will probably begin while the unemployment rate is elevated even if declining.
- The view of individual economic sectors is once again a bit more constructive this time. Today, the FOMC noted that “activity in the housing sector has increased,” it made no comment on housing activity last time. Household spending “seems to be stabilizing” instead of continuing to “show signs” of stabilizing, but the committee’s view of household sector prospects remains cautious. In particular, the statement still mentions “lower housing wealth” as a constraint on consumption, even though the Federal Reserve’s own Flow of Funds report showed that the value of real estate owned by households had stabilized as early as the second quarter. The assessment of the business sector was little changed, citing continued cutbacks in capital investment and in jobs, and that businesses “continue to make progress” in reducing inventories. The statement made no mention of recoveries outside the United States providing support for export demand.
- The statement came to the same conclusion as in previous statements on inflation – that it would “remain subdued for some time” – but the FOMC removed last month’s reference to rising energy and commodity prices. The output gap is still cited as the main factor responsible for keeping inflation low (“substantial resource slack likely to continue to dampen cost pressures”), but the committee also noted that “longer-term inflation expectations [were] stable.”

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- The stance of monetary policy is largely unchanged, but with one nuance. The statement that the Federal Reserve will “employ all available tools” to promote economic recovery has been replaced by “will continue to employ a wide range of tools”. At the margin, this connotes less urgency about economic and financial conditions, even if little change in policy itself has been made. The Fed Funds target remains in its zero to 25 basis point range, and the statement that the FOMC continues to anticipate that “exceptionally low levels of the Fed Funds rate” will be warranted “for an extended period” is unchanged. The size of the asset purchase programs has not been changed, but the MBS and agency debt program has been extended. Originally slated to be complete by year-end 2009, it is now set to end by March 31, 2010. This should help guard against an increase in mortgage rates at year-end at the same time as the expiration of the first-time home buyer tax credit may cause some short-term turbulence in housing markets. (Congress and the president could extend this credit but have not as of this writing.) The FOMC repeated its plan to conclude the Treasury bond purchase program by the end of October.

Source: U.S. Federal Reserve

The Fed’s decision is broadly consistent with market expectations. While some forecasters do not expect any increase in the Fed Funds rate before late 2011, we continue to believe that the FOMC will begin to tighten gradually by the middle of next year.

### **New home sales rise less than expected; existing home sales decline**

New home sales rose less than expected in August. Transaction prices dropped significantly, reflecting a continued mix shift away from higher-end units. Inventories fell on both an absolute and a months’ supply basis. Although the weakness in new and existing home sales in August was unexpected, both were up sharply in July, so that levels for the third quarter thus far remain considerably above second quarter levels.

- New home sales increased 0.7% to a 429,000 annual run rate in August, following three months of increases averaging more than 7%. The mean forecast had been for a 2.2% increase, with individual forecasts ranging from -3.0% to +15.5%. Sales for July were revised down from a 433,000 run rate to 426,000, but this still represented a 6.5% increase over June.
- Selling prices for new homes fell sharply in August, with the median price down nearly 10% to \$195,200 and the average price down 6% to \$256,800. This reflects the ongoing mix shift to lower priced homes that has resulted from the larger than normal share of first time buyers.

Source: U.S. Department of Commerce

Sales of existing single-family homes and apartments unexpectedly declined in August. Inventories of homes for sale fell even more, however, so that months’ supply of existing homes still declined. Both median and average transaction prices fell about 2%. The August decline is probably a fluke, but the prospect of a renewed move down in home sales after expiration of the home buyer tax credit in November remains a serious concern for the housing recovery.

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- Sales of existing homes fell 2.7% in August to a 5.1 million annual rate. Sales of single-family homes fell 2.8% and sales of apartments fell 1.6%. The mean forecast had been for total sales to increase 2.1% to a 5.35 million rate, with forecasts ranging from 5.1 million to 5.55 million. July's selling rate was left unrevised at 5.24 million. Even with the August decline, existing home sales were up 3.4% vs. August 2008, with single family sales up 2.5% and apartment sales up 10%. The National Association of Realtors estimated that 30% of sales in August were to first-time buyers, and that foreclosed properties made up 31% of transactions. These percentages were unchanged from July.
- Selling prices for existing homes declined everywhere except the West. Nationally, the median selling price fell 2.1% to \$177.7k while the average price fell 2% to \$222.8k. Median selling prices fell 4% in the Northeast and Midwest and 3% in the South, but rose 1.2% in the West.
- Mortgage rates fell modestly in August, with the 30-year, fixed-rate mortgage averaging 5.19% during the month vs. 5.22% in July. Rates have fallen further since, with the 30-year mortgage rate averaging 5.06% thus far in September.

*Source: National Association of Realtors*

These reports do not alter our view that a recovery in home sales, prices and construction has begun. However, lower than expected sales of new and existing homes, for August raise the possibility that the home buyer tax credit had brought demand forward into earlier months. If this is true, then we may see a few more weak months for home sales, but the timing distortion the credit introduced should not compromise the cyclical recovery.

### **Durable goods orders fall unexpectedly**

Durable goods orders fell unexpectedly in August following a strong July increase. The decline largely resulted from a sharp drop in aircraft orders; orders excluding transportation equipment were flat and core capital goods orders fell modestly. Shipments fell for nearly all non-defense durable goods categories.

- Durable goods orders fell 2.4% in August, following a 4.8% July increase. The mean forecast had been for an increase of 0.4%, with individual forecasts ranging from -2.0% to +4.0%. Forecasts for durable goods orders excluding transportation ranged between +0.3% and +2.3%.
- Orders for core capital goods (non-defense capital goods excluding aircraft) declined 0.4% after a 1.3% decline in July. Core capital goods orders had risen more than 8% cumulatively in May and June, but had previously fallen a cumulative 27% between August 2008 and April of this year. Last month, orders for machinery rose 0.7%, orders for IT equipment declined 0.7% and orders for motor vehicles rose 0.4%.
- Inventories of durable goods fell 1.3% in August, but with new orders falling faster, the ratio of inventories to new orders rose to 1.88 from 1.86 in July.

*Source: U.S. Census Bureau*

This report is clearly below expectations and has led some forecasters to cut estimates for capital spending in the current quarter. Nevertheless, our forecast had not called for a significant revival in non-residential fixed investment until the second quarter of 2010. Low capacity utilization and cautious management attitudes about the scale of economic recovery both suggest that a recovery in capital spending is more likely next year than immediately.

### Consumer confidence

The final University of Michigan consumer confidence survey results for September were above expectations and materially above the initial September results. Both the current conditions and future expectations components rose, while inflation expectations declined.

- The final September reading for the composite index was 73.5, compared with a preliminary level of 70.2 and with August's final figure of 65.7. The mean forecast had been for 70.5, with individual forecasts ranging from 67.0 to 72.0.
- The current conditions index rose to 73.4 from 71.8 in the preliminary September survey and 66.6 in August. The index of future expectations, covering the next 12 months, rose to 73.5 from 69.2 in the preliminary survey and 65 in August, and is at its highest level in two years. The current conditions index has 40% weight in the total and the expectations index has 60% weight.
- Respondents' average expectation of inflation declined, with the expectation of inflation one year out falling to 2.2% from 2.8% in the preliminary survey and the expectation of inflation five years out falling to 2.8% from 2.9%.

*Source: University of Michigan*

The Michigan index remains below the 89 level it averaged during the 2001-07 economic expansion, and may continue to revive slowly until there is a more definitive improvement in employment conditions. Nevertheless, stabilization and some recovery in household net worth should help promote greater optimism among consumers going forward.

### Initial and continuing jobless claims fall more than expected

Initial jobless claims fell more than expected in the week ending September 18. Continuing unemployment claims, for the week ending September 11, also declined more than forecast, and the insured unemployment rate declined both before and after seasonal adjustment. Although initial claims have been declining only gradually in recent weeks, we expect this decline to accelerate as the recovery progresses and business confidence improves.

- Initial jobless claims fell by 21,000 to 530,000 for the week ending September 18. The mean forecast had been for 548,000, with individual forecasts ranging from 510,000 to 565,000. The four-week moving average of initial claims fell to 553,500, and claims for last week before seasonal adjustment rose to 434,400. Claims for the week ending September 11 were revised from 545,000 to 551,000. (Revisions to weekly claims data are almost always upward because the initial data are preliminary.)
- Continuing claims fell to 6.138 million in the week ending September 11 from a revised 6.261 million in the week ending September 4. The mean forecast had been for 6.169 million, and individual forecasts ranged from 6.10 to 6.25 million. (Many fewer economists forecast continuing claims on a weekly basis than do initial claims.) The seasonally-adjusted insured employment rate fell to 4.6% from 4.7%; the rate before seasonal adjustment fell to 3.9%.

*Source: U.S. Department of Labor*

Initial claims are down more than 20% from their March 27 high of 674,000. They have been declining only slowly, however, reflecting continued employment cuts in many industries. Looking forward, we expect that claims should begin to decline more rapidly in coming weeks as business confidence in economic recovery grows. ■