Economic Notes

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A U.S. recovery has begun, but markets are grappling with its likely strength and composition.

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The initial report on third quarter U.S. GDP showed greater than expected growth at a 3.5% rate and suggested that the recession most likely ended at mid-year. Official confirmation of the start of recovery must wait, however, until the National Bureau of Economic Research decides on the date.

In the meantime, U.S. data releases over the past week show the conflicting influences facing the economy at this early stage of recovery. Durable goods and capital goods orders increased in September, driven by the global recovery in industrial production. This recovery also led to a sharp spike in the Chicago purchasing managers index, although that move was not echoed in the neighboring Milwaukee region. Consumption spending by U.S. households fell last month as auto sales dropped when the Cash for Clunkers program ended. Household income remains weak, and in our view should remain pressured for the next several months. These pressures have led to a renewed decline in consumer confidence, with both the Conference Board and Michigan indexes falling in October.

The conflicting influences facing the economy also helped produce heightened volatility in the stock market this week, as investors grappled with whether stock prices had discounted an excessively optimistic view.

For the next few quarters, we expect relatively modest U.S. GDP growth as consumption spending grows very slowly, housing recovers but remains at very low levels, and inventory liquidation tapers off. As employment starts to revive next year, GDP and consumer spending should accelerate, but growth should still remain modest by historic standards — especially considering the depth of the contraction the economy experienced.

Third-quarter GDP grew more rapidly than expected; government programs supported growth

Third quarter U.S. GDP growth was slightly greater than the consensus had anticipated and in line with our 3.5% forecast. A spike in auto sales stemming from the Cash for Clunkers program helped consumption rise at the fastest rate since early 2007. Business investment declined as non-residential construction continued to fall, but equipment and software spending rose. Housing activity increased for the first time since late 2005, but remained at a very low level. Both exports and imports rose at close to 15% annual rates. Inflation data in the report were in line with or below expectations.

- Real GDP grew at a 3.5% annual rate in the third quarter. The mean forecast had been for growth of 3.3%, with individual forecasts ranging from 2.0% to 3.3%. Domestic demand rose at a 3.0% rate.
- Household consumption grew at a 3.4% rate, spurred by a 56% annualized increase in vehicle sales as a result of the Cash for Clunkers program. Most other categories of consumption spending also increased, however, with spending on household durables rising at a 6.4% annual rate, spending on non-durable goods rising at a 2% rate, and spending on services rising at a 1.2% rate. Motor vehicles contributed about 1.0% to total GDP growth, but consumption would still have contributed positively to growth even if auto sales had been flat with their depressed 2Q level. Two categories of at least partially discretionary spending, recreation and apparel, fell in the quarter, pointing to continued caution among households.

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- Companies continued to liquidate inventory in the quarter, with total inventories falling at a $131 billion annual rate. Nevertheless, the pace of inventory drawdowns was slower than the second quarter's $160 billion rate, so that inventories contributed to growth this time (by a bit less than 1%).
- Business fixed investment fell at a 2.5% rate, a much less severe drop than the -39% seen in the first quarter or the -10% seen in the second. Spending on equipment and software rose at a 1.2% rate, driven by spending on IT equipment and on software. Spending on industrial equipment continued to decline, falling at a nearly 12% rate following a 15% drop in the second quarter. IT spending should continue to lead other kinds of equipment spending in the early quarters of recovery. Non-residential construction continued to be weak, with business spending on structures falling at a 9% rate. This is nevertheless more moderate than the 17% 2Q09 rate of decline or the 44% rate of decline seen in the first quarter.
- Residential investment increased for the first time since late 2005, rising at a 23% annual rate. Housing nevertheless remains nearly 55% below its late 2005 peak. We believe that both housing starts and residential investment can show significant growth over the next few years and still remain below trend levels implied by demographics and household formation.
- Exports rose at a nearly 15% annual rate as exports of goods increased more than 21%. Imports, however, rose even faster (16%). The trade deficit thus widened to 2.7% of GDP from 2.6% in the second quarter.
- The growth of government spending slowed dramatically, from a nearly 7% rate in the second quarter to 2.3%. Federal spending continued to increase rapidly (at a nearly 8% rate, down from 11% in the second quarter), but state and local government spending contracted. Severe fiscal pressures on state and local governments, combined with more spending restraint at the Federal level, are likely to keep the growth of government spending low. Our forecast calls for government spending to grow at an average 1.4% rate through the end of 2011.
- The total GDP price index rose at a 0.8% rate in the quarter, below the 1.4% consensus forecast. The core personal consumption expenditures price index rose at a 1.4% rate, in line with consensus forecasts and a bit above our forecast of 1.3%. Over the first three quarters of this year, the core PCE price index has risen at an average 1.5% annual rate, compared with 2.1% for 2008. We expect further declines in core inflation over the next several quarters because we believe unit labor costs should remain well controlled.

Source: U.S. Bureau of Economic Analysis

This report confirms our view that the recession ended at mid-year 2009. However, two of the major sources of growth in the quarter, consumption spending and housing, were at least partially supported by government programs. The Cash for Clunkers program has since ended and auto sales have dropped back dramatically, while the homebuyer tax credit is likely to be phased out between November and mid-to-late 2010. We expect much slower growth in consumption spending in 4Q09 (a 0.9% annual rate), as auto sales should drop back to a 9.5 million seasonally adjusted annual rate (SAAR) and as holiday retail sales should be tepid.

We expect about 2.5% annualized growth of consumption in the first half of 2010. Despite this, a continued recovery in housing from very low levels, a reduced rate of inventory liquidation and a gradual turnaround in business investment should suffice to produce GDP growth averaging about 3% for the next three quarters. By the second half of 2010, a recovery in employment and income should begin to produce a more sustainable revival in consumption, and GDP growth should increase to a 4.0–4.5% range.

Our forecast thus remains optimistic, but we also recognize the risks the economy continues to face.

Durable goods orders rise as forecast; capital goods orders recover

Durable goods orders rose in line with forecasts in September, while orders excluding transportation were up a bit more than expected. While aircraft orders and defense orders both increased, orders for core non-defense capital goods excluding aircraft increased for the first time since June. For the third quarter as a whole, both total durable goods orders and orders for core capital goods were up strongly. Shipments, however, did not rise as rapidly in the quarter, suggesting that business spending on equipment and software in the third quarter is likely to grow only modestly, in line with our forecast for 1.8% annualized growth.

- Total orders for durable goods rose 1.0% in September, following a 2.6% decline in August (first estimated at -2.3%) and a 4.8% increase in July. The mean forecast had been for orders to rise 1.0%. Excluding transportation, orders rose 0.9% last month, slightly more than the mean forecast of 0.7%, but August order growth was revised down to -0.4% from the previous estimate of zero. Taking the revisions into account, the data are essentially in line with expectations and show a continued recovery in orders.
- Orders for core capital goods (non-defense capital goods excluding aircraft) rose 2.0% in September following declines of 1.3% and 0.8%, respectively, in July and August. Machinery orders rose 8% while orders for IT equipment were down 0.2% and orders for electrical equipment were down 0.9%. Aircraft orders rose 23% and orders for motor vehicles and parts were little changed following two months of increases. Total defense orders rose 7% following a 3.2% drop in August, but total non-defense orders nevertheless rose 0.5%. Defense orders represent a little less than 6% of total durable goods orders.
- Shipments of durable goods rose 0.8% in August, led by a 37% increase in aircraft deliveries. Shipments of non-defense capital goods excluding aircraft fell slightly, led by a 3.6% decline in IT equipment. Inventories of durable goods fell for the ninth consecutive month, dropping 1%.
- For the third quarter as a whole, durable goods orders rose at a 12.3% annual rate and non-defense capital goods orders rose at a 22% annual rate. This order growth, however, is not likely to show up in the GDP accounts until early next year, when the equipment is shipped. In the third quarter, total durable goods shipments rose at a 4.8% annual rate while non-defense capital goods shipments were little changed (-0.2% annualized). This suggests that the growth of equipment and software spending as a whole in third quarter GDP should be modestly positive.

  Source: U.S. Census Bureau

On balance this report is in line with expectations and consistent with a continued recovery in global demand. It is encouraging in this connection that the strength in orders seen in July (most of which came from aircraft) has continued and has broadened out into other categories such as machinery. We continue to believe that weakness in non-residential construction should keep the growth rate of total business fixed investment negative through remainder of this year, with a slow recovery in the first half of 2010 and stronger growth thereafter.

Regional ISM indexes show conflicting results with Chicago up and Milwaukee down

Two business activity indexes prepared by regional chapters of the Institute for Supply Management showed conflicting results for October. The Chicago ISM business index, released by the Institute for Supply Management - Chicago, increased more than forecast after a surprise decline in September. The neighboring Milwaukee region, however, showed an unexpected decline in its purchasing management index for October following two months of strength.

- The Chicago "business barometer" rose to 54.2 following an unexpected decline to 46.1 in September and to 51.9 from 48.1 before seasonal adjustment. Consensus expectations had been for the index to rise to 49.1, with individual forecasts ranging from 47 to 52.5. Major components of the index were broadly higher, with the new orders index rising to 61.4 from 46.3 as 40% of firms saw higher new orders in October compared with 27% in September. The production index rose to 63.9 from 47.2; 38% of firms saw higher production levels in October compared with 29% in September. The order backlogs index rose to 41.9 from 36.7. Firms in the Chicago region continued to reduce inventories: the inventory index fell to 32.2 from 38.9 as 50% of respondents reduced inventories further in October compared with 37% in September. The employment index fell slightly to 38.3 from 38.8 and the prices paid index fell to 48.6 from 51.3.

- In the Milwaukee area, by contrast, the total PMI fell to 50 in October from 58 last month. (The "consensus forecast" of 57, however, was based on only three individual forecasts.) The new orders index fell to 53 from 66 and production fell to 56 from 71. The inventory index fell to 44 from 48. The employment indexes were mixed, with the "white collar" employment index rising slightly to 47 from 45, but the "blue collar" employment index falling back to 38 from 50, in line with its weaker July and August levels.

  Source: Institute for Supply Management

The September decline in the Chicago index had appeared somewhat anomalous at the time because it appeared to contradict other data on industrial activity, and it was not confirmed by the national-level ISM index. We continue to believe that the United States is only at an early stage of a sharp recovery in industrial production, a response to the sharp decline that started in the fourth quarter of 2008. This should continue to propel the national ISM manufacturing index, as well as the regional indexes, higher over time.

Both major consumer sentiment indexes fall in October

Both the final University of Michigan consumer sentiment index and the Conference Board consumer confidence survey for October were reported this week, and both fell vs. September. The final Michigan index was a bit above expectations and higher than the preliminary reading a few weeks ago, but the Conference Board's figure was below forecasts.

- The final Michigan sentiment index reading for October was 70.6, up from 69.4 in the preliminary October poll but down from 73.5 in September. Consensus expectations had been for the final October figure to come in at 70.0, with individual forecasts ranging from 68 to 74.
- In the Michigan report, the current conditions index (just below 40% of the total) rose to 73.7 from 72.1 in the preliminary survey and 73.4 in September. This index is at a new high for the current cycle. It gauges respondents' views on whether their financial position is better now vs. a year ago, and on whether respondents think it is a good time to buy major household items. The expectations index (about 61% of the total) was at 68.6 in the final October survey, up from 67.6 in the preliminary October report but down from 73.5 in September. This index is based on respondents' expected financial situation a year from now and views of broader business conditions one year from now and over the next five years.
- The Conference Board consumer confidence index fell unexpectedly in October, vs. consensus expectations for a slight increase. Both the present situation and expectations indexes fell, although the expectations index remained considerably higher than the present situation index. Respondents' view of job prospects was particularly negative, and the share of respondents planning to make major purchases fell slightly. The total index fell to 47.7 in October from 53.4 in September (revised up from 53.1). Consensus expectations had called for the index to rise slightly to 53.5, with individual forecasts ranging from 48 to 57. The three-month moving average rose slightly to 51.9 from 51.8 since October's reading was above July's.
- The present situation index fell to 20.7 from 23, and the expectations index fell to 65.7 from 73.7. Except for May, when it rose to 29.7, the present situation index has been between 20 and 25 all year. The expectations index, despite October's decline, is still well above first quarter levels.
- Survey respondents' views of job prospects worsened in October, with the share finding jobs "hard to get" rising to 49.6 from 47 and the share finding jobs "plentiful" falling from 3.6 to 3.4. Expectations for employment conditions six months out also deteriorated, with 26.6% of respondents expecting "fewer" jobs vs. 22.9% in September, and only 16.3% expecting more jobs six months from now. Income expectations also worsened modestly.
- Plans to make large-scale purchases declined slightly vs. September, with 2.3% of respondents intending to buy a house vs. 2.5% the previous month, 4.4% planning to buy a car vs. 4.5% the previous month and 23.3% intending to buy a major home appliance, vs. 24.5% in September.

  Source: University of Michigan (via Bloomberg), Conference Board

While our view of economic prospects in general remains above the consensus, we are cautious on prospects for consumer spending over the next few quarters because we see little prospect of an improvement in after-tax real income until mid-2010 (see comments on personal income below). This prospect of stagnant or falling incomes and continued job losses is depressing confidence and spending intentions even among the employed.

Personal income unchanged, spending down in September

Personal income for September was unchanged and in line with forecasts, while personal consumption spending was down, also as expected. Wage and salary income was down slightly, with a particularly sharp drop in construction and little change in service-sector wage income. Other income sources were mixed. Small business income was up slightly but income from financial assets continued to drop. Government transfer payments continued to increase while tax payments were little changed. Consumption spending declined, largely because auto sales fell back following the end of the Cash for Clunkers program; the savings rate rose as a result. The core personal consumption price index rose less than expected. This report highlights ongoing pressures on household incomes and spending, which we expect to remain acute until employment begins to revive in early to mid-2010. This is reflected in our forecast of weak personal consumption growth (averaging 1.9%) through the second quarter of next year.

- Total personal income was unchanged in September following small 0.1% increases in each of the previous two months. The mean forecast was for no change, with individual forecasts ranging from -0.2% to +0.2%. For the third quarter as a whole, personal income fell at a 0.5% annual rate after increasing at a 0.6% rate in the second quarter.
- Employee compensation declined slightly in September following two small monthly increases. Private sector wage and salary income fell 0.2%, led by a dramatic drop in income from employment in construction. Manufacturing wage income fell 0.2% and service sector wage and salary income fell 0.1%. More cyclical service industries (trade, transportation and utilities) accounted for the entire fall in service-sector wage income; wage income in other service industries was flat. Government wage and salary income was also unchanged.
- Income from small business activity rose 0.1% as a 5.6% decline in farm income partially offset a 0.2% increase in non-farm small business income. Income from financial assets declined 0.8%, in line with August, as dividend income fell 1.3% and interest income fell 0.6%.
- Income from government transfer programs, net of contributions, rose 1.6% as Social Security benefit income rose 1.2% and as contributions for social insurance programs fell slightly. Government benefits were thus the largest support for income in September; income excluding transfer receipts fell 0.2%.
- Current tax payments were unchanged in September and represented just under 9% of personal income, down from 12% in September 2008. Disposable personal income was thus unchanged in nominal terms and, given a 0.12% increase in the personal consumption price index, down 0.12% after inflation. Real disposable income was up 1.1% year-over-year as the decline in tax rates and in the Personal Consumption Expenditures (PCE) Price Index offset the fall in nominal pre-tax income.
- Consumption spending fell 0.5% in September, in line with the consensus forecast, as the end of the Cash for Clunkers program led to a decline in auto sales. Spending on durable goods thus fell 7% after rising 1.6% in July and 6.1% in August. Spending on non-durable goods rose 0.7% (part of which reflected increasing oil prices) and spending on services rose 0.2%. With consumption spending declining, the savings rate rose back to 3.3% from the low 2.8% reached in August as a result of the clunkers program. For the third quarter as a whole, the savings rate averaged 3.3%, a bit below our 3.5% forecast. We expect the savings rate to decline moderately in the next few quarters as a result of pressures on income, and then to begin increasing once again by the middle of next year as incomes recover.
- The PCE Price Index rose 0.12% in September, down from 0.34% in August, as energy prices rose much less rapidly. The core PCE Price Index rose 0.12%, less than the 0.2% consensus forecast. Prices for durable goods increased after two consecutive monthly declines of 0.5%.

Source: U.S. Bureau of Economic Analysis

As we have emphasized in past reports, income growth earlier this year depended on government benefits, tax cuts and deflation. All of these forces are either exhausted or reversing at present. We expect real after tax income to fall in the fourth quarter and to revive at a modest rate in early 2010 compared with previous recoveries. We do not expect that consumption spending will be the major driver of economic recovery and expansion in this cycle.

Initial jobless claims fall slightly for week ending October 24

Initial jobless claims fell slightly, and less than expected, in the week ending October 24; continuing claims, for the previous week, fell considerably more than expected. We continue to expect a gradual decline in claims between now and year end, bringing the weekly initial claims figure to the 400,000 rate consistent with recovery.

- The U.S. Labor Department reported that initial unemployment insurance claims fell 1k to 530,000 in the week ending October 24. The mean forecast had been for 523,000 and individual forecasts ranged from 515,000 to 540,000. The four-week moving average of claims fell to 524,750. However, claims before seasonal adjustment rose by more than 32,000 to 492,000.
- State-level data (for the week ending October 17) showed just about a reverse picture from the week before. In particular, California, which had been the only state to have a major decline in claims the previous week, was the only state with a large increase. The largest decreases, by contrast, were in Wisconsin, New York, Pennsylvania, Illinois and Oregon. No single industry predominated in the states with reduced layoffs, while California cited increased layoffs in construction, trade, services and agriculture.
- Continuing claims fell to 5.79 million for the week ending October 17, down 148,000 from a revised 5.945 million in the previous week and 6.034 million in the week ending October 3. Expectations had been for a smaller decline to 5.905 million. The insured unemployment rate fell to 4.4% after seasonal adjustment.

  Source: U.S. Department of Labor

We continue to expect claims to decline at an uneven pace over the next several months as employment conditions stabilize and begin to recover.

New home sales fall unexpectedly in anticipation of tax credit expiration

New home sales fell unexpectedly in September, with wide regional variation in sales. Inventories fell in absolute terms but were unchanged on a months supply basis. Both median and average selling prices increased as the mix of homes sold was less tilted toward the low end. The decline reflects uncertainty over the expiration of the homebuyer tax credit, but does not change our view that home sales should continue to recover.

- New home sales fell 3.6% in September to a 402,000 annual rate, following a revised 417,000 selling rate in August (first estimated at 429,000). The mean forecast had been for sales to rise 2.6% to a 438,000 annual rate, and individual forecasts ranged from 412,000 to 460,000. Revisions to sales over the June-August period reduced sales by an average of 9,000 (annualized) each month.
- Results once again varied widely by region, with sales up 34% in the Midwest, flat in the Northeast, but down 10.6% in the West and 10% in the South. The South remains the largest of the four housing regions, with more than 50% of new home sales.
- New home inventories continued to fall, dropping 10,000 to 251,000. Since the selling rate also fell, months supply was unchanged at 7.5. New home inventories were down 56% from their peak and 37% from September 2008.
- Selling prices for new homes, which had dropped sharply in August, increased last month. The median new home price rose 2.5% to $204,800 and the average selling price rose 10.2% to $282,600. Year-over-year, the median price was down 9% and the average price down 1.6%. The price changes were largely the result of mix shifts as the share of homes priced below $150,000 fell to 15% from 23%, while the

share of homes priced at $500,000 and above rose to 10% from 6%. The mix shifts reflect a reduced share of first time buyers in September as the expected expiration of the tax credit approached.

- New home sales are counted at the time of contract signings, so that sales included in this release might not close before the scheduled expiration of the credit November 30. Existing home sales, by contrast, are counted as of the time of closing, so that existing home sales reported for September would qualify for the credit even if it is not extended. This helps explain why September existing home sales surged more than 9% while new home sales dropped. The volume of existing home sales is also more than ten times greater than that of new home sales.

Source: U.S. Department of Commerce

Today's report suggests that some of the strength in new home sales seen in the May-July period, when sales rose more than 6% each month on average, was a result of the tax credit. It further suggests that and that new home sales may remain in the low 400,000s (at an annual rate) for the next few months even if the credit is extended or gradually phased out. (A phase-out now seems like the most likely resolution to this issue, but it is still under consideration in Congress.) Nevertheless, a 400,000 selling rate remains more than 20% above the trough sales rate seen this January. The timing differences created by the credit and its expiration do not in our view alter the underlying recovery in home sales.

Case-Shiller Home Price Index rises more than forecast in August

The Case-Shiller home price index rose more than expected in August. August's was the fourth consecutive monthly gain, and the increase was once again broad based, although less than that seen in July. Since the August index level is based upon home sales from June, July and August, it probably was not distorted by buyers moving to benefit from the first-time homebuyer tax credit before its slated November expiration. The report provides further evidence that home prices reached a bottom earlier this year, and that the prospect of further home price declines has now become a regional rather than a national economic problem.

- The 20 region composite rose 1.2% in August following increases of 1.6% in July, 1.4% in June and 0.5% in May. The mean forecast was +0.6; individual forecasts ranged from -1.1% to +1.5%. Year over year, the index was down 11.3%, compared with -13.3% in June and a consensus forecast of -11.9%.
- Regionally, price momentum was a bit less favorable in August than in July, with 16 of the 20 regions showing higher prices as compared with 18 of the 20 in July and in June. Prices fell in Cleveland (-0.5%), Charlotte (-0.4%) and Las Vegas (-0.3%) and were little changed in Seattle. The largest price increases were in Minneapolis (+3.2%) and San Francisco (+2.8%).
- All 20 regions remained down on a year over year basis, but Dallas (-1.2% year-over-year) and Denver (-1.9%) year-over-year appear closest to turning positive on this measure. Las Vegas (-30%) continued to show the largest year-over-year decline. (Although the Case-Shiller index does not include condominiums, prices of single family homes in markets with large vacant apartment inventories are affected by condominium oversupply.)

Source: Standard & Poor's

The Case-Shiller composite index is now up 4.2% from its April low. It may decline modestly early next year if home sales are affected by the expiration or phase-out of the home buyer tax credit (which remains unresolved as of now), but we nevertheless believe that this past spring's lows were the bottom in home prices and that the problem going forward should remain confined to regions with the most serious supply and foreclosure issues. Home price declines are unlikely to impact household wealth on a national scale going forward. ■