Twelfth Federal Reserve District

FedViews

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John Fernald, vice president at the Federal Reserve Bank of San Francisco, states his views on the current economy and the outlook:

- The economic recovery has lost some momentum in recent months. Not counting the effects of hiring for the 2010 census, employment was rising by several hundred thousand jobs per month earlier in the year. Since May, these gains have averaged only 55,000 jobs per month.

- Consumer spending continues to grow, but at a fairly modest and uneven pace. Purchases of durable goods, nondurable goods, and services all remain below their pre-recession peaks. In recent months, services have picked up, durables have moved sideways, and nondurables have ticked down. Consumers remain very cautious. Income growth has been subdued and unemployment remains high. Moreover, households have taken big hits to their housing, stock market, and other wealth.

- As wealth has fallen, the household saving rate has risen from around 2% in the mid-2000s to around 6% more recently—a rate not seen since the early 1990s. Historically, the saving rate tends to rise when household net worth falls as a multiple of disposable income, and fall when net worth rises as a multiple of disposable income. For example, when net worth relative to income rose in the 1980s, the saving rate fell. And when net worth rose again in the mid-1990s, the saving rate fell again. Net worth and saving relative to income are now about where they were in the late 1980s and early 1990s, suggesting that much of the wrenching adjustment to a new higher saving rate might be behind us.

- Business surveys from the Institute for Supply Management show continued expansion, albeit at a less robust pace than earlier in the year. These diffusion indexes are defined in such a way that a reading above 50 indicates that more respondents see business as expanding than as contracting. Although manufacturing remains well above 50, nonmanufacturing is barely staying in the expansionary range.

- What are the major constraints facing businesses? For decades, the National Federation of Independent Business has surveyed small businesses about what they see as the single biggest constraint on their activity. Taxes and government requirements have been growing more important as constraints recently. But the share of respondents citing these factors today is lower than it was in the fast-growth period of the late 1990s. Almost no one thinks that labor quality or insurance costs are a major constraint today. The unusual feature of the current period is the degree to which poor sales are a predominant constraint for many businesses. The proportion of respondents listing poor sales is above the peak response for this category even during the depths of earlier recessions going back to the early 1970s.

The views expressed are those of the author, with input from the forecasting staff of the Federal Reserve Bank of San Francisco. They are not intended to represent the views of others within the Bank or within the Federal Reserve System. FedViews generally appears around the middle of the month. The next FedViews is scheduled to be released on or before October18, 2010.

- Housing remains in the intensive care unit. The only signs of a heartbeat come when there are life-support measures in place. Both new and existing home sales plunged in the most recent monthly data. Existing home sales in July were at their lowest levels in 15 years. New home sales were at their lowest levels on record based on data going back to the early 1960s. Earlier spikes in activity reflected the expiration of tax credits for first-time homebuyers. As soon as this support was removed, activity collapsed. With home sales weak, including a large overhang of unsold existing homes, and homes in or near foreclosure, it's no surprise that homebuilding activity is also weak.

- One factor that ought to support the market is that home prices have stabilized somewhat. When prices are falling rapidly, homebuying is very expensive no matter how low the mortgage rate might be. The median respondent in an August MacroMarkets survey of over 100 economists expected prices to remain fairly stable around their current level. The pessimists in the survey see fairly notable further declines in prices over the next year or so, given the the slow pace of sales and high inventory. And even the optimists see prices remaining far below their recent peaks for many years.

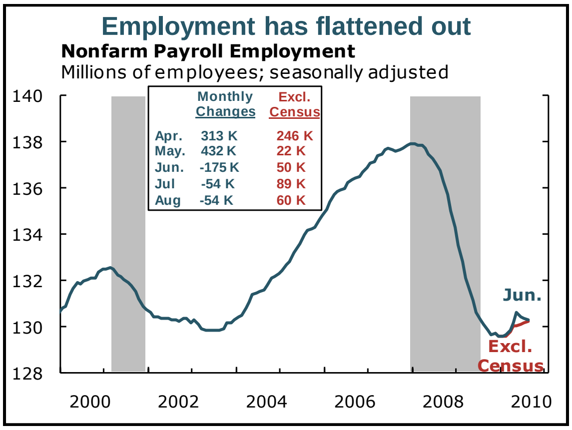
- On balance, the recovery is ongoing, but the pace is modest. The economy seems to be in a holding pattern, characterized by a sense of waiting or delay. That is, although the economy isn't crashing, it also isn't making rapid progress. We expect growth to pick up over the next few years as uncertainty diminishes and the headwinds from tight credit and household balance-sheet adjustments abate.

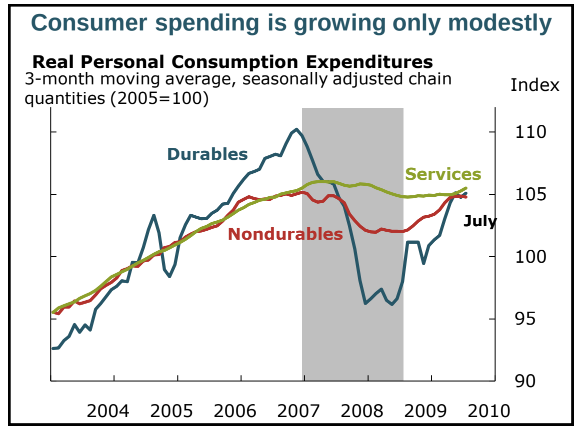
- With enormous slack in labor markets, wage pressures have been low. Compensation per hour, a broad but relatively volatile measure, registered growth of only 1% in the second quarter from a year earlier. Growth in the employment cost index, which includes health and other benefit costs, but excludes bonuses, also remains subdued relative to history. By any of these measures, business labor costs haven't been growing rapidly.

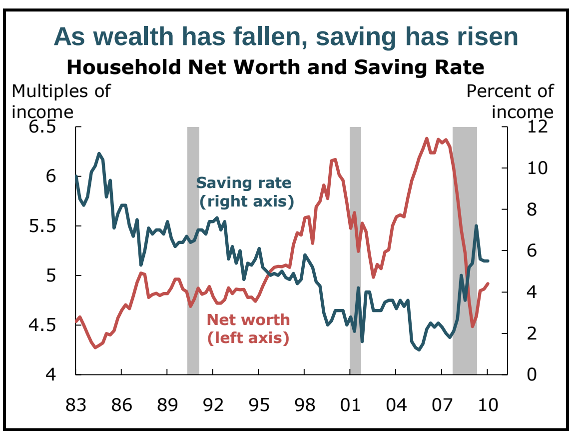
- We expect the high degree of resource slack to cause core inflation to moderate even more in the near term. Overall inflation will run somewhat above the core level in the next few quarters, given recent movements in oil prices.

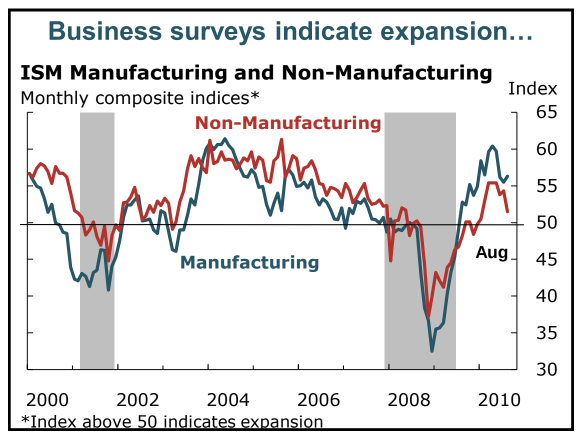
- The modest pace of recovery combined with low inflation has put downward pressure on interest rates in recent months. Nominal mortgage rates, for example, are at or near record lows. Fed funds futures rates for the next year are as flat as a pancake. Markets don't expect the Federal Reserve to raise its target rate anytime soon.

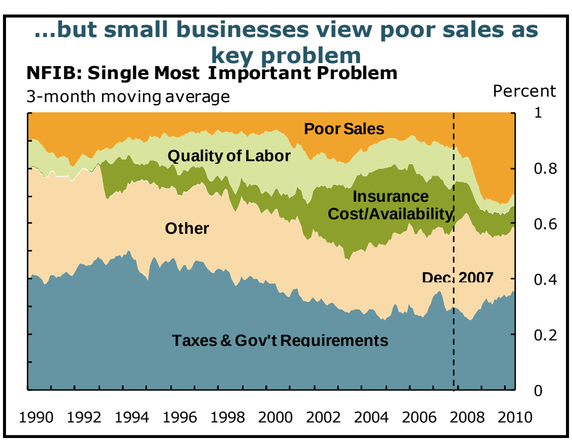
- At its August meeting, the Federal Open Market Committee agreed to "keep constant the Federal Reserve's holdings of securities at their current level by reinvesting principal payments from agency debt and agency mortgage-backed securities in longer-term Treasury securities." The statement reflected concerns that, as the economic outlook weakened, long-term interest rates were falling, which boosted prepayments on mortgage-backed securities as homeowners refinanced. Those prepayments were shrinking the Federal Reserve balance sheet, leading to a "passive tightening" of policy.

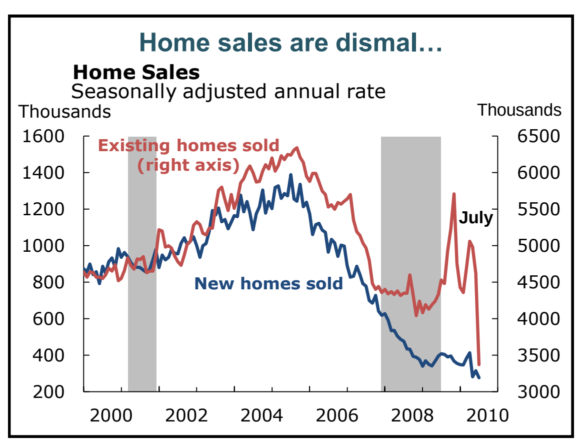

Employment has flattened out
Nonfarm Payroll Employment
Millions of employees; seasonally adjusted
Monthly Changes
Excl. Census
Apr. 313 K 246 K
May. 432 K 22 K
Jun. -175 K 50 K
Jul -54 K 89 K
Aug -54 K 60 K
Jun.
Excl. Census
140
138
136
134
132
130
128
2000
2002
2004
2006
2008
2010


Consumer spending is growing only modestly
Real Personal Consumption Expenditures
3-month moving average, seasonally adjusted chain quantities (2005=100)
Index
Durables
Services
Nondurables
July
110
105
100
95
90
2004
2005
2006
2007
2008
2009
2010

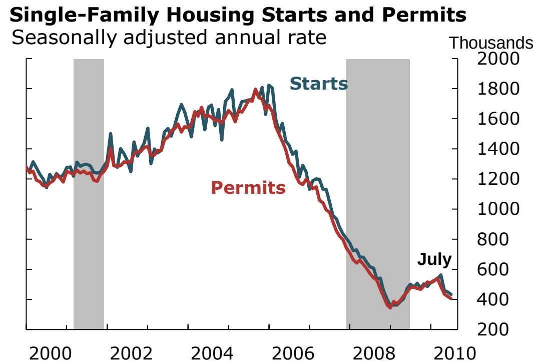

As wealth has fallen, saving has risen
Household Net Worth and Saving Rate
Multiples of income
Percent of income
Saving rate (right axis)
Net worth (left axis)
6.5
6
5.5
5
4.5
4
12
10
8
6
4
2
0
83
86
89
92
95
98
01
04
07
10


Business surveys indicate expansion…
ISM Manufacturing and Non-Manufacturing
Monthly composite indices*
Index
Non-Manufacturing
Manufacturing
Aug
65
60
55
50
45
40
35
30
2000
2002
2004
2006
2008
2010
*Index above 50 indicates expansion

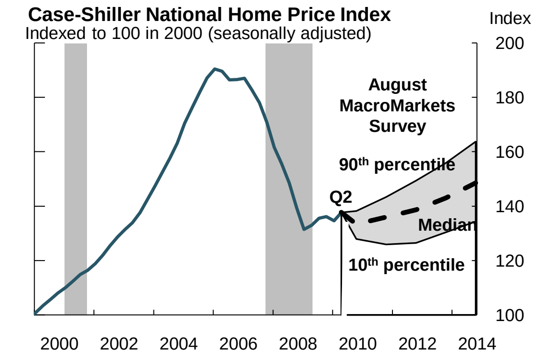

…but small businesses view poor sales as key problem
NFIB: Single Most Important Problem
3-month moving average
Percent
Poor Sales
Quality of Labor
Insurance Cost/Availability
Other
Dec. 2007
Taxes & Gov't Requirements
1
0.8
0.6
0.4
0.2
0
1990
1992
1994
1996
1998
2000
2002
2004
2006
2008
2010


Home sales are dismal…
Home Sales
Seasonally adjusted annual rate
Thousands
Thousands
Existing homes sold (right axis)
New homes sold
July
1600
1400
1200
1000
800
600
400
200
6500
6000
5500
5000
4500
4000
3500
3000
2000
2002
2004
2006
2008
2010

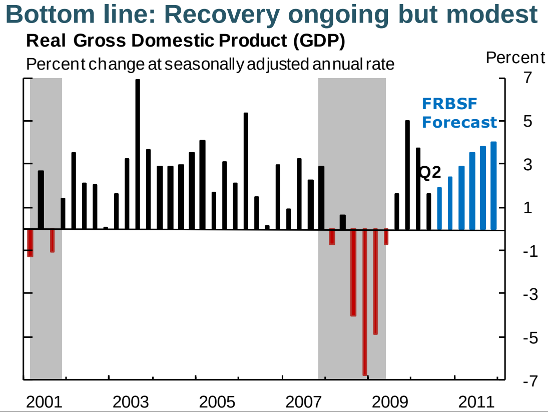
…as is homebuilding



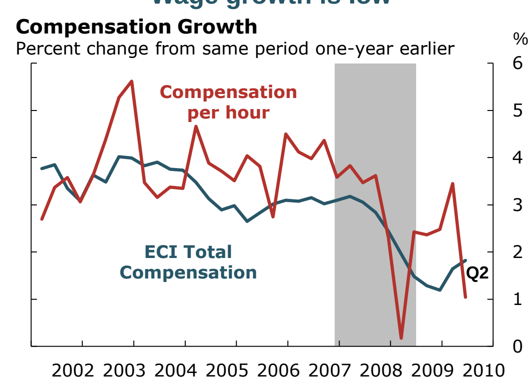
Home prices expected to rise gradually at best



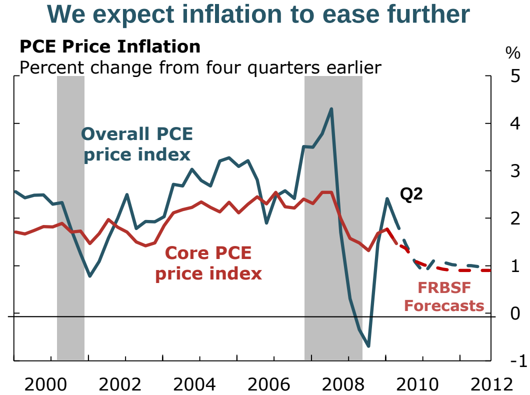
Bottom line: Recovery ongoing but modest



Wage growth is low



We expect inflation to ease further



Interest rates have been trending down