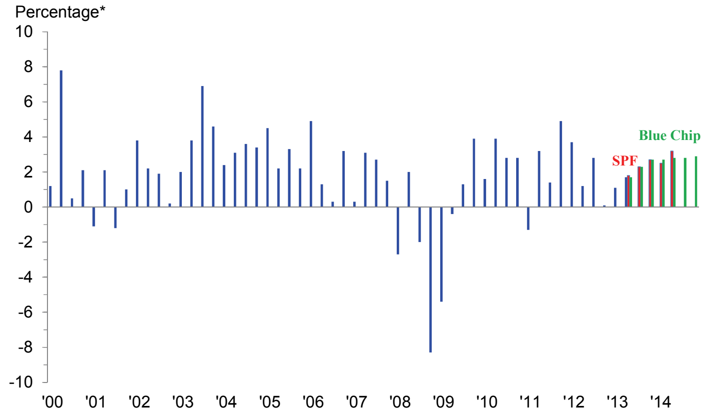
DALLASFED Economic Update
National

A Time for Cautious Optimism

August 2, 2013

Leading economic indicators, surveys of purchasing managers and modest consumer optimism suggest that the economy is poised for above-trend growth in the second half of the year. This anticipation comes from signs of improvement from a number of economic factors. Unemployment should continue falling steadily, and inflation remains low but shows signs of returning to normal. Housing markets appear to be picking up and sustaining a relatively healthy recovery. Home prices rose strongly in the past year, and permits and starts trended upward. Strong equity markets contributed largely to output growth, and the appetite for risk is normalizing following the recession. To date, the recovery has been slow relative to previous economic cycles, and various challenges remain, but downside risks to growth appear low.

Chart 1
Forecasts Offer Expectations of Higher Growth



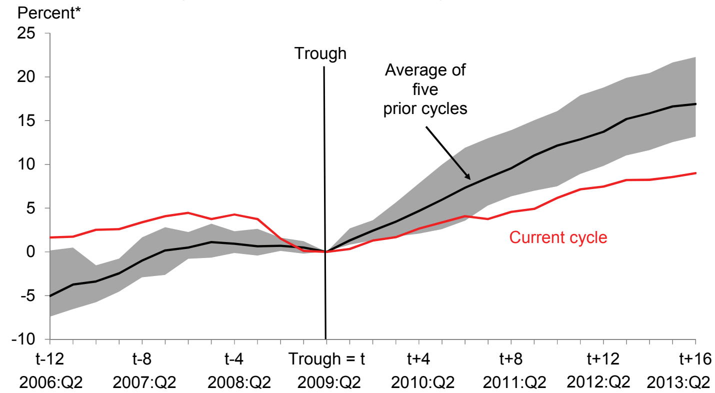
*Quarter/quarter, seasonally adjusted annualized rate.
SOURCE: Bureau of Economic Analysis.

Output Forecasts Improve Amid Tepid Recovery

The latest Blue Chip and Survey of Professional Forecasters (SPF) forecasts show real gross domestic product (GDP) growth rising gradually for the rest of the year (*Chart 1*). Both surveys suggest 2.3 percent growth in third quarter 2013 and 2.7 percent in the fourth quarter, notably higher than in previous quarters. This optimism persists for forecasts of around 3 percent for the first half of 2014 compared with the 2 percent average growth rate of the previous two years.

The rate of recovery in output is slower than in previous recessions. Chart 2 shows the level of real GDP relative to the 2008–09 recession "trough"—the lowest real GDP level within the recession—as well as the average and range of previous recoveries. Even after four years, the current recovery is still well below the previously slowest recorded recovery, which was the 2001 recession indicated by the lower frontier of the shaded area in Chart 2. A number of factors contributed to this sluggishness, not the least of which are ongoing debt, deleveraging by households and businesses, continuing U.S. fiscal headwinds, uncertainty in Europe and a recent slowdown in emerging markets.

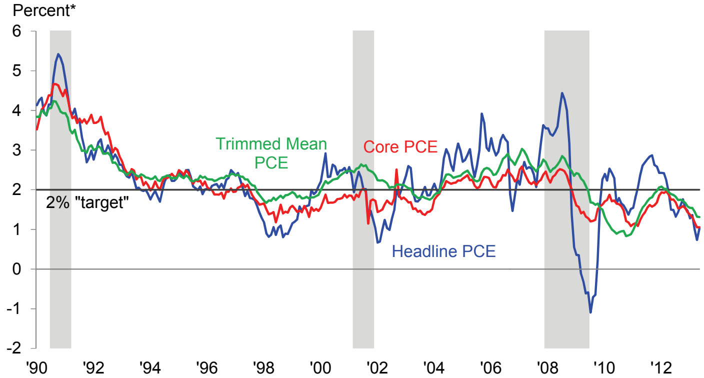
Chart 2
Current Recovery Slower Than Previous Cycles



*Deviation from trough; seasonally adjusted, annualized rate.
NOTE: Shaded area indicates range of previous five recoveries.
SOURCE: Bureau of Economic Analysis.

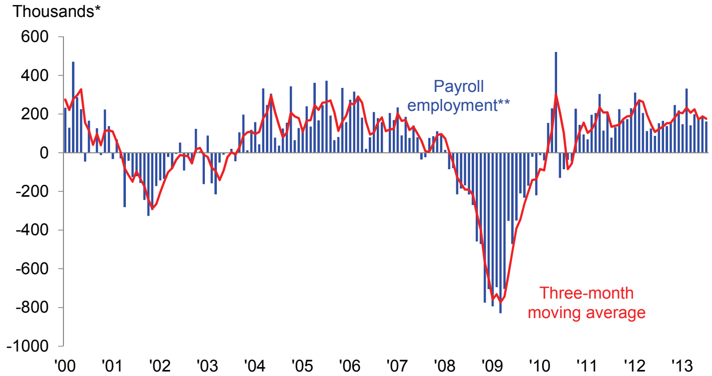
The headline personal consumption expenditures (PCE) price index rose slightly from a 0.7 percent year-over-year rate in April to a 1 percent rate in May, still well below the Federal Open Market Committee's (FOMC) 2 percent target rate of PCE inflation. The Federal Reserve Bank of Dallas' Trimmed Mean PCE inflation rate was unchanged at 1.3 percent (*Chart 3*). Inflation expectations remain anchored, and PCE inflation is forecasted to return to the target in the next couple of years.

Chart 3
Inflation Remains Low



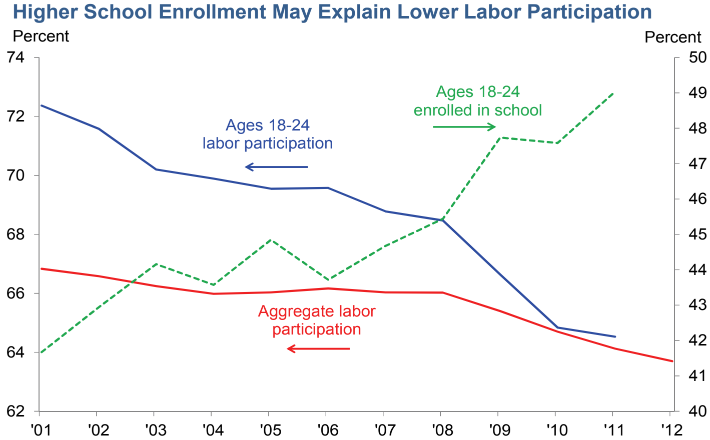
*Year/year, seasonally adjusted.
NOTE: Shaded areas indicate recession.

Chart 4
Labor Market Gains Continue



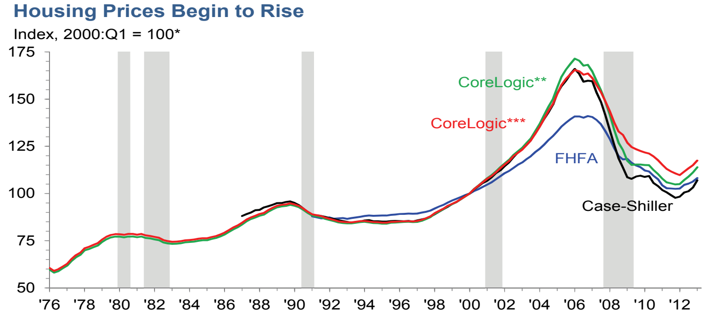
*Seasonally adjusted.
**Month/month change.
SOURCE: Bureau of Labor Statistics.

Chart 5
Higher School Enrollment May Explain Lower Labor Participation



SOURCE: Bureau of Labor Statistics.

Chart 6
Housing Prices Begin to Rise



*Adjusted for inflation.
**Distress included.
***Distress excluded.
NOTE: Shaded areas indicate recession.
SOURCES: Federal Housing Finance Agency; Standard & Poor's/Case-Shiller; CoreLogic.

Labor Markets Improve

The unemployment rate dropped slightly in July to 7.4 percent. This is over 2 percent higher than the Congressional Budget Office' estimate of the natural rate of unemployment, suggesting that considerable slack remains in the labor market. Broader measures of unemployment and underemployment rose in June but are significantly lower than a year ago. The unemployment rate is forecast to continue falling with improvements in the economy and a notable increase in average nonfarm payroll employment gains (*Chart 4*).

Despite the anticipation of better employment prospects, labor participation rates continue to decrease, especially among younger workers aged 18 to 24 (*Chart 5*). However, evidence may suggest that this abstention comes from school reentry or continuation. Enrollment rates for ages 18 to 24 have increased roughly 7 percent since 2001, with a decrease in labor participation of approximately 8 percent.

Housing Normalizing

Housing markets show signs of a healthy recovery. New and existing single-family home sales have continued to increase from the beginning of 2013. Some relaxation in lending standards for prime borrowers and very affordable housing contributed to steady increases in housing prices (*Chart 6*).

Meanwhile, foreclosure rates and inventory continue to decline from housing-bubble highs. Delinquent mortgages (those with payments past due for 90-plus days) are still high at 2.9 percent of mortgages but are trending down from the peak of 5 percent in first quarter 2010.

Financial Markets Continue to Climb

Equity prices dipped slightly following the June FOMC briefing announcing an inevitable end to the Federal Reserve's agency mortgage-backed security purchases. In response, the Standard & Poor's 500 Index dropped 1.2 percent and the Dow Jones Industrial Average dropped 0.9 percent in June. However, indexes are well beyond the prerecession zeniths and have seen gains of over 100 percent from the trough. Correspondingly, equity price volatility and financial stress indexes continue to remain stable, and risk premiums are low along with record low interest rates.

These gains in equity markets have provided substantial support to the overall recovery, as have improving housing markets. With these improvements, labor markets will likely reduce slack, and inflation should remain steady. These signs for future growth, despite the relative sluggishness, are reason to expect better times ahead.

—Camden Cornwell

About the Author

Cornwell is a research assistant in the Research Department at the Federal Reserve Bank of Dallas.