Bart Hobijn, senior research advisor in the Economic Research Department of the Federal Reserve Bank of San Francisco, states his views on the current economy and the outlook.

- GDP grew at a 1.8% annualized rate in the first quarter of 2011, a significant slowdown from the fourth quarter of 2010. Several temporary factors helped push down first-quarter GDP growth. Data released in recent weeks suggest that this sluggishness will persist longer than initially anticipated. We now forecast second-quarter GDP growth will come in at around a 2½% annualized rate. But growth should rebound in the third quarter. We expect GDP to expand at an annualized 3½% rate in the second half of the year and to continue to strengthen throughout 2012.

- Among the temporary factors that have pushed down GDP growth are the effects of the supply chain disruptions caused by the earthquake in Japan, the recent tornadoses and floods in the South and Midwest, and the spike in commodity prices, especially oil. The winding down of these temporary factors depressing economic activity should contribute positively to GDP growth in the third quarter.

- In addition to these temporary factors, however, other data signal that the recovery’s momentum is weaker than earlier data had suggested. The pace of hiring slowed in May, with only 54,000 jobs added to nonfarm payrolls. This increase was far below the average of 182,000 jobs per month gained from January through April.

- After declining by a percentage point earlier this year, the unemployment rate has stalled around 9% since February. In May, it ticked up a tenth of a percentage point to 9.1%. Consistent with our forecast of sluggish GDP growth, we now expect the unemployment rate to decline to around 8% by the end of 2012.

- Growth of household spending has tapered off. Personal consumption expenditures grew at an annual rate of 0.6% in April, well below the first-quarter pace of 2.2%. Meanwhile, real disposable personal income declined at an average annualized rate of 0.4% in the three months ending in April 2011. This suggests that the purchasing power of U.S. households is not growing at the rate it was in the second half of 2010.

- Some of the effects of reduced income growth on consumer spending could potentially be offset by increases in household wealth. However, since the beginning of May, U.S. stock market indexes have declined about 6%. Moreover, homeowners continue to see the value of their houses—their most important investment—decline. House prices are continuing to slide in most parts of the country, although the rate of decline varies substantially from state to state.
• Since consumer spending makes up 71% of expenditures in GDP, the drag that declining house prices cause on consumption is important for understanding the momentum of the recovery. More than three-quarters of U.S. household spending comes from people who own their homes rather than rent.

• The final factor pointing to reduced momentum of recovery is the slowdown in the manufacturing sector’s growth. Manufacturing has been a pocket of strength during the past six months. However, industrial production did not grow in April, partly because of the supply chain disruptions related to the Japanese earthquake. In addition, the Institute for Supply Management manufacturing purchasing managers index showed a sharp decline in the share of manufacturers reporting growth in their activity levels in May. The Federal Reserve Bank of San Francisco’s Tech Pulse Index showed a similar deceleration in tech-sector growth.

• On the upside, foreign demand for U.S. goods was robust in April. Over the past year, the dollar value of U.S. exports increased 18.8%.

• The anticipated sluggishness of the recovery implies that the economy will continue to show substantial slack. This should restrain underlying inflationary pressures. Consequently, we expect headline inflation to wane as the effects of recent commodity price increases wear off. We anticipate that headline PCE inflation will subside below a 1½% annualized rate in the second half of this year.
GDP growth expected to improve

GDP growth and FRBSF forecast
Annualized quarterly GDP growth; seasonally adjusted

Soft patch or reduced momentum?

Spending:
- Weak
- Medium
- Strong

Consumption, investment, govt outlays, and exports

Demand:
- Households, businesses, govt, foreigners

Production:
- Goods & svcs

Income & wealth:
- Wages, interest, dividends, housing, equity

Pace of hiring suggests momentum slowing

GDP growth and changes in payroll employment

Change in payroll employment (right axis)

Sluggish recovery in unemployment
Unemployment rate and forecast

Inflationary pressure should be transitory
PCE Price Inflation
Percent change from four quarters earlier

Most consumption driven by homeowners
Share of consumer spending by homeownership status
2009 consumption spending

Homeowner with mortgage: 55
Homeowner without mortgage: 22
Renter: 23

Source: Consumer Expenditure Survey
House prices continue to slide
Home Price Index: 4-quarter growth
Non seasonally adjusted; quarterly data; Mar-10 to Mar-11

-9.1  37  0.7
-4.2  -3.6 -2.4
-0.7  3.0  2.8
-7.0 -1.2  0.8
-5.6  -3.8  -23
-10.8 -2.8  1.8
-1.4  1.8  -1.2

Source: Federal Housing Finance Agency

Slower expected pace of tightening
Forward Fed Funds Rate
Implied by Fed Funds and Eurodollar Futures

Last FOMC: 4/27/2011
Most Recent: 6/9/2011

Source: Federal Housing Finance Agency