Revisions to second-quarter GDP showed that the U.S. economy grew at a 1% rate, down from the initial estimate of 1.3% reported in July. The change was more than accounted for by downward revisions to net exports and inventories, which tend to be volatile from one quarter to the next. Some of the more stable components of GDP, such as consumption and business investment in equipment and software, were actually revised upward, which provided a bit of a silver lining to the report. In addition, the March Japanese earthquake and tsunami disrupted U.S. production in the auto and a few other manufacturing industries, accounting for part of the weakness in second-quarter GDP.

As the Japanese supply-chain disruptions faded, we saw some bounce back in manufacturing production in July relative to April, May, and June. We expect data to show that this rebound continued in August. However, the Institute for Supply Management’s manufacturing survey was a little weak in July and August, particularly the new orders component, which is a good leading indicator. The readings below 50 suggest that new orders in manufacturing contracted slightly in July and August, raising concerns about the strength of manufacturing production in coming months.

The August employment report was weak overall, with no change in nonfarm payrolls in August and downward revisions to June and July. However, a strike at Verizon during the survey week reduced August payrolls by about 45,000 workers. Discounting the strike’s effects, the August numbers look very similar to those for the previous three months. Nevertheless, these readings are far below the typical increases in recoveries of 300,000 or more jobs.

The unemployment rate was also unchanged in August, remaining at a very high 9.1%. Although initial claims for unemployment insurance have come down since their recession peak, they need to fall much further to bring the unemployment rate down. There are still more people flowing into unemployment every week—over 400,000—than at most points during the 2001 recession.

Business investment has been one of the economy’s brighter spots. Investment by businesses tends to be correlated with purchases of durable goods, and both durable goods orders and shipments have recovered substantially since 2009, almost reaching their pre-recession peaks. Moreover, new orders continue to exceed shipments, suggesting that durable goods shipments are likely to increase over the next several months.
• The housing sector is still extremely weak and shows no signs of improvement despite mortgage rates that are again near all-time lows. In particular, new home sales continue to bounce along the bottom at levels below the depths of the recession. New home sales remain lower than at almost any time in the 50-year history of the series. Only at a few points in 2010 was the sales pace more lackluster.

• Measures of consumer sentiment plunged in August to levels roughly in line with the depths of the recession. Three main factors probably explain this. First, stock market volatility rose to extremely high levels at the end of July and in the first few weeks of August, driven largely by financial market concerns about Europe. Second, the contentious congressional debate over raising the federal debt ceiling seemed to undermine public confidence in Congress and the U.S. outlook in general. Third, the Standard & Poor’s downgrade of U.S. Treasury securities on August 5 seemed to amplify the public’s perception that the U.S. economy was headed in the wrong direction. Hopefully, consumer attitudes will start to rebound in September as these factors fade from public memory. When consumer sentiment is weak, households are less likely to make big-ticket purchases, such as autos, furniture, and appliances. So the sharp drop in consumer attitudes is a worrisome sign for future consumption.

• Financial market concerns about possible European debt defaults spiked in July and early August, but have since fallen back, probably for two reasons. First, the European Central Bank stepped in to support euro zone bond markets by purchasing Spanish and Italian government bonds. Second, meetings between French and German leaders in August appeared to reassure markets that the euro zone core would do what was necessary to contain the crisis. However, market concerns about Europe have flared up again in recent days.

• Oil prices have fallen substantially from their peak a few months ago, reducing business costs and providing a welcome boost to household spending power. This should put downward pressure on inflation and help support growth in coming quarters.

• Interest rates hit historic lows over the past few weeks. The 10-year Treasury yield briefly dipped below 2%, its lowest level since at least 1960. A small part of the drop was due to the Federal Reserve’s August 9 statement that exceptionally low levels of the federal funds rate are likely to be warranted “at least through mid-2013.” But most of the decline was due to a series of generally weaker-than-expected data releases, which lowered market expectations about economic growth and inflation, and pushed out the date when market participants expect the Fed to begin tightening monetary policy.

• We have lowered our forecast since the last FedViews, but our projections remain qualitatively similar. We expect continued sluggish growth for the next several quarters, gradually picking up to a more normal recovery pace in 2013 and beyond. The zigzag pattern in the second and third quarters of 2011 reflects the effects of the Japanese earthquake and tsunami, which reduced second-quarter growth but probably is increasing growth in the third quarter, as idled production starts coming back on line and extra shifts are added to bring inventories back to normal levels.

• Finally, despite the uptick posted earlier this year, we see inflation moderating over coming quarters as the weak labor market keeps wages low and the decline in oil prices puts downward pressure on energy and transportation costs.
GDP in 2011:Q1 weak, Q2 revised down

Some production bounce back, new orders remain weak

Employment growing very slowly

Unemployment remains stubbornly high

Business investment recovering

Housing sector still moribund
Consumer sentiment has plunged

Market concerns about European debt

Oil prices have fallen sharply from recent peaks

Interest rates hit historic lows

We forecast continued slow recovery

And recent uptick in inflation will dissipate