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

- After growing at a fairly strong pace at the end of last year, real GDP has decelerated. Some of the slowdown is probably due to temporary factors, such as a payback for unseasonably warm winter weather that may have accelerated economic activity earlier this year. However, a broad range of economic indicators for the second quarter, including payroll job growth, personal income, and manufacturing orders, have come in softer than we expected.

- Recent data suggest that the recovery has less momentum than we anticipated. This evidence, coupled with increasing strains in global financial markets, has led us to mark down our forecast for GDP growth for 2012 and 2013. Our current view is that real GDP will grow about 2 to 2½% this year and next.

- This forecast is based on interpreting the recent data as signaling a temporary soft patch, similar to what occurred a year ago, not a more persistent slowdown. As a result, we think that average growth over the past three quarters of 2.2% is a better gauge of the underlying strength of the recovery than the most recent data.

- The main risk to the pace of the recovery is a further escalation of the financial crisis in Europe. That would reduce European demand for U.S. exports and would accelerate the recent flight to safety in financial markets that has fueled demand for U.S. Treasury securities. Because of this flight to safety, yields on 10-year U.S. Treasuries have fallen to historic lows. This trend tends to strengthen the dollar and increase risk premiums on corporate bonds and equities. A stronger dollar makes U.S. exports more expensive for foreign buyers, while higher risk premiums push up financing costs and lower stock market valuations.

- The combination of the European crisis and slowing growth in some emerging market economies has already led to a weakening of global demand. That, in turn, has prompted steep declines in commodity prices. Falling commodity prices, combined with only a gradual drop in the high unemployment rate, suggest that inflationary pressures will be very limited. Thus, we expect inflation as measured by the personal consumption expenditures price index to remain below a 2% annualized rate this year and next.

- In line with the revisions of our forecast for GDP growth, we have raised our forecast for the unemployment rate. We now expect the rate to remain above 7.5% throughout 2013. This implies a marked slowdown in the pace of decline of the unemployment rate relative to what has taken place over the past year.
This unemployment rate forecast is shaped by our view that a substantial part of the rate’s 1 percentage point decrease over the past nine months occurred because many workers, especially the long-term unemployed, gave up looking for jobs and left the labor force until conditions improve. If labor market conditions do improve, as our forecast implies, then we expect those workers to rejoin the labor force. As they resume their search for work, they will be counted as unemployed again.

Consistent with the falling unemployment rate, indicators of labor market churn suggest that labor market conditions have gradually improved over the past 12 months. The quits rate, which measures the number of workers who voluntarily leave their jobs, mostly people who decide to pursue better opportunities, has been steadily increasing. In addition, the job finding rate, as measured by the fraction of unemployed in a given month who are employed the following month, has been steadily increasing over the past year, though it’s still near its historic low.

These alternative labor market indicators suggest that payroll job gains of about 150,000 per month over the past year are probably more indicative of the labor market’s overall momentum than were April and May’s disappointing job gains. Our unemployment rate forecast is based on a rate of labor market recovery comparable to that of the past year. Such a pace is only slightly higher than what is needed to keep up with population growth. The result would be only a very slow and gradual decline in the unemployment rate.
Continued gradual recovery

GDP Growth: Actual and FRBSF Forecast

Euro crisis is not abating

10 year government bond yields

Inflation expected to remain in check

PCE Price Inflation

Forecast slow decline in unemployment

Unemployment rate and forecast

Unemployment durations remain a concern

Unemployment rate split up by duration

Slight improvement in odds of finding job

Share of unemployed who are employed next month
... and more people are switching jobs

Share of employed who voluntarily leave their job

Quits Rate

Percent