Reuven Glick, group vice president at the Federal Reserve Bank of San Francisco, states his views on the current economy and the outlook.

- Recent data have generally disappointed and suggest some loss of momentum in the ongoing economic recovery.

- Nonfarm payrolls increased in June by 80,000, somewhat worse than expectations, but similar to the rates of job creation in April and May. The June data appear to confirm a slowdown in job creation in the second quarter of 2012. New jobs averaged 75,000 per month in the second quarter compared with an average of 226,000 per month in the first quarter. The unemployment rate was unchanged at 8.2% in June.

- Data on May personal income and spending confirm the gradual softening observed during the past few months. Real personal consumption expenditures, which represent about two-thirds of gross domestic product (GDP), rose only 0.1% in May. Meanwhile, the saving rate ticked up, indicating that consumers may have become more cautious. The Thomson Reuters/University of Michigan Index of Consumer Sentiment fell in June to its lowest point this year.

- Manufacturing activity, one of the bright spots so far in the recovery, is cooling. The Institute for Supply Management’s latest survey dipped below 50%, the first such reading since mid-2009. A reading below 50% indicates that manufacturing is generally contracting. The ISM manufacturing survey’s new orders and production indexes fell to their lowest levels in three years. The ISM index for nonmanufacturing activity also dropped slightly, although it is still signaling growth.

- Output growth as measured by GDP is likely to expand by a little less than 2% through the end of the year and pick up slightly to about a 2¼% pace next year. In line with the tepid outlook for growth, unemployment is expected to decline very gradually to slightly below 8% by the end of 2013.

- Overall inflation as measured by the personal consumption expenditures price index rose 1.5% over the 12 months that ended in May. Continuing declines in the price of energy are likely to push inflation even lower for the next few quarters, though higher food prices will partly offset this. We expect inflation to then rise close to 1¾% early next year. Despite persistent slack in the economy, inflation seems likely to edge up very gradually in subsequent years.

- In considering risks to the outlook, there is a great deal of uncertainty about a possible escalation of financial stresses in Europe. Recent actions by European policymakers have not reduced sovereign borrowing costs of the key countries of Spain and Italy in a sustained way. A more severe recession in Europe and spillovers to global financial markets could sharply weaken U.S. prospects for growth.
The United States is exposed to Europe through several channels, including trade. The euro area and the rest of Europe account for 22% of total U.S. exports. Fallout from the European crisis is also holding back growth in many emerging market countries, including China. The growth slowdown in these emerging countries is exacerbating the effects of the European crisis in the United States by further limiting demand for U.S. exports. Increased demand for high-quality, liquid U.S. financial assets as a result of a flight to safety has caused the dollar to appreciate, which also damps demand for our exports.

U.S. financial institutions are exposed to European financial markets through their claims on European banks, governments, and nonfinancial businesses. Concerns about this exposure have led U.S. banks and money market funds to reduce their holdings of euro-zone debt over the past two years.

U.S. capital markets are also vulnerable to developments in Europe. U.S. equity prices generally have risen relative to European prices since the U.S. recovery began in 2009. However, shorter-term U.S. and euro-area stock market movements have been highly correlated. This correlation reflects the impact of Europe’s troubles on U.S. exporters and multinational corporations doing business in Europe, as well as effects on investor confidence and risk appetite. Corporate bond rates in the United States and Europe have also been moving together for similar reasons.
Labor market improving slowly
Change in nonfarm payroll employment
Monthly change in payrolls
Thousands
Source: Bureau of Labor Statistics

Expect continued gradual recovery
Gross domestic product (GDP)
Percent change at seasonally adjusted annual rate
Source: Bureau of Labor Statistics

Expect unemployment to fall slowly
Unemployment rate
Monthly data; seasonally adjusted; forecast is quarterly avg.
Source: Bureau of Labor Statistics and FRBSF staff

Expect inflation to remain below 2%
PCE inflation
Percent change from four quarters earlier
Source: Bureau of Labor Statistics

Spain, Italy sovereign rates stay elevated
10-year government bond yields
Source: Bloomberg; LTRO denotes first long-term refinancing operation

U.S. exposed to Europe through trade
U.S. exports by destination: Share of total U.S. exports, 2011
Note: May figure is 12-month percent change.
U.S. banks exposed to euro zone

U.S. bank claims on euro zone
As a percent of U.S. bank total foreign claims, end of period

Peripheral Countries
Core Countries

Source: BIS Consolidated Statistics, Table 9E. Peripherals = Greece, Portugal, Ireland, Spain, Italy

U.S. money funds exposed to euro zone
U.S. prime money market fund claims on euro zone
Percentage of total assets, end of period

Source: Investment Company Institute
Note: 2010-Q3 figure is for Nov 2010; 2012-Q2 figure is for May 2012

U.S., European stock markets are linked...
Stock market indexes
January 1, 2009 = 100

Source: Bloomberg

...as are corporate bond markets
Corporate bond spreads
Investment grade bond relative to Treasury rates, in percent

Sources: Bloomberg, Barclays Capital