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

- Recent data have been consistent with our forecast of a moderately growing economy and stable inflation, setting aside the economic effects of Hurricane Sandy, which are difficult to estimate at this point. We see growth picking up gradually over 2013 and beyond, but still expect significant labor market slack even at the end of 2014.

- Real GDP grew at a 2% annual rate in the third quarter, but the report illustrates a pattern evident in recent data: a divergence between households and businesses in terms of both recent spending and expectations about the future. Real personal consumption expenditures grew at a 2% annual rate in the third quarter, matching GDP. And residential investment rose at a 14% annual rate, though it constitutes less than 3% of GDP. At the same time though, inflation-adjusted business spending looked quite different. Spending on nonresidential structures fell at a 5% rate, while spending on equipment and software was unchanged.

- Nonfarm payroll employment grew 171,000 in October, and data for the previous two months were revised up substantially, according to the Bureau of Labor Statistics (BLS) survey of employers. The BLS household survey showed the unemployment rate rising to 7.9% from 7.8%, reversing part of the 0.3 percentage point decline in September. The household survey also showed a substantial employment increase in October. Measured over the past 12 months, civilian employment is now growing at rates not seen since the mid-2000s. Of course, the nation still has a long way to go to make up for the substantial job losses during the recession.

- Faster job growth seems correlated with rising consumer optimism about the job market. A major consumer survey showed that, in October, the percentage of respondents expecting the unemployment rate to be lower in six months had risen to its highest level since March 1984. And optimism is not limited to job market conditions. The expectations component of the Thomson Reuters/University of Michigan Surveys of Consumers sentiment index has recently risen to levels not seen in five years. The expectations component includes questions about how survey participants see their financial situation over the next year and what economic condition they expect over the next one and five years.

- Rising consumer optimism seems reflected in how consumers have been spending their money. Before Hurricane Sandy, auto sales had been rebounding quite smartly. Home sales have been growing as well, although they remain far below pre-recession levels. Over the past 12 months, existing home sales are up 11%, while new home sales have climbed 27%. Lower long-term interest rates have surely played a part. But both homes and autos are long-term purchases, requiring a substantial financial commitment. Consumers are unlikely to make these commitments if they are worried about the future.
Other housing market indicators have turned positive as well. Inventories of unsold homes have declined noticeably of late. Stocks of both new and existing homes are below their long-term averages, measured relative to monthly sales. Home prices have begun to rise in a more sustained manner, though the increases are not large. For example, the S&P/Case-Shiller 20-City Composite Home Price Index is up 2% over 12 months, while the CoreLogic Home Price Index is up 5%. Moreover, housing starts are growing faster, rising nearly 35% over the past 12 months.

These improvements are showing up in builder sentiment, which, though still below average levels, has jumped noticeably in recent months. However, the same thing cannot be said of business sentiment in general. For instance, National Federation of Independent Business surveys show the shares of members planning capital expenditures over the next three to six months or expecting higher inflation-adjusted sales in six months remain below average. More importantly, these indicators have not improved much over the past year.

This pessimism appears to be showing up in orders for nondefense capital goods, which have fallen nearly 10% since their December 2011 peak. While this is nowhere near what one would see in a recession, declines of this magnitude are rare at other times. In other data, manufacturing is a bright spot, with orders rising in both September and October.

These declining orders for nondefense capital goods raise the risk that the economy will perform worse than we expect. The looming federal “fiscal cliff” and the European financial crisis and recession also pose risks to the outlook.

Even so, we expect the pace of growth will increase over time, once the economy works through the effects of Hurricane Sandy, the drought in many parts of the country, and the fiscal tightening that we anticipate at the beginning of next year as at least some fiscal cliff measures are implemented. Specifically, we expect real GDP to increase roughly 2¼% in 2013 and 3½% in 2014. This gradual pickup won’t be enough to bring down the unemployment rate quickly. At the end of 2014, we expect the rate to still be about 1½ percentage points above its inflation-neutral equilibrium level.

Apart from short-run swings in the price of oil and agricultural goods, we see little inflationary pressure in the economy. Inflation is expected to remain below the Federal Reserve’s 2% target for several years.

Our forecast takes into account the stimulus measures announced by the Federal Reserve’s policy committee in September. The Federal Open Market Committee said then that the Fed will buy additional agency mortgage-backed securities at a pace of $40 billion per month until substantial progress toward the Fed’s maximum employment goal is evident. It also said it anticipates that exceptionally low levels for the benchmark federal funds rate will be warranted at least through mid-2015.
Recent growth has been uneven

Third Quarter Growth Rates
Real, seasonally adjusted, annualized

Jobs grew faster than expected in October

Employment
12-mo. change, seasonally adjusted

Consumers most optimistic since recession

Consumer Expectations
Not seasonally adjusted, 1966:Q1 = 100

Home sales recovering

Home Sales
Seasonally adjusted annual rate

Declining housing inventory overhang...

Months of Supply
3-mo. moving average

...means less pessimistic homebuilders

Homebuilders: Housing Market Index
Seasonally adjusted
Other business sentiment not improving

-40

% Expecting Higher Real Sales in 6 Mos.
Seasonally Adjusted

86 88 90 92 94 96 98 00 02 04 06 08 10 12

Source: National Federation of Independent Business

No rebound in planned investment

% Planning Capital Expenditures Next 3-6 Mos.
Seasonally Adjusted

86 88 90 92 94 96 98 00 02 04 06 08 10 12

Source: National Federation of Independent Business

Pessimism shows in capital goods orders

Nondefense Capital Goods (excluding Aircraft)
Seasonally adjusted, 3-mo. moving average

$ bil.

00 01 02 03 04 05 06 07 08 09 10 11 12

Source: Census Bureau

We forecast gradual pickup in growth...

GDP Growth: Actual and FRBSF Forecast

% 6

Actual  FRBSF Forecast

05 06 07 08 09 10 11 12 13 14

Source: Bureau of Economic Analysis

...while inflation remains subdued

PCE Inflation
% change from four quarters earlier

-2

Overall PCE Price Index

Core PCE Price Index

FRBSF forecast

04 05 06 07 08 09 10 11 12 13 14

Source: Bureau of Economic Analysis