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

- The economy continues to expand at a moderate pace. Ongoing federal deficit reduction will weigh on the recovery in the near term, and so we expect growth of only about 2¼% this year. We expect growth to pick up to about 3¼% next year as monetary policy remains accommodative and the forces restraining recovery ease somewhat. These adverse forces include restrictive fiscal policy at home; the economic, fiscal, and financial situation in Europe; and the pervasive uncertainty that has been weighing on households and businesses.

- Despite increases in payroll, income, and other taxes at the beginning of this year, consumer spending has held up well in recent months. This resilience is a positive for the outlook going forward.

- Housing has become a tailwind for the recovery and is supporting consumer spending more broadly. For example, though they are well below their previous peak, home prices are up sharply over the past year. Those price increases have improved household balance sheets and pulled some homeowners above water on their mortgages.

- More generally, other asset prices have also risen over the past year, with stock markets reaching new nominal highs. That has further bolstered household balance sheets and spending.

- Capital investment for equipment and software has risen substantially since the recession ended. In the past year, the rate of increase has been choppy. Investment dipped a bit in mid-2012, recovered sharply at the end of the year, and then rose only modestly in the first quarter of this year.

- Orders for nondefense capital goods, which are a forward-looking indicator of capital investment, have edged up in recent months. Growth in this indicator is consistent with modest investment growth again this quarter. We expect investment to gain more traction in the second half of this year, as the forces weighing on recovery slowly ease.

- Most labor market indicators have shown ongoing, if gradual, signs of improvement. The April employment report showed gains of 165,000 jobs, and gains in February and March were revised up. Over the first four months of the year, the labor market added almost 200,000 jobs per month on average.

- Similarly, the unemployment rate has been coming down. In April, the unemployment rate fell to 7.5% from 7.9% in January and 8.1% a year ago. Going forward, as economic growth picks up, we expect that the unemployment rate will gradually decline further.
• A wide range of other labor market indicators—including initial claims for unemployment insurance, surveys of household perceptions of job availability, and temporary help employment—are improving. These indicators tend to lead job growth and unemployment declines, so we expect that the labor market will continue its gradual return to normal.

• Not all labor market measures show improvement yet. For example, employment relative to the working-age population has been flat. Indeed, if a shortfall of available jobs leads some people to stop searching for work, they are not counted as unemployed even if they don’t have a job. When the labor market improves sufficiently, many of these potential workers are likely to return to the labor force. Nevertheless, we do not expect the employment-to-population ratio to return to its pre-crisis level, in large part because the population is aging.

• Recent inflation data have been subdued. Over time, we expect inflation to rise towards the Fed’s 2% inflation objective. In particular, as slack in labor markets continues to diminish, some of the downward pressures on wages, costs, and prices should ease.

• With labor markets falling short of maximum employment and inflation running below the Fed’s objective, monetary policy remains quite accommodative. Resulting low interest rates have especially helped the recovery in interest-sensitive sectors such as housing and motor vehicles.
Moderate recovery is continuing

GDP Growth: Actual and FRBSF Forecast
Annualized growth rate, seasonally adjusted

Consumer spending held up in first quarter
Real Personal Consumption Expenditures
Seasonally adjusted annual rate

Housing is becoming a tailwind
U.S. House Prices
Seasonally adjusted; indexed to 100 in 2000:1

Capital investment choppy recently
Real Equipment and Software Investment
Seasonally adjusted annual rate

Orders for capital goods edging up
Nondefense Capital Goods (ex. Aircraft)
Seasonally adjusted; three-month moving average

Employment continues to improve
Nonfarm Payroll Employment
Millions of employees; seasonally adjusted

Source: Bureau of Economic Analysis
Source: CoreLogic/Haver Analytics. Index excludes distressed sales.
Source: Census Bureau
Source: Bureau of Labor Statistics
Unemployment rate continues to decline

- Unemployment rate: Seasonally adjusted; forecast is quarterly average.

But employment flat relative to population

- Employment-to-Population Ratio: Percent of population aged 16 and older; seasonally adjusted.

Subdued inflation rises towards 2%

- PCE Inflation: Percent change from four quarters earlier.

Interest rates remain low

- Interest Rates: Weekly average.