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*Simon Kwan, vice president at the Federal Reserve Bank of San Francisco, states his views on the current economy and the outlook:*

- Incoming data continue to indicate that the economic recovery is taking hold. Deterioration in the labor market is abating. Household spending is expanding at a moderate pace. Tentative signs suggest that the housing sector may have bottomed, and housing construction has begun to grow. Financial market conditions have improved further.
- The employment report for the month of November was better than expected. Nonfarm payroll employment edged down by just 11,000 jobs, much less than expected, and the employment counts in September and October were revised to show smaller declines than previously reported.
- The unemployment rate fell 0.2 percentage point to 10.0%, which was also better than expected. Based on all available data, including physical product data, it appears that the unemployment rate is close to its cyclical peak and is expected to come down gradually. Nevertheless, the unemployment rate is expected to remain elevated for several years.
- Resource slack in the economy is both large and persistent, and longer-term inflation expectations are fairly stable. As a result, inflation is expected to remain subdued over the next few years.
- A key driver of recovery is a pickup in household consumption. Real personal consumption expenditures rose by a brisk 0.4% in October, boosted by a 2% jump in consumption of durable goods. Economic fears are abating. The housing sector is stabilizing, as is housing wealth. These developments allow for release of pent-up consumer demand, providing a positive impetus to household consumption. However, going forward, a weak labor market, sluggish income growth, and tight credit will likely restrain household consumption, pointing to a slow recovery.
- An important barometer of household consumption is auto sales, which have been holding up reasonably well over the past two months, despite the end of the cash-for-clunkers program. While heading in the right direction, car sales are still recovering from very low levels of early this year.
- In the housing sector, home sales surged in October as buyers rushed to lock in the first-time homebuyer tax credit, which has since been extended and expanded. Residential investment rose at an annualized rate of almost 20% in the third quarter, albeit from a very low base, providing the first positive contribution to GDP growth since 2005.

- A key element supporting the housing sector is very low conforming mortgage rates. The 30-year conforming mortgage rate is the lowest since Freddie Mac began reporting the weekly average in 1971. Since last November when the Federal Reserve announced the purchase of up to \$500 billion in agency mortgage-backed securities (MBS), since raised to up to \$1.25 trillion, the 30-year conforming mortgage rate has dropped from 6.04% to 4.71%, a decline of 1.33 percentage points. The spread between the yield on agency MBS and 10-year Treasury bonds has also been very low. Currently it is just 0.77 percentage point. From 2000 to 2007, this spread averaged about 1.30 percentage points. A reversion to the pre-crisis average would widen the spread by about 0.50 percentage point, which would push the 30-year conforming mortgage rate up by about the same amount, and could pose a risk to the housing recovery.
- Elsewhere in the credit markets, a substantial decline in corporate bond yields raises the question of whether a bubble is brewing. It should be noted, though, that corporate bond yields have come down from unusually high levels. The spike in bond yields following the bankruptcy of Lehman Brothers reflected a classic flight to quality. As financial market conditions improve and liquidity returns to the bond market, the retracing of bond yields should be seen as a normalization process rather than as a sign of excessive risk-taking. Indeed, the yield spreads of corporate bonds over Treasury securities remain somewhat elevated, which seems to reflect default risk priced into corporate bonds due to uncertainties about the economic recovery going forward.
- Corporate profits have rebounded in the last two quarters, perhaps reflecting aggressive cost cutting more than top-line revenue growth. Nevertheless, equity analysts are projecting relatively respectable profit growth over the next four quarters. In response to corporate earnings announcements and profit guidance, and investors' increased risk tolerance, overall stock prices have risen briskly since March, also raising concerns of excessive risk-taking by market participants. The price/earnings (P/E) ratio for the Standard and Poor's 500 stock index, based on the past four quarters' earnings, is currently at about 22, somewhat higher than its long-term average of around 16.5. To the extent that corporate profits are expected to be higher over the next four quarters, the forward P/E ratio based on expected future earnings would be lower. Another measure of stock valuation, the equity premium between earnings yield and bond yield, remains elevated. Overall, the runup in stock prices also looks more like normalization than excessive risk-taking.
- One area of potential concern may be prices of certain commodities, most notably gold. Unlike other asset classes that can be examined under a capital asset pricing framework, commodity prices are largely determined by supply and demand, which can be challenging to analyze precisely.



