

## FedViews – June 11, 2009

*Eric Swanson, research advisor at the Federal Reserve Bank of San Francisco, states his views on the current economy and the outlook:*

- Over the past several weeks, forward-looking economic indicators such as stock prices, corporate bond spreads, and the Institute for Supply Management (ISM) survey of manufacturers have been giving more positive readings, while lagging economic indicators such as employment and unemployment have continued to reflect the ongoing contraction in the U.S. economy.
- In the manufacturing sector, output declined further in April, but at a less rapid pace than in previous months. However, the new orders component of the ISM survey of manufacturers, which is a good leading indicator, rose to 51.1 in May, implying that more than half of the survey respondents experienced growth in new orders relative to the month before. This marks the first time that the index has risen above 50 since November 2007.
- The unemployment rate shot up to 9.4% in May from 8.9% in April, a dismal reading that was substantially worse than expected. Part of the rise in unemployment was due to an increase in the number of people entering the labor force, which can be a positive sign that people see a reasonable chance of finding a job. Continuing claims for unemployment insurance have trended upward, much like the overall unemployment rate, but initial claims for unemployment insurance have been coming down since March, suggesting that new layoffs of workers may have passed their peak.
- The number of workers on nonfarm payrolls fell by 345,000 in May, a marked slowing of the rate of job losses relative to the past several months and better than forecasters expected. The number of jobs lost in March and April were also revised down by about 50,000 and 30,000 respectively.
- Autos and light trucks sold at a 9.9 million annual rate in May, a level broadly similar to the historically low readings of the past several months. Aggregate vehicle registrations data from the Federal Highway Administration can be used to infer how many vehicles were not re-registered from one year to the next, and we refer to those vehicles as having been “scrapped.” Auto sales are running not only at the lowest level in decades, they are running two to three million vehicles below reasonable estimates of scrappage as well, suggesting that auto sales are likely to pick up soon. Indeed, several manufacturers have announced plans to increase production in the third quarter.
- Like auto sales, home sales continue to bounce along what appears to be a bottom. An important source of support for home sales has been the historically low level of conforming mortgage interest rates for the past several months. However, those rates leapt almost a full percentage point over the past two weeks, and now stand at 5.69%. Although conforming mortgage rates are still low by historic standards, the recent spike is likely to dampen sales and put further downward pressure on prices in the housing market.

The views expressed are those of the author, with input from the forecasting staff of the Federal Reserve Bank of San Francisco. They are not intended to represent the views of others within the Bank or within the Federal Reserve System. FedViews generally appears around the middle of the month. The next FedViews is scheduled to be released on or before July 13, 2009.

- The recent spike in mortgage rates reflects an equally dramatic rise in long-term Treasury yields. Reasons for the rise can be divided into three main categories: First, inflation expectations may have increased due to rising oil prices and other factors, which causes nominal bond yields to rise. Second, the large increase in the quantity of securities being issued by the Treasury to fund record deficits may be pushing up interest rates in order to induce lenders to purchase the growing supply of securities. Finally, domestic and international investors may be displaying an increased appetite for riskier, higher-yielding assets, thereby reducing demand for Treasuries, the traditional flight-to-safety investment, pushing their yields higher.
- For example, despite the recent sharp rise in Treasury yields, AAA corporate bond yields are up only slightly, BAA bond yields are down somewhat, and high-yield corporate bond yields are down dramatically. These movements suggest an improvement in the U.S. economic outlook and in the attractiveness of riskier, higher-yielding corporate bonds relative to Treasuries.
- Short-term corporate financing rates have also been dropping steadily. The commercial paper market, which was thrown into chaos following the Lehman Brothers bankruptcy in September, has been showing signs of healing. Spreads on commercial paper relative to the federal funds rate are now even lower than they were in the six months prior to Lehman's collapse, although still not as low as in the years prior to 2007.
- Oil prices have rebounded from their lows of the past few months, and now stand at over \$70 per barrel. To some extent, this may reflect an improving economic outlook in the United States, China, and elsewhere, but the price increase is also putting downward pressure on that outlook through higher fuel and energy costs.
- The data for the second quarter that have come in so far strongly suggest that GDP is contracting, but at a much slower pace than in the past two quarters. We forecast that GDP will contract at about a 1% annual rate in the second quarter and will post a small positive growth rate in the third quarter. Looking further ahead, we expect GDP to grow at an above-trend rate for several quarters as the economy returns to a more normal level of labor-force and capacity utilization.
- This forecast is more sluggish than would be suggested by past recoveries for two main reasons: First, firms and households are having a more difficult time obtaining credit from banks in the current episode, a constraint we view as relaxing only gradually over time. Second, we forecast that consumption will not grow as strongly as in years past as households increase their saving rate to rebuild their balance sheets.
- Given the weak level of retail sales, manufacturing, and output more broadly, we see substantial downward pressure on prices outside the energy sector over the next several quarters. As a result, we expect that inflation will continue the gradual downward trend that has been evident since the middle of last year.



