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

- On balance, it's probable that the economy has reached bottom and begun its slow recovery. The course going forward surely won't be smooth or painless, and clear risks remain.

- Housing activity has been showing fairly uniform signs of recovery. For example, housing starts and permits have been rising fairly steadily since the beginning of the year. Home sales are also picking up, a factor contributing to the resumption of construction activity. By some measures, home prices have also shown some signs of stabilizing. Given the importance of housing in the balance sheets of both households and banks, stabilization in housing markets would aid a broader economic recovery.

- Surveys of purchasing managers by the Institute for Supply Management suggest that manufacturing activity is now expanding. A reading above 50 indicates expansion. The new orders component of the index was particularly strong last month, showing the highest monthly reading since late 2004. Indeed, the last time the index recovered to above 50 while the economy was still in recession was in the 1950s. Manufacturing production is closely correlated with this index.

- On the consumer side, the big positive indicator was light vehicle sales, where cash-for-clunkers was a resounding success at driving up auto sales, at least temporarily. Light vehicle sales in August surged to an annual rate of 14 million units, the highest level since early last year. Because of this strength in auto sales, durable consumption spending in the third quarter has been very strong.

- Much of the boost to vehicle sales appears temporary. Many or most of the sales under the program were probably shifted from the months to come, or even from next year.

- There are clear risks to the outlook, and some indicators continue to decline—most notably employment. Nonetheless, the pace of job losses is slowing. In the first half of the year, employment fell by more than half a million jobs a month. In August, employment fell only 216,000. Employment has now fallen by nearly 7 million jobs since the peak at the end of 2007. Indeed, the level of employment is about where it was in early 2000.

- At the same time that employment has fallen—contributing to weak household income growth—mortgage loan foreclosures also continue to mount on fixed as well as adjustable-rate mortgages. Rising foreclosures and ensuing sales of foreclosed properties raise the risk that home prices might resume their downward trajectory. That would, of course, put renewed stress on household and bank balance sheets.

- Since the housing correction began, home prices have fallen substantially. Much of the adjustment in that market has certainly taken place. But, relative to their rental equivalent, home prices remain about 20 percent above their average from 1970 to 2000. This ratio, which is like a price-dividend ratio for housing, rose well above its long-term average in the early 2000s. The ratio might not need to adjust all the way down, but it does suggest that home prices have probably not overcorrected on the downside.

- With the lingering effects of declining wealth, a poor job market, weak income growth, and tight credit, consumption growth outside of motor vehicles has remained anemic.

- Despite the risks, we still expect the return to positive output growth to begin in the current quarter. We expect the recovery will gradually pick up steam over the next year or two.

- How does the recession and anticipated recovery compare with historical experience? The recession began in the fourth quarter of 2007. By the second quarter of 2009, the sixth quarter after the recession began, GDP had fallen nearly 4 percent.

- The current recession is longer than any recession since 1933 and, in terms of GDP, is as deep as any in the post-war period. Yet the forecast for recovery is anemic compared with historical experience. The relative weakness reflects in part continuing tight credit conditions for households and businesses as financial institutions and markets slowly heal. At the same time, as noted earlier, consumer spending is likely to remain relatively weak. In the forecast, it takes 11 quarters, until the third quarter of 2010, just to get GDP back to its pre-recession level.

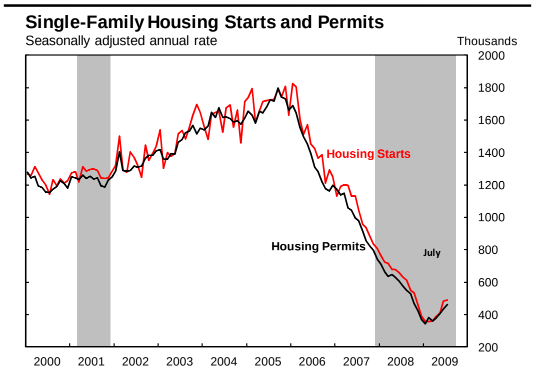
- As far as the outlook for inflation is concerned, cost pressures remain low. In particular, wages are barely growing. Compensation per hour, a broad, but relatively volatile measure, is rising at close to its slowest pace since the series began in the 1940s. The employment cost index, a somewhat smoother indicator, is growing at the slowest pace since that series began in the early 1980s. A key reason for the lack of wage pressures is the degree of slack in labor markets, reflecting the very high unemployment rate.

- With the weakness in wage growth and the overall high degree of slack in the economy, little inflation pressure is evident in the near term. Overall consumer prices have fallen year-on-year for the first time since the 1950s. The big reason for that, of course, is that energy prices are down by nearly a third from their level in the summer of 2008. But core inflation, which excludes volatile food and energy, has also fallen to a year-over-year pace of about 1-1/2 percent.

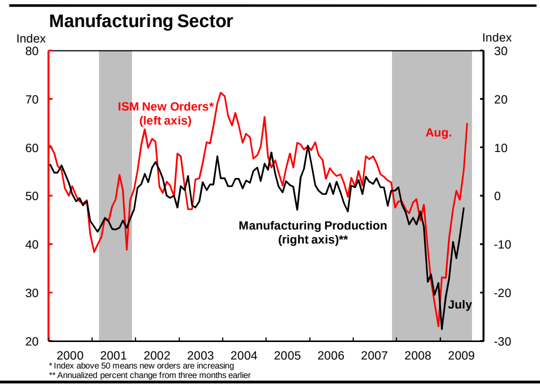
- We expect the high degree of slack to cause core inflation to moderate even more in the near term. Overall inflation will rise somewhat more in the next few quarters, given the rise in oil prices from their lows earlier in the year.

- Rates on Treasury securities and 30-year conforming-mortgages remain well below their pre-recession levels. Futures prices indicate that market participants expect the federal funds rate to begin to rise early next year.

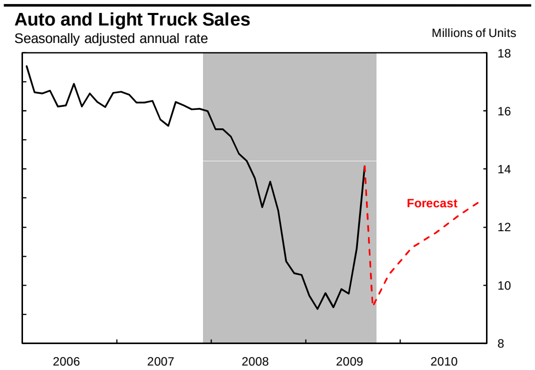
Housing activity is picking up



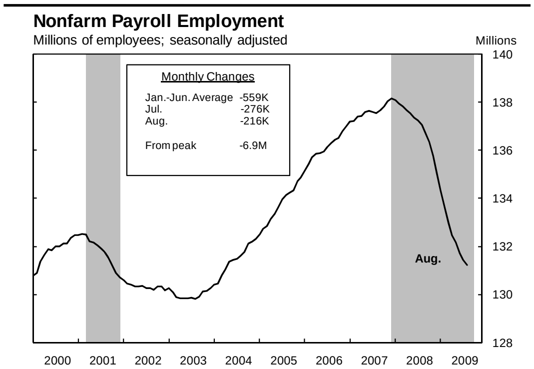
Purchasing-manager survey shows expansion



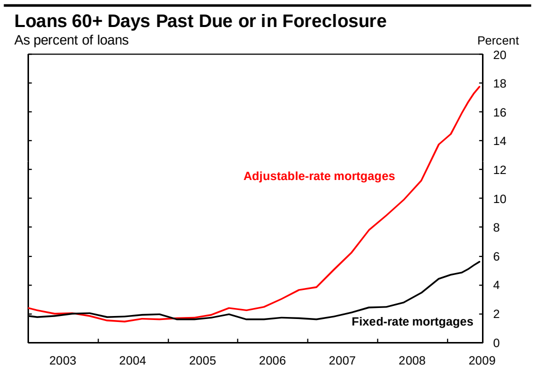
Cash-for-clunkers drove up auto sales



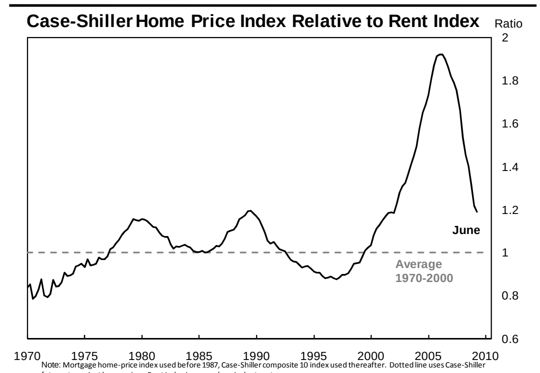
But employment continues to fall



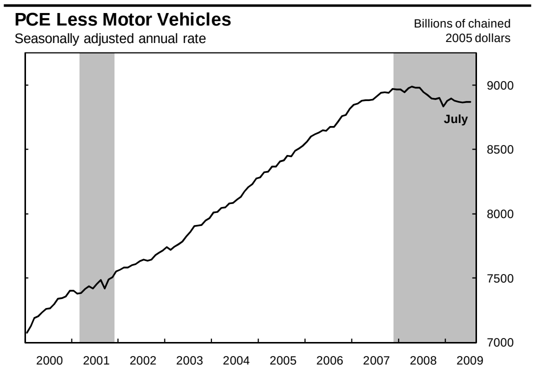
Foreclosures are still rising



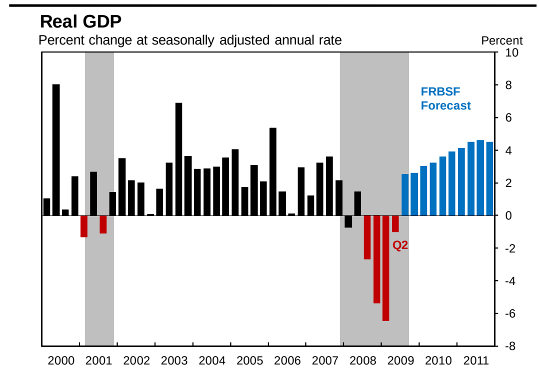
Home prices could fall further



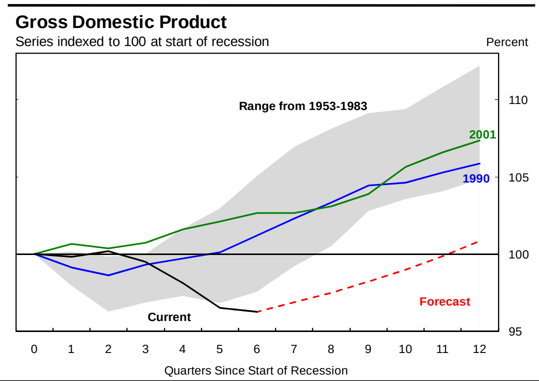
Outside autos, consumption remains weak



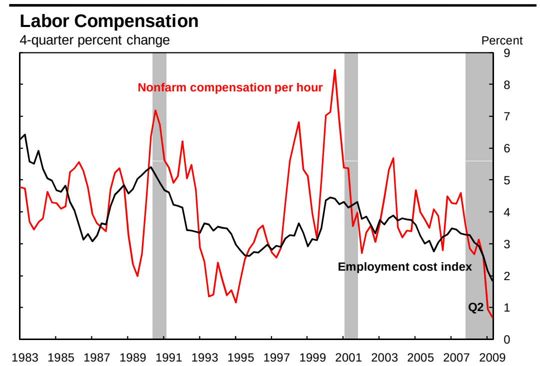
Despite risks, rebound appears to have started



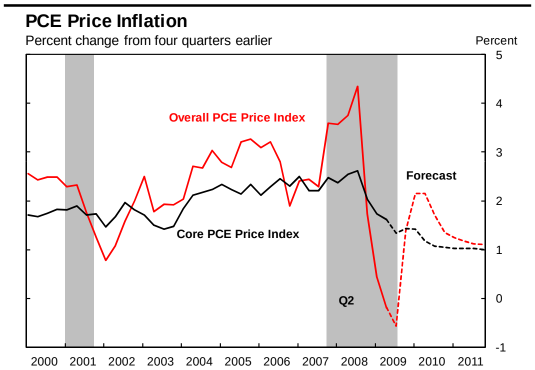
Finance and consumption will weigh on recovery



Wages are barely growing



Inflation has moderated



Markets expect rate increases next year