Twelfth Federal Reserve District

FedViews

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Bart Hobijn, senior research advisor in the Economic Research Department of the Federal Reserve Bank of San Francisco, states his views on the current economy and the outlook.

- GDP grew at a 1.8% annualized rate in the first quarter of 2011, a significant slowdown from the fourth quarter of 2010. Several temporary factors helped push down first-quarter GDP growth. Data released in recent weeks suggest that this sluggishness will persist longer than initially anticipated. We now forecast second-quarter GDP growth will come in at around a 2½% annualized rate. But growth should rebound in the third quarter. We expect GDP to expand at an annualized 3½% rate in the second half of the year and to continue to strengthen throughout 2012.

- Among the temporary factors that have pushed down GDP growth are the effects of the supply chain disruptions caused by the earthquake in Japan, the recent tornadoes and floods in the South and Midwest, and the spike in commodity prices, especially oil. The winding down of these temporary factors depressing economic activity should contribute positively to GDP growth in the third quarter.

- In addition to these temporary factors, however, other data signal that the recovery’s momentum is weaker than earlier data had suggested. The pace of hiring slowed in May, with only 54,000 jobs added to nonfarm payrolls. This increase was far below the average of 182,000 jobs per month gained from January through April.

- After declining by a percentage point earlier this year, the unemployment rate has stalled around 9% since February. In May, it ticked up a tenth of a percentage point to 9.1%. Consistent with our forecast of sluggish GDP growth, we now expect the unemployment rate to decline to around 8% by the end of 2012.

- Growth of household spending has tapered off. Personal consumption expenditures grew at an annual rate of 0.6% in April, well below the first-quarter pace of 2.2%. Meanwhile, real disposable personal income declined at an average annualized rate of 0.4% in the three months ending in April 2011. This suggests that the purchasing power of U.S. households is not growing at the rate it was in the second half of 2010.

- Some of the effects of reduced income growth on consumer spending could potentially be offset by increases in household wealth. However, since the beginning of May, U.S. stock market indexes have declined about 6%. Moreover, homeowners continue to see the value of their houses—their most important investment—decline. House prices are continuing to slide in most parts of the country, although the rate of decline varies substantially from state to state.

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 July18, 2011.

- Since consumer spending makes up 71% of expenditures in GDP, the drag that declining house prices cause on consumption is important for understanding the momentum of the recovery. More than three-quarters of U.S. household spending comes from people who own their homes rather than rent.

- The final factor pointing to reduced momentum of recovery is the slowdown in the manufacturing sector's growth. Manufacturing has been a pocket of strength during the past six months. However, industrial production did not grow in April, partly because of the supply chain disruptions related to the Japanese earthquake. In addition, the Institute for Supply Management manufacturing purchasing managers index showed a sharp decline in the share of manufacturers reporting growth in their activity levels in May. The Federal Reserve Bank of San Francisco's Tech Pulse Index showed a similar deceleration in tech-sector growth.

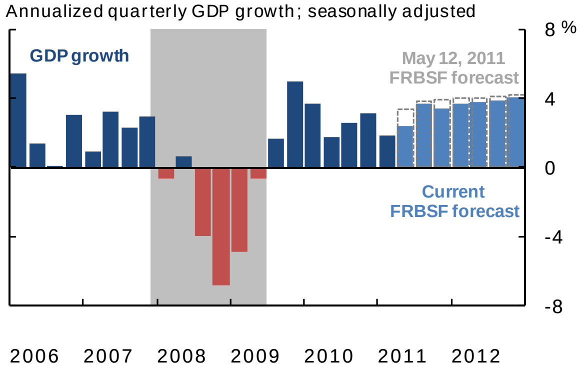
- On the upside, foreign demand for U.S. goods was robust in April. Over the past year, the dollar value of U.S. exports increased 18.8%.

- The anticipated sluggishness of the recovery implies that the economy will continue to show substantial slack. This should restrain underlying inflationary pressures. Consequently, we expect headline inflation to wane as the effects of recent commodity price increases wear off. We anticipate that headline PCE inflation will subside below a 1½% annualized rate in the second half of this year.

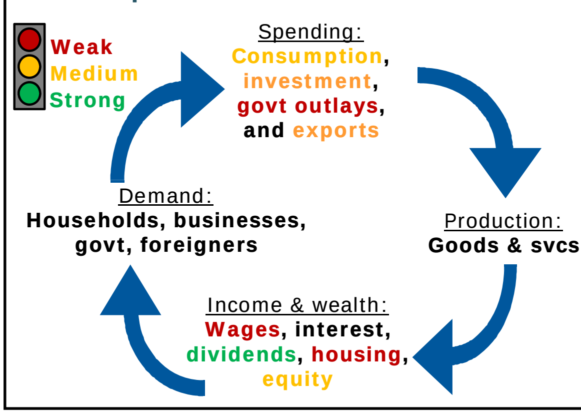
GDP growth expected to improve

GDP growth and FRBSF forecast

Annualized quarterly GDP growth; seasonally adjusted

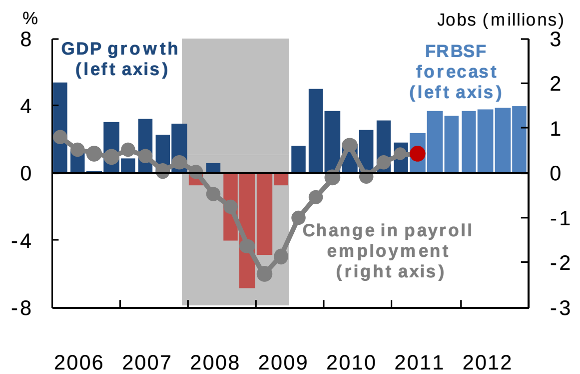


Soft patch or reduced momentum?



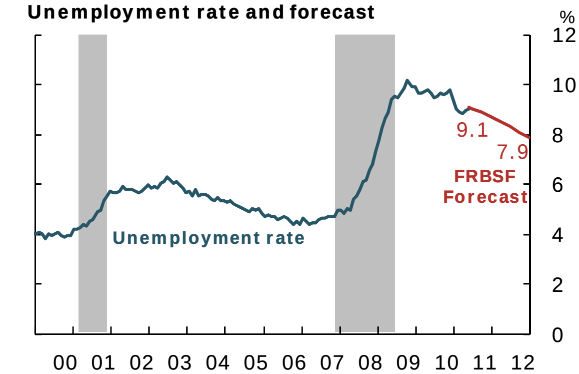
Pace of hiring suggests momentum slowing

GDP growth and changes in payroll employment



Sluggish recovery in unemployment

Unemployment rate and forecast

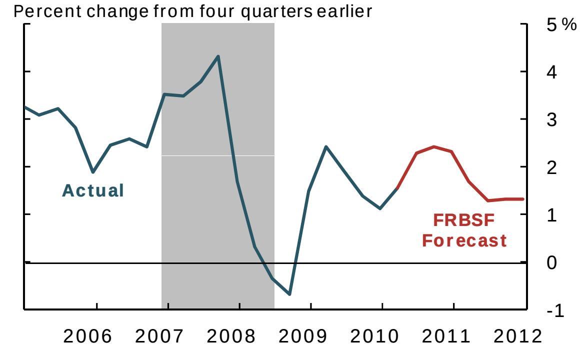


Source: Bureau of Labor Statistics and FRBSF staff

Inflationary pressure should be transitory

PCE Price Inflation

Percent change from four quarters earlier

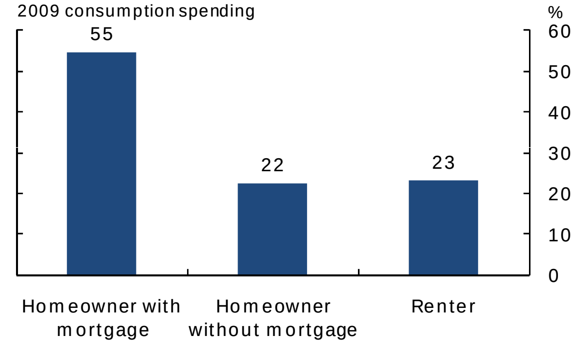


Source: Bureau of Economic Analysis and FRBSF

Most consumption driven by homeowners

Share of consumer spending by homeownership status

2009 consumption spending

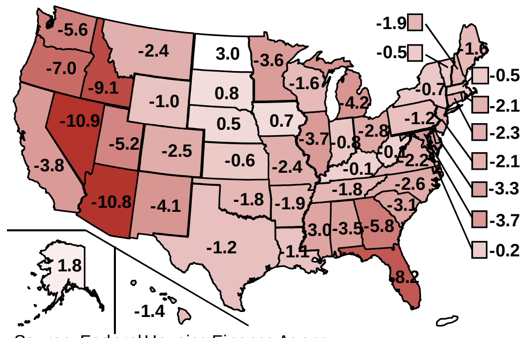


Source: Consumer Expenditure Survey

House prices continue to slide

Home Price Index: 4-quarter growth

Non seasonally adjusted; quarterly data; Mar-10 to Mar-11



Source: Federal Housing Finance Agency

Slower expected pace of tightening

Forward Fed Funds Rate

Implied by Fed Funds and Eurodollar Futures