Fourth Quarter 2007 Performance Review and Outlook for the Economy

The Bureau of Economic Analysis released its advance estimate of 0.64% annualized real GDP growth for the fourth quarter of 2007. The advanced estimate is well below consensus forecasts, suggesting that the economy came out of 2007 in worse shape than most analysts expected. While growth remained positive, economic conditions took a turn for the worse as subprime loan losses mounted beyond expectations and credit problems became more apparent in other credit markets. Weak jobs growth data in the first months of 2008 signal further problems for households faced with higher energy prices, declining housing values, lower equity wealth, large debt balances, tight credit conditions, and higher mortgage reset rates. Policy makers officially adopted the "recession" terminology to describe the economy for 2008 as both fiscal and monetary responses took shape in the first quarter of 2008.

Predictions of slow growth in the first half of 2008 have been in place for almost a year. Changes from those forecasts to more pessimistic views stem from the growing and yet uncertain magnitude of credit problems that now reach beyond mortgages. Consumer spending is resilient but the "perfect storm" conditions from debt imbalances, low savings, declining asset values, and potential job loss now make it likely that consumer spending will hit a wall. Over 60% of forecasters responding to a Moody's survey call for a recession in the first half of 2008. Sentiment surveys also hover at the threshold for contraction, with less upside potential than downside risk.

The first half of 2008 may not reach the technical definition of a recession with two successive quarters of negative real GDP growth. Nevertheless, the economy clearly faces a slump with negative or very low growth for the next few quarters. The downturn may not be severe by historical standards due to prompt policy responses, but duration of the slump depends of the severity of credit market losses that continue to unfold. Inflation should be moderate at the core level, ranging from 2.25% to 2.75%. Even so, food and energy prices show no signs of retreating, leaving consumers with less real spending power for core goods. Interest rates are low by historical standards and may need to go lower to stimulate real investment. Unemployment should move up to 5.6% by mid-year from the current 4.9% rate. These expectations are a best-case scenario without added shocks from international sectors or energy markets.

Risk of Recession

The risk of recession increased at the end of 2007 as job market data began to turn down, making it more likely that debt-heavy households will pull back consumption more than expected in the first half of 2008. Average weekly hours worked in manufacturing declined in December with only 18,000 additional jobs created. Payroll employment fell in January and the Bureau of Labor Statistics revised 2007 job gains downward. The unemployment rate increased to a two-year high of 5% from a low of 4.4% last spring.

Households facing declining real estate values, falling equity values, high debt financing, tight credit conditions, and slumping confidence in the future all weigh heavily on spending in the first half of 2008. To complicate the economic picture even more, global equity market fluctuations combined with rising volatility in the U.S. equity market eroded investor confidence. Weaker investor confidence both reflects the decline in economic conditions as well as shapes future economic conditions where private investment is necessary to help fill a decline in consumer spending.

While consumers deal with the prospects of a slower economy, the battle with inflation is not over. Energy prices continue to push new to new highs. The 4% year-over-year CPI growth going into 2008 is largely due to oil and food prices. Analysts focus more on the core rate because it tends to reflect underlying "trend" inflation and the core rate should slow as the economy slows. The lower core inflation rate suggests that monetary policy has room to maneuver to stimulate the economy. Nevertheless, consumers must make income substitutions toward energy and food and away from other forms of spending. In this sense inflation adjustments will hurt households. The challenge of making substitutions in consumption as energy and food take a bigger portion of income is especially difficult given the record low level of household savings.

Monetary and Fiscal Policy Can Not Prevent the Slump

Policy responses to deteriorating economic conditions are taking shape rapidly. Fed moves to bring the Fed Fund rate down to 3% in the first few months of 2008 show an aggressive response to the slowing economy. The Fed Fund target is 225 basis points lower than in August of 2007. Housing is the typical conduit from monetary policy to economic stimulation, but this link is more complicated now. The preoccupation of financial institutions with credit risk in light of the subprime lending debacle continues to make credit conditions tight even with increased liquidity. Additional Fed easing will have a more limited impact on the economy if financial institutions absorb increased liquidity without making loans. More aggressive steps are likely if the Fed is going to ease credit conditions enough to stimulate spending. The futures market shows a 2% Fed Funds rate expectation for the end of 2008.

Fiscal policy responses to the economy are taking shape sooner than normal, but long lags make it likely that these moves will not affect the economy until later in 2008. Fiscal policy will help dampen the severity and length of the slump, but will not have much effect until the last two quarters of 2008. Rebates are not likely to be available until the summer and first round spending effects will occur in the third quarter at best. One-time spending does not offer permanent help to consumers and will not provide much stimulation. Tax cuts offer more permanent stimulation but political support for such cuts is unlikely.

Time to Restructure Credit Markets

Financial markets continue to worry about the depth and breadth of mortgage losses as well as spillover effects on other credit markets. Lower interest rates and increased liquidity will not be enough to restore confidence in lenders and investors. More focused programs aimed at easing credit market problems are necessary to address the key flaws in the economy. Examples of necessary policy initiatives to focus on the key problems include mortgage loan modifications, expansion of FHA lending authority, increases in Fannie Mae and Freddie Mac loan caps, state assistance in mortgage refinancing, and congressional changes in Chapter 13 bankruptcy laws to allow cramdowns of first mortgage loans (limits on liability to appraised values). Programs similar to those created to ease the savings and loan crisis in the early 1990s may be necessary.

The most likely scenario is that the economy follows the flat fourth quarter GDP growth rate with two successive quarters of low to negative growth. Inherent problems caused by the subprime mortgage market and fallout in other credit markets will not go away for several years. These credit market issues will be a drag on the economy beyond the second half of 2008 and into 2009. Unfortunately, programs to ease the credit market transition may not be forthcoming until after the fall elections.

Summary of Recent Economic Data

GDP and Production

- According to the advanced estimate by the Bureau of Economic Analysis, the economy grew at an annualized rate of .64% in the fourth quarter of 2007. Slow growth in the fourth quarter followed healthier rates of 4.91% in the third quarter and 3.82% in the second quarter. Fourth quarter GDP came in weaker than expected, suggesting that the housing market weakness spread to other areas of the economy. The consensus expectation called for a fourth quarter GDP growth rate of 1.3%.

- On a year-ago basis, real GDP increased 2.5% in the fourth quarter. For all of 2007, GDP grew 2.2%, which is the lowest rate since 2002.

- Inventories provided the largest single negative component of fourth quarter GDP

- Industrial production increased .1% in January, matching the increase in December.

- Capacity utilization remained steady at 81.5% in January, December, and November. Utilization rates in manufacturing also held steady at 79.6%.

- New orders for manufactured durable goods increased 5.2% in December, exceeding expectations of about 1.6%. December followed disappointing growth rates of .5% and -.5%.

- Total business inventories increased by .4% in November and the total inventory to sales ratio declining from 1.26 to 1.24.

- Inventories subtracted about 1.3% from fourth-quarter GDP growth, which normally suggests stronger growth potential in the next quarter. However, the reduction in retail autos accounted for most of this decline. Non-farm inventories excluding autos added .2% points to real GDP.

- The ISM composite index increased to 50.7 in January from 48.4 in December, an improvement in near term production. Overall, the index is close to the borderline between expansion and contraction.

- The Chicago PMI for January came in slightly above 50, the threshold for expansion. The index declined from 56.4% in December, suggesting a weakening of manufacturing in the Midwest.

- Construction spending decreased 1.1% in December following declines of .4% and .9% in the prior two months.

- Factory orders rose 2.3% in December.

- Vehicle sales fell to a seasonally adjusted annual rate of 15.2 million in January. January vehicle sales posted the lowest rate since 2005. Durable goods, such as vehicles, typically experience the largest declines early in a downturn.

Inflation

- The implicit price deflator for the fourth quarter was 2.55%, up from the third quarter’s 1.03% increase in the third quarter.

- The core personal consumption expenditure index (PCE) increased 2.7% in the fourth quarter. The core PCE index is the Feds preferred index. The index increased by 2% in the third quarter and only 1.4% in the second quarter.

- The CPI inflation index decreased slightly in December. On a year-ago basis, the CPI increased 4.1% in December of 2007. The core CPI edged up to 2.4%, which is the upper end of the Fed’s target range. Consumer prices started an upward trend in August of 2007 that carried through the year. This trend would be a cause of concern if there were low prospects of a weak economy going forward into 2008. The consensus seems to be that soft economic conditions in the first half of 2008 will take pressure off the core inflation rate.

- Producer prices for finished goods declined by .1% in December, but “topline” PPI increased by 6.3% for 2007 as a whole. Excluding food and energy prices, the PPI increase in 2007 is only 2%. For the fourth quarter of 2007, core PPI prices increased 2.2%.

Labor Markets

- The unemployment rate fell to 4.9% in January from 5% in December. Weak labor force growth offset increases in the number of unemployed and decline in the number of employed workers. The labor force participation-rate was 66.1% in January.

- The median duration of unemployment increased to 8.8 months from 8.4 months in December.

- The average workweek declined to 33.7 hours in January.

- Real hourly compensation for nonfarm business fell .3% in the fourth quarter.

- Non-farm payrolls fell by 17,000 in January marking the first decline since 2003. January's numbers were well below expectations of payroll gains in the 75,000 to 100,000 range. Payrolls gained 82,000 jobs in December, 60,000 jobs in November, and 140,000 in October.

- Employment costs rose .8% in the last quarter of 2007 following increases of .8% and .9% in the prior two quarters. Wages and salaries increased .8% in the last three quarters of 2007 following a 1.1% increase in the first quarter of 2007. The low rates of increase for labor costs suggest weak labor markets and relatively low pressure for domestic wage-induced price increases.

- Nonfarm business productivity increased 1.8% in the fourth quarter following a 6% increase in the third quarter. Productivity growth was 2.6% from the fourth quarter of 2006 to the fourth quarter of 2007.

- Wages are 3.4% higher compared to one year ago. Unit labor costs in nonfarm businesses increased 2.1% in the fourth quarter following declines of 1.9% in the third quarter and 1.1% in the second quarter.

- Hourly earnings rose only .2% in January, representing one of the three weakest months in the last two years.

Personal Income and Consumption

- On a three-month annual basis, real consumption fell from a peak of 3.7% growth in September to 1.3% in January.

- Real personal consumption grew at an annualized 2% rate in the fourth quarter following a 2.8% rate in the third quarter.

- Total retail sales fell .4% in December, offsetting a gain of 1% in November. The decline in December is the first since June of 2007.

- Household credit quality declined rapidly at the end of 2007. Rates of delinquency and default increased for first and second mortgages, auto loans, and credit cards. In the fourth quarter, delinquency rates as a percent of outstanding credit reached 3.9% for mortgages, 7.2% for consumer finance, 3.4% for autos, and 4.4% for bankcards. All delinquency rates in the fourth quarter are higher than at any other time in 2007. Household finances are likely to get worse in 2008 with rising unemployment, falling housing values, resets of house payments, soft vehicle prices, weak equity values, rising energy prices, rising food prices, and more cautious lending standards.

- Consumer credit reached $2.519 trillion in December. Total credit grew at an annualized 2.1% rate in December following growth rates of 8.2% in November and 2.7% in October. The growth in credit related spending helps keep aggregate demand above water, but it also puts pressure on credit quality.

- Personal income increased .5% in December following an increase of .4% in November and .2% in October. On a year-ago basis, personal income increased 5.8%.

- Consumer income grew at a healthy rate in nominal terms over the last year, but after inflation, real rates were more modest. Nominal disposable income grew 5.6% over the past year with a 4.1% annual rate over the last three months. Real income increased only 2.1% over the past year and declined .5% over the last three months.

Sentiment and Leading Indicators

- The University of Michigan Consumer Confidence Index declined throughout most of 2007 but ended the year on an uptick. The index ended the year below 76 after starting 2007 at 95. Consumers gained some confidence in January with a modest gain of 2.9 points but February's report shows a decline in confidence to 69.6. February's index is the lowest since 1992. Overall, consumer sentiment is consistent with slow or contracting economic growth.

- Moody's Survey of Business Confidence index fell to a record low at the end of January.

- The Conference Board Index of Leading Economic Indicators fell .2% in December following a decline of .4% in November. The index fell in four of the past six months, suggesting GDP growth slowing to somewhere between 0% and 1%. The index level of 136.5 is the lowest in two years.

- The Conference Board's Consumer Confidence Index fell in January to 87.9 from 90.6 in December. Overall, the index remains low compared to levels of 112 reached earlier in 2007.

- Equity market uncertainty continues to be a drag on investor optimism. The Chicago Board of Options Exchange volatility index averaged 26 in January following an index of 21 in December. The index averaged 15 for 2006 to 2007.

Housing

- New home sales fell 5% in December while inventory rose to a new high of 9.6 months. On a year-ago basis, sales are down 40.7%, which is the largest decline since 1981.

- The Case-Shiller index of housing prices shows a decline of approximately 9% from the peak earlier in July of 2006. Increased foreclosures, tight credit conditions, lower consumer income, and higher unemployment all work in the direction of lower housing prices for the first half of 2008 before prices stabilize later in the year.

- Real investment in residential structures fell 24% on an annualized basis in the fourth quarter following a 21% decline in the third quarter. Total residential construction permits are down nearly 50% from the peak in late 2005.

- Residential construction declined 14.2% in December to 1.006 million units. December's housing start data represents a decline of 38.2 % from one year ago.

- The January Survey of Senior Loan Officers from the Federal Reserve suggests tighter credit standards since the last survey in October of 2007. Not only are standards higher, but loan applications are down. Standards are now higher for all loans, not just subprime and nontraditional loans. For example, 52.9% of respondents reported tighter standards for prime loans.

International

- The trade deficit continues to grow. The November goods and services deficit reached $63.1 billion representing a 9.3% increase from October. Both imports and exports increased with the higher import price of oil contributing a significant amount to the deficit. Trade with China represents about one-third of the deficit, but slow appreciation of the yuan relative to the dollar has eased the deficit somewhat.

- U.S. import prices remained unchanged in December while export prices increased .4%. On a year-ago basis, import prices increased 10.9% while export prices increased 6%.