Outlook and Review: Third Quarter 2010

The economy remained soft in the third quarter with real GDP growth of 2.5%, according to the revised estimate by the Bureau of Economic Analysis. Advanced estimates are constructed without data for the last month of the quarter. Growth must exceed 2.5% to gain any ground on the employment front. With slow growth in the past few quarters the unemployment rate remains stuck at 9.6%. Housing inventory remains too large for stabilization of housing prices and borrowers find it difficult to qualify for loans even as banks hold high levels of liquidity. Manufacturing and new orders have slowed from the pace set earlier in the recover.

The economy shows signs of strengthening, but the pace of improvement is painfully slow. Households are deleveraging, allowing room for higher consumer spending going into 2011. Household debt as a percentage of income is now below 120% compared to the 136% mark set in 2008. If the trend continues the percent of debt to income will hit 100% in 2011, returning back to the levels of the 1980s. Third quarter earnings tended to offer surprises on the upside but prospects for the fourth quarter are more subdued. Additional "quantitative easing" by the Fed is underway with a plan for at least $600 billion in purchases of Treasury securities. The move is controversial, but it is intended to boost bank liquidity, lower lending rates, encourage more lending, and ultimately stimulate private domestic spending. Historically low interest rates are likely to go lower for the intermediate maturities of five to ten years. Eventually, the concern is that inflationary pressures will build as the economy gains traction unless the Fed is able to execute a flawless exit for quantitative easing.

Economic data have taken a slightly better turn in recent weeks. The job market, retailing, and housing statistics all appear a bit better than they did in the summer. Financial conditions have also improved with a rally bringing stocks close to the level reached before Europe's sovereign debt crisis. Credit spreads have stabilized and there are some signs that banks may react to improved credit quality by opening up lending. While the economy's growth is not positioned to accelerate significantly, it is unlikely to decelerate. Real GDP growth is tracking below the estimated potential of 2.75%. Job gains are averaging about 100,000 per month, which is still short of the 150,000 needed just to keep the unemployment rate from rising further.

Fourth quarter growth is not likely to exceed the 2.5% rate of the third quarter. The economy will see sluggish growth as the boosts from inventories and fiscal stimulus fade. Growth should pick up later in 2011. Unemployment may creep up rather than down as more workers enter the workforce looking for jobs. Inflation will remain below 2% on an annual rate basis, but specific prices in food, energy, and healthcare are likely to increase. Quantitative easing should bring rates lower in intermediate maturity segments of the yield curve, but longer term rates may edge up due to higher inflation expectations. The dollar will continue its decline with more downward pressure from quantitative easing by the Fed.

Quantitative Easing 2 (QE2) – A Stimulus of Last Resort?

In the first round of quantitative easing the Fed purchased two trillion dollars worth of securities in an effort to "save the financial system." The second quantitative easing plan is now underway with a minimum of $600 billion worth of new Treasury security purchases that will be more like $900 billion when the Fed uses proceeds of maturing securities to complete the plan. The second phase of Fed stimulation has been widely anticipated since the end of the summer as a preemptive move to ward off a second recessionary dip. The plan is now officially underway with intended purchases of Treasuries continuing through June 2011. The central logic of QE2 is to target five-through ten year Treasury maturities, which are most closely linked to mortgage and corporate bond rates.

Quantitative Easing - the Only Remaining Policy Option

It is clear that the economy needs help to reach a self-sustaining level of growth high enough to make a dent in unemployment. Fiscal policy stimulation had its chance and is unlikely to get another shot. There is no appetite for further widening of the deficit and not enough political support to seriously contemplate such a move. Monetary policy has already used unprecedented easing to bolster liquidity in financial markets with little to show in the way of economic stimulation. Interest rates are at historic lows and bank liquidity appears to be ample. A key indicator of the degree of excess reserves in the system, the Fed Fund rate, has hovered around zero for almost a year. Banks are cautious in lending and borrowers with sufficient credit risk are hard to find. Households are deleveraging rather than taking on new debt. High unemployment, low equity values in homes, and uncertain security values do not provide a backdrop for confident borrowing. So, how will adding additional reserves to banks by buying Treasury securities accomplish economic stimulation under the current conditions? There are two sides to the story.

The QE Arguments are not New

In the Great Depression, Keynes suggested that monetary policy is impotent in certain economic conditions. In a severe downturn, Banks will not lend and households will not borrow even if the Fed expands the money supply. The Fed can push reserves into banks but there is no stimulus if banks do not lend and borrowers do not borrow. This condition of futility for the Fed is often called the "liquidity trap" where interest rates cannot go low enough to prompt borrowing and spending. The first round of quantitative easing fell under this same shadow as ample liquidity and historically low interest rates did not stimulate home buying, private investment, and household borrowing. Banks achieved capital adequacy but little expansion in spending came about.

The Fed chair, Bernanke, is a student of the Great Depression and is well versed in the writings of Milton Friedman. Friedman's classic arguments provide the framework for the current Fed initiative under QE2. Friedman argued that even in a depression, massive increases in the money supply will eventually stimulate the economy. As the velocity of money declines, the Fed must simply continue to grow the supply of high powered money (bank reserves) to offset bank lending and borrower behaviors. Friedman made the case that an inability to supply enough money was a major factor in starting the depression and the failure to push hard enough with money expansion allowed the depression to continue. QE2 is consistent with this view.

QE2 may Prevent a Double Dip but it Won't Push a Recovery

Analyst estimates suggest that QE2 will add no more than 35 basis points to GDP growth in 2011 and will boost net employment by 300,000 jobs in 2011. The unemployment rate may go down by about 25 basis points as a result. These are not dramatic improvements on any scale, raising the possibility of a QE3 and QE4 to keep a recovery on track. The Fed's resumption of quantitative easing sends a strong statement that it will do what is necessary to keep the economy from slipping back into recession. But, many critics are concerned that consequences of such massive increases in the money supply will not be reversed in a manner consistent with stable prices when the recovery takes hold. While the Fed publicly suggests a 2% inflation rate is good for the economy, it is not clear that monetary policy instruments are precise enough to prevent rapid inflation when the economy achieves a stronger recovery. The Fed position is that the chances of higher than 2% inflation in a few years are worth taking if the chance of a second dip in the economy can be reduced.

Wild Card – Will Trading Partners Cooperate?

After jawboning China about the overvalued Yuan and arguing for stability in global currency values, QE2 does not sit well with global trading partners. Rather than stability, QE2 will further lower the value of the dollar as more dollars are pumped into the markets. If the apparent breach in the understanding of stabilizing currencies is deemed serious enough, trade retaliation may shake global trade and retard global recoveries. It will be important to navigate around this issue without trade restrictions, tariffs, and competitive devaluations of currencies. Such a disruption to trade would hurt the recovery of the U.S. and most of the rest of the world.

Summary of Recent Economic Data

GDP - *The recovery continues but growth is too weak to improve the labor market. Growth will remain near its current pace for the next few quarters, just barely enough to keep pace with an expanding labor force. Demand from consumers and businesses is too weak to sustain the recovery, helping to explain why the Fed is launching a second round of quantitative easing. Growth for 2011 is likely to be about 3%.e*

- Real GDP grew 2.5% at an annualized pace in the third quarter of 2010. The third quarter represents a slight improvement from the 1.7% pace in the second quarter. Private inventories accounted for 1.4 percentage points of growth. Investment growth slowed dramatically, but consumer spending growth picked up, and government was a major contributor to expansion. Trade was a major negative.

- Table 1 illustrates the breakdown of GDP components over the last five quarters.

Table 1. Gross Domestic Product and its Components (Annual Percentage Change)

Quarterly Series	2010 Q3	2010 Q2	2010 Q1	2009 Q4	2009 Q3	6-Month Average	CH Year Ago
GDP	2.5	1.7	3.7	5.0	1.6	1.9	3.2
Private Consumption	2.6	2.2	1.9	0.9	2.0	2.4	1.9
Government	3.3	3.9	-1.6	-1.4	1.6	3.6	1.0
Private Domestic Investment	0.8	18.9	3.4	-1.3	0.7	9.8	5.2
Exports	5.0	9.1	11.4	24.4	12.2	7.1	12.2
Imports	17.4	33.5	11.2	4.9	21.9	25.4	16.3

- On a year-ago basis, real GDP rose 3.2% in the third quarter. This is the largest year-over-year gain since the first quarter of 2005.

- Inventories accounted for more than one-half of growth in the third quarter. However, inventory changes are likely to be much smaller next quarter as businesses remain cautious. Inventories may soon turn from a positive for growth to a negative.

- Consumer spending remains a positive for growth as consumers release some pent-up demand. However, consumer spending will see only small gains until the labor market takes a decisive turn for the better in late 2011.

- Business investment is still growing rapidly, but the pace of growth is slowing. Businesses will be reluctant to invest if they are not sure the recovery will continue.

- The boost from the federal stimulus is fading while budget cuts at the state and local levels in the coming months will dampen growth through 2011.

- Exports continue to increase with the global recovery but imports are also increasing as consumer spending increases. On net, trade was once again a serious negative for growth in the third quarter. Trade should turn positive for growth in the near term as a result of continued global economic growth and a weaker dollar.

Income

- Both personal income and spending fell in September. The decline in income was driven by a $25.5 billion reduction in emergency unemployment insurance benefits (at an annual rate). Emergency benefits had boosted transfer income by $20.5 billion in August.

- The saving rate fell to 5.3%, matching its lowest level in over a year as consumers continue to keep saving more than they have since the early 1990s. Table 2 shows the monthly movement of personal income, consumption, and the saving rate.

Table 2. Personal Income, Consumption, and Savings Rate

% Change One Year Ago	Nov 2010	Oct 2010	Sept 2010	Aug 2010	July 2010	June 2010	May 2010	April 2010
Personal Income	3.1	3.2	3.0	2.5	1.4	2.8	2.8	2.2
Consumption	3.7	2.8	3.5	3.3	3.9	3.9	4.0	3.0
Savings Rate	5.3	5.6	5.7	6.0	6.0	5.8	5.3	5.4

Household Credit and Deleveraging

- Consumer credit balances, which have fallen at a steady pace in recent months, increased unexpectedly in September. The increase was due to a substantial rise in nonrevolving credit balances. Despite the surprising increase, consumer credit is expected to fall over the months ahead. Table 3 below illustrates the monthly pattern of deleveraging up to September.

Table 3. Consumer Credit by Month

	Sep 2010	Aug 2010	Jul 2010	Jun 2010	May 2010	Apr 2010	Mar 2010	Feb 2010
Change in Billions of $s	2.1	-4.9	-5.4	-3.6	-8.3	-5.8	-5.9	-7.7
Annualized % change	1.1	-2.5	-2.7	-1.8	-4.1	-2.9	-2.9	-3.8

Source: Federal Reserve

- Consumer credit conditions remain weak. Table 4 provides monthly rates of growth in credit, delinquency, and defaults. The year-over-year decline in credit balances was 3.7%. Dollar defaults were mixed, falling in aggregate but failing to reverse September's increase. Conditions are in place for slower deleveraging and reduced defaults as early-stage delinquencies drop.

Table 4. Household Credit Growth, Delinquencies, and Defaults

	Oct 2010	Sep 2010	Aug 2010	Jul 2010	Jun 20 10	May 2010	Apr 2010
Credit Growth, % change 1 yr. ago							
All Credit Lines	-3.7	-4.0	-3.5	-4.0	-4.0	-3.7	-3.9
Mortgages	-3.5	-3.6	-3.1	-3.7	-3.7	-3.4	-3.5
Delinquency Rates, % of Balances							
All Credit Lines	6.6	6.8	6.9	7.2	7.2	7.1	7.1
Mortgages	7.0	7.1	7.2	7.5	7.5	7.5	7.6
Default Rates, % of Balances							
All Lines	3.2	3.2	3.2	3.1	3.1	3.0	3.0
Mortgages	2.6	2.7	2.6	2.6	2.5	2.4	2.5

Source: Equifax

- High unemployment and a lack of cash flow destroy household credit. Limited originations are also a negative for aggregate delinquency and default rates. Offsetting these negatives are the purging of bad accounts from portfolios and the high quality of newly originated loans.

Unemployment

- Private sector payroll growth surpassed 150,000 in October but was not strong enough to lower the unemployment rate.

- The household survey recorded a drop in labor force participation rate from 64.7% to 64.5%, indicating that the exodus of discouraged workers from the job market continued to outpace the decline in the overall number of workers with jobs. The average workweek improved to 33.6 hours. The key data on unemployment, participation rates, and average workweek appear in Table 5 below.

Table 5. Employment Data (Seasonally Adjusted)

	Oct 2010	Sept 2010	Aug 2010	July 2010	June 2010	May 2010	April 2010	March 2010
Unemployment rate, %	9.6	9.6	9.6	9.5	9.5	9.7	9.9	9.7
Labor Force Participation Rate	64.5	64.7	64.7	64.6	64.7	65.0	65.2	64.9
Average Workweek (hours)	33.6	33.5	33.5	33.4	33.4	33.5	33.4	33.3

Source: Bureau of Labor Statistics

- The unemployment rate was unchanged at 9.6% in October, largely due to a large decline in labor force participation. The only unemployment "strata" with a decline was for 5 weeks or less strata. People without jobs for an extended period of time are leaving the labor force.

Manufacturing

- The ISM manufacturing index strengthened in October to its highest level since May. Manufacturers were bolstered by a strong increase in export orders.

- New orders for manufactured goods increased 2.1% in September—the largest rise since January.

- According to the Bureau of Labor Statistics, nonfarm business productivity rose 1.9% at an annualized rate in the third quarter of 2010, with unit labor costs falling 0.1%. The increase in hours worked was much smaller than the increase in output, leading to the increase in productivity.

- Capacity utilization remains well below the benchmark where inflationary pressures begin. Table 6 illustrates the low and slow moving utilization numbers since April. Total capacity utilization was unchanged at 74.8% in October, while manufacturing capacity utilization rose from 72.6% to 73%, the highest since August 2008.

Table 6. Capacity Utilization in Production and Manufacturing

	Oct 2010	Sept 2010	Aug 2010	July 2010	June 2010	May 2010	April 2010
Total Capacity Utilization-	74.8	74.8	74.9	74.8	74.2	74.2	73.2
Manufacturing	73.0	72.6	72.5	72.4	71.9	72.1	71.3

Source: Federal Reserve

- The October industrial production report was mixed. Total production was unchanged, but manufacturing output rose 0.5%, the biggest gain since July. Manufacturing posted a 4.2% annualized gain in the third quarter and is on track to meet that rate of increase in the current quarter.

- Consumer goods were once again a sore spot, showing no growth in October after declining 0.5% in both August and September.

HOUSING

- The proportion of U.S. homes that were vacant was unchanged in the third quarter at 2.5%, which is only slightly below the all-time high of 2.9% reached at the end of 2008.

- The falling rate of homeownership is drag for homebuilders. While the rate was unchanged at 66.9% in the third quarter, further declines are expected based on changing demographics behind lower rates of hew household formation. The combined forces of a growing inventory of foreclosed property and a high level of unemployment will keep the homeownership rate down.
- Even as the volume of delinquent loans eases, foreclosure will increase again in 2011 as modification efforts have pushed many foreclosures back into 2011. According to RealtyTrac, more than 2 million homes remain in some stage of foreclosure. While foreclosures have eased in the last three months, is not likely for foreclosures to fall below 2 million in 2011.

- Modification efforts by both the government and private lenders reduced the absolute number of foreclosures required to resolve the housing crisis. But, the process also pushed back many foreclosures into 2011, setting the stage for more downward pressure on home prices next year.

- Sales of new homes gained by 6.6% in September from August. Sales are running at an annualized pace of 307,000 units. The September gain still leaves sales near a historic low.

- The number of new homes available for sale continues to inch downward. This trend, combined with the gain in sales, is helping the months of inventory to decline from 8.6 to 8.0.

- The median new-home price is up by 3% from one year ago. Low inventories of new homes are helping to support prices.

Inflation

- Consumer prices, as measured by the consumer spending deflator, rose 0.1% in September and were up unchanged excluding food and energy. The market-based deflator, which is based on observable prices and excludes the most implicit prices and expenses of nonprofit institutions, posted identical readings.

- Based on the Personal Consumption Deflator shown in Table 7, prices were 1.4% above their year-ago level in total and up 1.2% excluding food and energy, as inflation remains well contained. The comparable readings for the market-based indices were 1.2% and 0.9%, respectively. Inflation is again drifting lower.

Table 7. Personal Consumption Deflator

% Change from One Year Ago	Nov 2010	Oct 2010	Sept 2010	Aug 2010	July 2010	June 2010	May 2010	April 2010
PCE Deflator	1.4	1.4	1.5	1.4	2.1	2.3	2.5	2.3
PCE-Core	1.2	1.3	1.4	1.4	1.5	1.5	1.8	1.7

Source: University of Michigan

- There are no indications of inflation any time soon. With the unemployment rate heading back to 10% and slack prevalent throughout the economy, it is very difficult for firms to raise prices.

- Table 8 provides data on the Consumer Price Index (CPI). The top-line CPI for urban consumers (CPI-U) rose 0.2% from its September level. The index is up by only 1.2% from October 2009, before the seasonal adjustment. The Core CPI Index has only a 0.6% increase over that time period, the smallest pace of year-ago increase ever recorded.

Table 8. Consumer Price Index

	Oct 2010	Sep 2010	Aug 2010	Jul 2010	Jun 2010	May 2010	Apr 2010	Mar 2010
% Change								
CPI	0.2	0.1	0.3	0.3	-0.1	-0.2	-0.1	0.1
Core CPI	0.0	0.0	0.0	0.1	0.2	0.1	0.0	0.0
% Change one Yr. Ago								
CPI	1.2	1.1	1.2	1.3	1.1	2.0	2.2	2.4
Core CPI	0.6	0.8	1.0	1.0	1.0	1.0	1.0	1.2

Source: Bureau of Labor Statistics

- Recent data show continued stronger support for headline inflation, as confidence in both the global economy and financial markets has risen.

- Expected inflation is significantly higher than the inflation rates observed over the past year. Part of this higher inflation expectation factors in a recovery and part of the expectation is based on the massive degree of monetary expansion that is in the system. If a stable recovery materializes and the Fed does not execute an appropriate exit strategy from monetary easing, high inflation rates are possible in the longer term. Table 9 provides expected inflation rates from the University of Michigan sentiment survey. Quantitative easing is likely to revise expectations upward throughout the remainder of the year.

Table 9. University of Michigan Inflation Expectations Survey

	Nov 2010	Oct 2010	Sept 2010	Aug 2010	July 2010	June 2010	May 2010	April 2010
One-year	3.0	2.7	2.2	2.7	2.7	2.8	3.2	2.7
Five-year	2.8	2.8	2.7	2.8	2.9	2.8	2.9	2.7

Source: University of Michigan

- Producer prices for finished goods rose 0.4% in October on higher energy prices. Excluding food and energy, core prices for finished goods retreated 0.6% in October because of falling vehicle prices as new models were incorporated into the index. Table 10 provides monthly percentage changes and percentage changes from one year ago for finished producer goods. Inflation rates in producer prices are gaining momentum and will likely put some upward pressure on consumer prices in 2011.

Table 10. Producer Price Index for Finished Goods

	Oct 2010	Sep 2010	Aug 2010	Jul 2010	Jun 2010	May 2010	Apr 2010	Mar 2010
% change	0.4	0.4	0.4	0.2	-0.4	-0.3	-0.1	0.8
% change one year ago	4.3	4.0	3.0	4.1	2.6	5.0	5.3	6.1

Source: Bureau of Labor Statistics

- Since October 2009, producer prices for finished goods have risen 4.3%. Despite fluctuations in its components, finished consumer good prices have been rising for a year now.
- Price growth further down the supply chain is positive for a third month, reversing any weakness in prices during the summer. Prices of intermediate goods rose 1.2%. With a 0.6% rise, core prices for intermediate goods are also higher as the index for organic chemicals and plastics advanced. Since last year, core intermediate prices are up 4.4% and trending higher once again.

Sales

- Retail sales soared 1.2% in October in total, led by surging auto sales. Sales were up 0.4% excluding autos, the fourth straight month of good growth. Further improvement came in the modest upward revision to September growth to 0.7% from 0.6%.

- Sales were 7.3% above their year-ago level, the second straight month of above-7% growth. In this environment, spending will continue to grow, though the recent top-line pace is likely unsustainable. Consumers will not consistently lead the recovery.

Consumer Sentiment

- The University of Michigan consumer sentiment index rose modestly in November. The index came in at 69.3 and is the highest level since June. The expectations component improved more modestly. Short-term inflation expectations increased, while long-run expectations held steady. The movement of the Michigan Index since April is provided in Table 11 below.

Table 11. University of Michigan Consumer Sentiment Survey

	Nov. 2010	Oct. 2010	Sept. 2010	Aug. 2010	July 2010	June 2010	May 2010	April 2010
Overall	69.3	67.7	68.2	68.9	67.8	76.0	73.6	72.2
Change	1.6	-0.5	-0.7	1.1	-8.2	2.4	1.4	-1.4

Source: University of Michigan

- Confidence rose slightly in November, but it remains at a very low level. November was the fourth consecutive small move in the index. Consumers remain uncertain about the economy and this uncertainty has not been resolved.

International Trade

- The U.S. trade deficit narrowed to $44 billion in September from a revised $46.5 billion in August. Most of the change came from a $2.2 billion decrease in goods imports, reversing about half of last month's rise in imports. Table 12 shows the monthly balance of trade and the import and export components.

Table 12. International Trade in Billions of $s

	Sept. 2010	Aug. 2010	July 2010	June 2010	May 2010	April 2010	Mar 2010	Feb 2010
Exports	154.1	153.6	153.5	150.6	152.6	148.8	150.0	144.4
Imports	198.1	200.1	196.1	200.3	194.4	188.9	189.7	184.3
Balance	-44	-46.5	-42.6	-49.8	-41.8	-48.0	-39.7	-39.9

Source: Bureau of Economic Analysis/Census Bureau

- A weakening dollar played a large role in improving the trade balance. Trade deficits with Canada and Europe narrowed sharply, aided by a 6% depreciation against the euro and a 2% depreciation against the Canadian dollar. Even the persistent trade deficit with China narrowed somewhat. Quantitative easing may weaken the dollar further and help improve the trade account, but it is not clear how trading partners will react to further weakening of the dollar.