

Weekly Economic Commentary

July 18, 2011



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Highlights

- Economic data likely to play second fiddle to debt talks in the U.S. and Europe this week.
- What's missing in this economic recovery?

Economic Calendar

Monday, July 18

NAHB Housing Survey
Jul

Tuesday, July 19

Building Permits
Jun

Housing Starts
Jun

Wednesday, July 20

Existing Home Sales
Jun

Pending Home Sales
Jun

Thursday, July 21

Initial Claims
wk 07/16

Leading Indicators
Jun

Philadelphia Fed Index
Jul

What's Missing?

Economics and central bank policy will most likely play second fiddle to the ongoing debt ceiling debate in the United States, the fiscal woes in Europe, and the heart of the second quarter earnings reporting season for S&P 500 companies. Housing data (homebuilder sentiment, housing starts, building permits, existing and pending home sales) will dominate the week, but the key report of the week may very well be the July reading of the Philadelphia Fed manufacturing index. Overseas, data on June consumer spending in Japan and July manufacturing in China will draw the most attention from market participants. It is a relatively quiet week for the Federal Reserve, with only a few speakers on the docket. Meanwhile the central banks in Brazil, Canada, India and South Africa meet this week, with only Brazil poised to raise rates. Indeed, many overseas central banks may now be much closer to the end of their tightening cycles than they were in the early part of 2011.

The Great Recession ended over two years ago and yet, economic growth remains sluggish, the labor market is still moribund, and consumer confidence has barely budged since June of 2009. So what's missing? The answer of course, is in the question: The recovery is missing growth, and jobs and confidence, but why? The section below briefly examines how we got here (i.e. two years into the recovery) and what makes this recovery "different" from prior economic recoveries. Our answers may surprise you.

In testimony to Congress last week (July 11–15), Federal Reserve Chairman Ben Bernanke noted that although the economy was growing, and expected to continue to grow in the coming quarters, headwinds to growth were prevalent. The headwinds noted by Bernanke included the following:

- Slow growth in consumer spending, even after accounting for the effects of higher food and energy prices
- The continuing depressed condition of the housing sector
- Still-limited access to credit for some households and small businesses
- Fiscal tightening at all levels of government.

In prior public appearances over the past few months, Bernanke, in addition to mentioning temporary factors—the earthquake and Tsunami in Japan and its impact on the global supply chains, severe weather and higher energy prices—has cited "weakness in the financial sector" and "balance sheet and deleveraging issues" as longer-term issues that may be impacting the recovery.



While consumers have “hung in there” as we expected at the beginning of 2011 (see *2011 Outlook* publication), the slow labor market and ongoing repair of consumer balance sheets (i.e. consumers are paying down debt and saving, along with doing a little spending) has clearly limited the consumers’ influence on the recovery. Through the first seven quarters of the recovery (the second quarter of 2009 through the first quarter of 2011), consumer spending’s contribution to overall real domestic product (GDP) growth has been 11 percentage points, which sounds great considering that consumer spending accounts for two-thirds of GDP. But the consumer’s contribution to GDP growth in this recovery pales when compared to the recoveries following the mild 1990–91 and 2001 recessions, and is not even in the same league with the performance of the consumer following the severe 1973–75 and 1981–82 recessions.

**Contribution to GDP Growth Over the First Seven Quarters of Recovery
(In Percentage Points of GDP Growth)**

	Recovery From Great Recession	Recovery From 2001 Recession	Recovery From 1990-91 Recession	Recovery From 1981-82 Recession	Recovery From 1973-75 Recession
Consumer Spending	11.0	13.3	15.4	24.7	18.9
Housing	-0.3	3.0	3.0	7.3	6.2
State and Local Government Spending	-1.5	0.8	1.4	2.2	0.2

Source: Haver 07/18/11

On average, during the first seven quarters of the economic recovery following the two mild recessions (1990–91 and 2001), consumer spending contributed around 14 percentage points to growth. In the similar period following the severe recessions (1973–75 and 1981–82), consumer spending contributed around 22 percentage points to growth. Tepid real income growth which, in turn, is a result of tepid job growth, takes most of the blame here during the current recovery, along with the aforementioned balance sheet repair. Looking ahead, the consumer-related headwinds are likely to persist, keeping a lid on spending and consumer confidence. Our forecast remains that the consumer will continue to “hang in there” but will not be the driver of economic growth it was during similar stages of prior recoveries.

Turning now to housing, over the first seven quarters of the current recovery, housing has been a net drag on overall GDP growth, marking the first time in the post-WWII era that housing has not made a contribution to overall economic growth this far into a recovery. On average, during the economic recoveries following mild recessions, housing contributed three percentage points to GDP growth, and that figure is closer to seven percentage points in recoveries from severe recessions. As one might expect, the weakness in housing in this recovery has had a major impact on employment in the construction industry.

Construction employment has declined at a 3.7% annualized pace since June 2009, while in the recoveries from the severe recessions in the 70s and 80s, construction employment at this point in the cycle had increased

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by 4.0%. Looking ahead, housing is likely to continue to bounce along the bottom, not getting any worse, but not getting any better either.

A large overhang of unsold existing homes—officially around four million, but there are another two million or so existing homes in the so-called “shadow inventory” (bank-owned houses mired in the foreclosure pipeline) —continues to be the largest impediment to an improved housing market, although tighter lending standards (relative to the 2002–2006 boom years) and a tepid labor market are also helping to restrain housing. On the plus side, housing affordability (the ability of a family with the median income to afford the payment on the median priced house) is at an all-time high, and banks are becoming more willing to lend in this sector. There is a ton of housing-related data due out this week for June and July that the market will continue to monitor to assess the health of this small, but important segment of the economy.

Since WWII, state and local government spending and employment has been a reliable source of economic growth at virtually all points in the business cycle. But as noted last week by Fed Chairman Bernanke (and often by LPL Financial Research in recent months) state and local governments have been an unprecedented impediment to growth and employment in this recovery.

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For the first time since WWII, state and local government spending has not added to growth over the first seven quarters of an economic recovery. In fact, state and local government spending has subtracted one and a half percentage points from growth over the past two years, and state and local government employment has contracted at a 1.5% annualized rate over that time. In contrast, state and local government spending has added around one full percentage point to growth over the first seven quarters of the prior four economic recoveries, while adding jobs at a 1.5% annualized rate. Looking ahead, the best case would be that state and local government’s contribution to GDP growth stabilizes, and that the job losses seen in the sector continue at the current pace (around 15,000 to 20,000 per month) for the foreseeable future, as states and municipalities of all sizes continue to struggle with too much spending and not enough revenue.

Of course, the lack of contribution from state and local government and housing, along with the historically low contribution from the consumer at this stage of the recovery, has left the heaving lifting to the export sector, inventory accumulation, business spending and, of course, federal government spending. Three of the four of the drivers of growth thus far in the recovery—business capital spending, exports, and inventory accumulation—appear likely to continue, while federal government spending will likely fade as budget cuts at the federal level loom on the horizon.



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Stock investing involves risk including loss of principal.

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