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Economic Research:

U.S. Economic Forecast: Fright Month

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Economic Research:

U.S. Economic Forecast: Fright Month

October is always the scariest month of the year, both for the stock market and the economy. Especially when the economy is flirting with recession, as it is now, and financial markets remain under stress, memories of past October crashes come to the fore. The housing market has broken, with the worst year-on-year drop in home prices (down 3.9% in July) in the history of the Standard & Poor's/Case-Shiller index. But so far, strength in other sectors of the economy has kept the overall economy growing.

The approach of the critical holiday shopping season increases worries that the housing downturn could begin to spill over into consumer confidence and consumer spending. Consumer spending is the key to continued economic expansion—as always, because consumer spending accounts for 70% of U.S. GDP. We have been surprised that consumers haven't slowed appreciably despite being squeezed by higher energy prices and higher mortgage rates. So far, the decline in home prices seems to have had little impact on consumer confidence. But the drop in confidence in September could be the beginning of more severe problems.

Nonresidential construction has also been an offset to the weakness in the housing market. However, this sector is showing some signs of strain, with contract awards slipping and prices beginning to show some fragility. Problems in the residential mortgage market are having some impact on commercial mortgages as well, as investors are avoiding all credit risks.

But the biggest positive swing has been in the trade deficit. The rest of the world has largely ignored the U.S. slowdown, and the declining dollar has improved U.S. competitiveness. Exports have risen 8.6% in real terms over the past four quarters, well above the 1.8% growth of imports. We expect this trend to continue, with the current account deficit dropping to $727 billion by next year from $811 billion in 2006.

The freeze in short-term financial markets could still cause a recession, but the upward revision to the August employment data, an 89,000 increase from a 4,000 decline and the 110,000 gain in September reduce the fear factor. We still think that the Federal Reserve should do more after its 50 basis point (bps) rate cut on Sept. 18 to ensure that does not happen. We expect another rate cut, possibly on Halloween. Even with the expected cuts, however, the risk of a recession remains high, at 33%.

Keep On Spending

The most important sector is consumer spending. So far, consumers have been surprisingly resilient in the face of higher energy prices and rising monthly payments on mortgages. The drop in housing wealth has also left them little affected. But will the mortgage resets coming in the next few months and the continuing decline in home prices finally slow consumers down?

The drop in light vehicle sales in June and July had scared us, because it suggested that high gasoline prices were keeping buyers away from auto dealers. However, sales have come back to their recent 16.1 million unit average in August and September. This may in part be because gasoline prices have dropped back, but they are still high, and oil is near a record level. Consumers don't seem too worried about gasoline prices, although they may be causing a shift to smaller (and thus non-Big three) vehicles.

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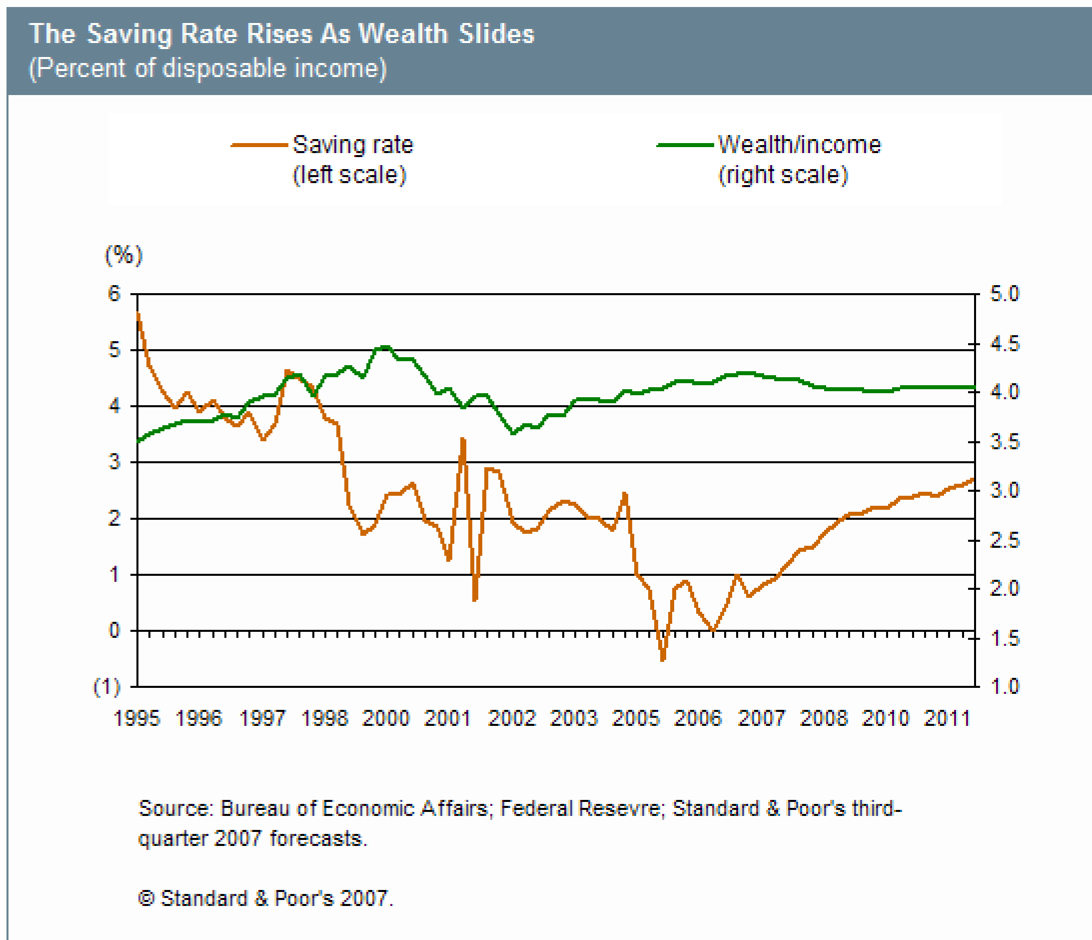
Chart 1



The impact of housing on wealth also seems modest. In part, the strong stock market has offset the decline in home prices. The market correction in late summer had again added to the worry quotient, but it has strengthened to a new record high at the start of the fourth quarter. Admittedly, the high stock prices affect mostly the wealthiest part of the population, whereas housing is more widely owned, but rich people spend money too—although maybe not quite as much at the margin.

Overall, we expect consumers to slow down next year, with real spending rising only 2.2% in 2008 compared with 3.0% this year. The saving rate will rise to 1.5% from 0.8%—not exactly an excessive level as baby boomers approach the retirement cliff.

Investment Slows

Capital spending is showing signs of slowing down. The August decline in orders for nondefense capital goods (excluding aircraft, which have a longer delivery time) fell 0.5%, and is down 0.9% from a year earlier. For the first eight months of 2007, capital equipment orders are down 1.4% from the same period in 2006, and we expect only a 1% rise in real expenditures on equipment this year.

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The offset has been the strong growth in nonresidential construction, but there are signs that this too is beginning to wane. In 2007, real nonresidential construction spending is expected to rise 10.7%, led by jumps in office and hotel construction and strong energy-related spending. However, the outlook for 2008 is much less optimistic; recent contract data suggests a rise of only 0.3%.

Prices of nonresidential structures are still up significantly year over year, in contrast with residential properties. The Standard & Poor's/GRA commercial real estate shows apartment prices down 3.5% in the 12 months through June, but office prices are up 16%, and retail space up is 15%. Prices do seem to be tapering off in the past few months, however.

The 2007 jump in construction was the result of strong employment growth, which has finally used up the excess office and other space left over from the 2001 recession. But employment growth is now slowing, and construction activity is thus likely to level off.

Cutting The Trade Deficit

The narrowing of the trade gap has been an important offset to the weakness of the housing sector, adding back about 0.3 percentage points to growth over the past four quarters. The decline in the dollar and continued strong growth in most overseas markets have allowed exports to accelerate, while the weaker growth in U.S. demand has slowed imports. In 2007, we expect export volumes to rise 7.3%, while imports are up 2.3%.

We anticipate a continued decline in the dollar. The current account deficit is at 5.5% of GDP, down from the record 6.8% of GDP reached in the fourth quarter of 2005. Until recently, this was balanced by the strong inflow of foreign capital attracted by high U.S. interest rates. But a year ago, U.S. Treasury yields were a full percentage point above equivalent European yields. That spread has now narrowed to only 35 bps, and with the dollar declining, Treasuries and other U.S. interest-bearing instruments are less attractive to foreign investors. Also, the worries about defaults have made foreign investors more nervous about private U.S. securities, which could also slow inflows.

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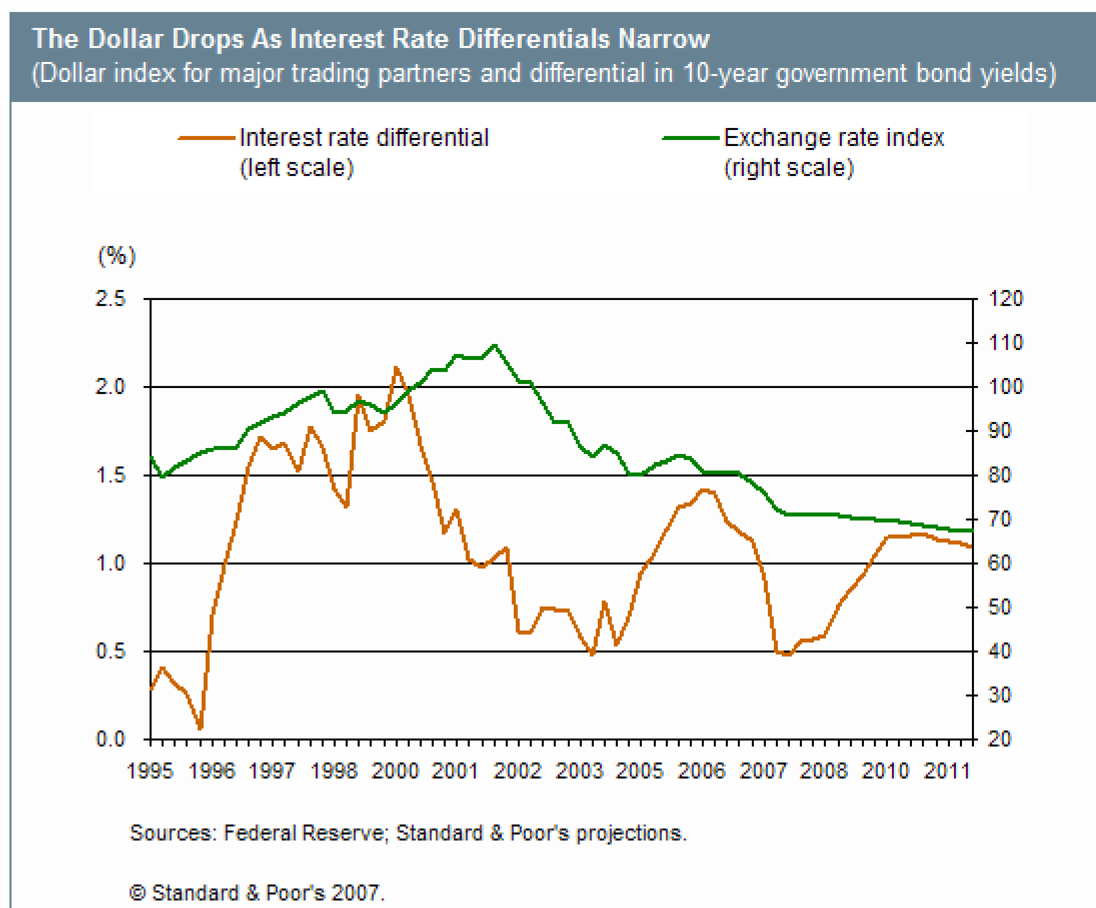
Chart 2



Note that the recent improvement in the trade gap is the result of the decline in the dollar in 2003 and 2004. In the short run, a drop in the dollar actually worsens the trade deficit, because it increases the cost of imports. But eventually, the increased competitiveness offsets the higher prices. Despite some recent articles that claim this relationship no longer works for one reason or the other, it always seems to happen about when people begin to worry that it won't.

Even more important for trade, however, has been the resistance of foreign economies to the U.S. slowdown. Our forecast of world growth has not changed much, especially on a purchasing power basis, because the downward revision to forecasts of U.S. and other industrial countries' growth has been offset by positive surprises in China and India.

Economists have talked about the decoupling of the world economy, but that is really the wrong analogy. The world economy remains tightly coupled, but there are more locomotives attached to the train than in the past. When the U.S. slows down, China and India are now big enough to carry some of the load.

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The Fed At Halloween

It seems appropriate that the next Fed policy announcement will come Halloween afternoon, as someone is sure to be scared by it. If the Fed doesn't move, they will scare those who fear recession; if they do, they will scare the inflation hawks. Right now, I'm more scared of recession than inflation.

I expect a quarter-point cut from the Fed at the next meeting, with another cut coming in December or (more likely) January. Timing and extent will, of course, depend on the incoming monthly data. But the monthly inflation data are coming in fairly comfortably; the core consumer price deflator is up 1.8% from a year earlier, inside the Fed's 1%-2% comfort zone. The data on the real economy are not far enough away from recession for comfort, however. Another cut seems safer than standing pat, even if there wasn't an election next year.

Whenever the economy is expected to grow by less than 2%, it is one bad accident away from recession. Economists, including myself, are still predicting that the economy will stay out of recession. My own estimate is that the probability of recession has dropped to 33%. But, the consensus of economists has yet to call a recession before it happens. This is partly because when a recession does occur, it gets predated to an earlier peak (as happened in 2001, for example). Calling the exact timing of a recession is also pretty much impossible, so even if economists do expect a recession, they may put the decline in different quarters and the average for each quarter will remain positive.

But I can remember back to 1973, when I was just starting to do forecasts. We said that the oil embargo and price hikes would cause a recession and were roundly laughed at for several months when it didn't happen. I moved to London too early to say, "I told you so."

Standard & Poor's Economic Outlook: October 2007

	--2007--										
	First quarter	Second quarter	Third quarter	Fouth quarter*	2005	2006	2007	2008f	2009f	2010f	2011f
% change											
Real GDP	0.6	3.8	2.7	1.5	3.1	2.9	2.0	2.1	2.7	2.9	3.1
Consumer spending	3.7	1.4	3.4	2.1	3.2	3.1	3.0	2.2	2.6	2.8	3.1
Equipment investment	0.3	4.7	2.0	7.1	9.6	5.9	1.0	3.5	5.7	4.3	5.1
Nonresidential construction	6.4	26.2	4.3	2.8	0.5	8.4	10.7	0.3	(1.9)	2.0	2.5
Residential construction	(16.6)	(11.9)	(18.2)	(28.2)	6.6	(4.7)	(17.0)	(16.4)	2.7	8.6	9.3
Federal government	(6.3)	6.0	4.6	3.3	1.5	2.2	1.6	3.1	0.3	(0.4)	(0.9)
State and local government	3.0	3.0	0.8	2.3	0.3	1.6	2.0	1.4	1.1	0.9	1.1
Exports	1.1	7.5	11.8	8.2	6.9	8.4	7.3	9.5	8.4	7.8	7.8
Imports	3.9	(2.7)	4.5	4.6	5.9	5.9	2.3	3.5	4.8	5.5	6.1
CPI	3.8	6.0	1.8	1.6	3.4	3.2	2.7	1.8	1.8	2.0	2.0
Core CPI	2.3	1.9	2.5	1.9	2.2	2.5	2.3	1.8	1.8	2.0	2.1
Nonfarm unit labor costs	5.2	1.4	2.5	2.6	2.0	2.9	4.2	1.9	1.5	1.7	1.8
Nonfarm productivity	0.7	2.6	1.6	1.3	1.9	1.0	1.1	1.6	2.0	2.0	2.1
Levels											
Unemployment rate (%)	4.5	4.5	4.6	4.8	5.1	4.6	4.6	4.9	4.9	4.7	4.5

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Standard & Poor's Economic Outlook: October 2007(cont.)											
Payroll employment (mil.)	137.4	137.9	138.1	138.3	133.7	136.2	137.9	139.0	140.6	142.4	144.3
Federal funds rate (%)	5.3	5.3	5.1	4.6	3.2	5.0	5.0	4.5	4.5	4.5	4.5
10-year Treasury yield (%)	4.7	4.8	4.7	4.6	4.3	4.8	4.7	5.1	5.5	5.8	5.8
'AAA' corporate bond yield (%)	5.4	5.6	5.8	5.8	5.2	5.6	5.6	6.2	6.7	6.9	6.9
Mortgage rate (30-year conventional, %))	6.2	6.3	6.5	6.4	5.9	6.4	6.4	6.8	7.3	7.5	7.5
Three-month Treasury bill rate (%)	5.0	4.7	4.3	3.7	3.1	4.7	4.4	4.0	4.3	4.4	4.4
S&P 500 Index	1,425	1,496	1,491	1,550	1,207	1,311	1,491	1,603	1,686	1,771	1,864
Standard & Poor's operating earnings ($/share)	22.39	24.19	23.45	23.05	76.45	87.72	93.08	96.87	104.32	108.98	118.03
Current account (Bil. $)	(788)	(763)	(771)	(772)	(755)	(811)	(774)	(728)	(707)	(727)	(748)
Exchange rate (major trade partners)	81.0	78.0	76.0	72.0	82.0	81.0	77.0	71.0	71.0	70.0	68.0
Crude oil ($/bbl, WTI)	58.09	64.96	75.49	77.00	56.56	66.12	68.88	74.25	74.35	74.03	73.60
Saving rate (&)	1.0	0.6	0.8	0.9	0.5	0.4	0.8	1.5	2.1	2.4	2.6
Housing starts (Mil.)	1.46	1.46	1.31	1.14	2.07	1.81	1.34	1.16	1.39	1.57	1.72
Unit sales of light vehicles (Mil.)	16.4	16.0	15.9	16.2	16.9	16.5	16.1	16.0	16.1	16.6	17.5
Federal surplus (fiscal year unified, Bil. $)	(178)	$137	(41)	(83)	(321)	(248)	(162)	(254)	(309)	(297)	(245)

*Estimate. f--Forecast.

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