

U.S. Macro Outlook: Pickin' Up Good Vibrations

Risks to the positive economic outlook are less threatening than they have been in many years.

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- In spite of weaker growth earlier this year, the U.S. economy is performing well.
- The market is on track to create a prodigious 2.5 million jobs this year.
- Disappointing GDP growth during the recovery can be explained in part by severe fiscal austerity, but that's winding down.
- For the recovery to power forward, consumers will need to step up their spending.
- Risks to the economic outlook today appear less threatening than they have in many years.

The economic recovery has lasted six years and shows no signs of old age. The economy is performing well, the weaker growth earlier this year notwithstanding, and its prospects are good.

This is best seen in the job market. Some 3 million jobs were created last year, the most since 1999, at the height of the technology boom. And the market is on track to create a prodigious 2.5 million jobs this year, despite the slowdown. This is more than double the pace necessary to absorb the growth in the working age population.

If the current pace of job growth is sustained, which seems likely, the economy will be back to full employment by this time next year. This is consistent with a near 5% unemployment rate, a somewhat higher labor force participation rate, and fewer part-timers who would like full-time work.

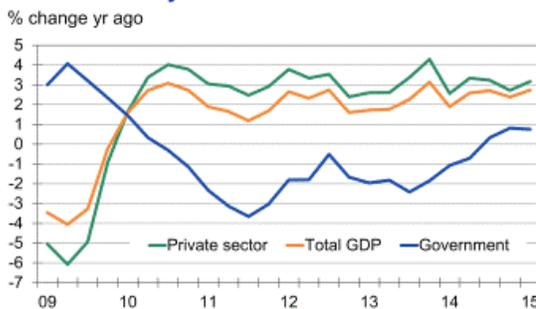
It's been a long time coming. The last time the economy was at full employment was almost a decade ago. But in the context of the contraction of the financial system and Great Recession, it is a significant achievement. Few economies in history have made it back so quickly after such a devastating financial crisis.

GDP head fake

Viewed through the prism of GDP growth, the economy's performance hasn't been nearly so good. GDP has expanded at a pedestrian 2.2% per annum pace during the recovery, and has turned negative in a few quarters along the way, including the first quarter of this year.

Disappointing GDP growth during the recovery can be explained in part by severe fiscal austerity. Government spending surged during the recession with policymakers' aggressive use of fiscal stimulus, but this gave way to spending cuts soon after the recession ended. GDP excluding government spending—private sector GDP—has grown at a much more respectable pace, of more than 3% per annum during the recovery.

Fiscal Austerity Stunts GDP Growth



With fiscal austerity winding down, the stronger private sector GDP growth should become more evident. Indeed it is. Underlying GDP growth, abstracting the vagaries of the data, appears close to 3%.

A key vagary of the GDP data is seasonal adjustment. The Bureau of Economic Analysis, the agency that puts the numbers together, acknowledges that its current adjustment for seasonality

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is not working well. In recent years, first quarter growth has been inordinately weak and second and third growth inordinately strong. It plans to address this problem with the annual GDP revisions to be released later this summer.

Software and social media

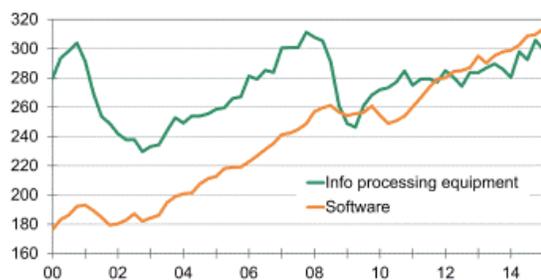
An even more pernicious measurement problem plaguing the GDP numbers involves the rapidly growing importance of the software and social media industries. Business spending on software has recently surpassed spending on information technology equipment, and it is clear that households are spending more and more time and money enjoying social media and other digital content.

The GDP statistics aren't keeping up. The measurement challenge posed by software is measuring its improving power and quality. Take econometric software, for example. A quarter century ago, most econometric packages could do only rudimentary regression analysis. Today, the most sophisticated econometric techniques are available for wide use almost as soon as they are devised.

This improvement should be captured by the BEA in its estimate of the price for software. So that even though economists are spending no more on econometric software today than 20 years ago (and probably less), the value of that software is much greater. In other words, nominal value added to GDP is no higher, but real value added to GDP is. Judging by the BEA's price measures for software, this dynamic isn't being captured, at least not adequately.

Software Surpasses Info Processing Equipment

\$ bil, SAAR



Sources: BEA, Moody's Analytics

The popularity of social media and other digital content creates another vexing bias in the GDP data that's due to the introduction of new products, especially of those that are free or nearly so. Snapchat, for example, is all the rage, particularly among young people, and it is free. It is unlikely the BEA is measuring the impact of Snapchat-like new products in its price and GDP estimates.

The upshot is that inflation has been probably meaningfully lower and real GDP growth stronger during the economic recovery than the BEA's data currently suggest. Future revisions to GDP will likely bear this out.

AWOL consumers

Measurement issues aside, for the recovery to power forward, consumers will need to step up their spending. This seemed almost assured when oil prices declined last year. Consumers' combined gasoline bills are on track to be more than \$100 billion less this year than last. If consumers spent less filling their gas tanks, then surely they would spend more on everything else.

That has not been the case; at least not yet. Vehicle sales have been strong, particularly for less gas efficient light trucks and SUVs, and people are driving more, but the rest of retailing has been effectively flat since before Christmas. The personal saving rate has jumped nearly a percentage point, as consumers are largely banking their gasoline windfall.

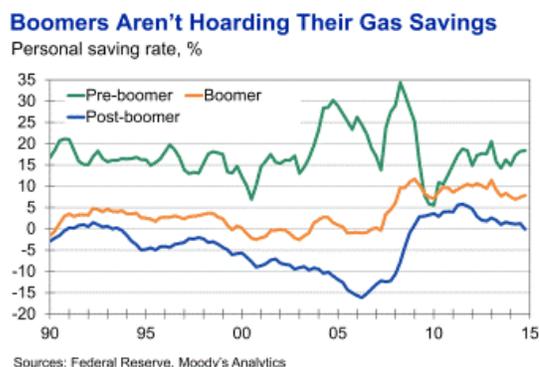
Our view has been that it is only a matter of time before consumers begin to spend more of their gasoline savings. Judging from consumer surveys, people don't quite believe the lower gas prices are here to stay. But this should change as it becomes clear that they are. It also takes time for the gas savings to build up in deposit and saving accounts to the point that it is enough money to make a difference and consumers spend it.

We still hold to these explanations, and we thus expect spending to soon revive. But with each passing month that gas prices stay low and spending fails to pick-up, they become less convincing.

Changing attitudes

It suggests that something else is afoot. The Great Recession may have more fundamentally changed consumer attitudes toward spending, and they will save their windfall. They view it as an opportunity to rebuild their nest eggs, particularly among poorly-prepared baby boomers who are fast approaching retirement. Reinforcing this are expectations that interest rates and asset returns will remain low and volatile, which means even more saving is required.

Perhaps, although saving rates among boomers rose sharply in the wake of the recession, they don't appear to have changed much since.



Moreover, even if consumers save their gasoline windfall, unless saving rates continue to push higher, consumer spending growth will accelerate to be consistent with currently much stronger income growth. The consumer spending boost in coming quarters won't be as strong as we are expecting, but it will be a boost nonetheless.

Financial tailwinds

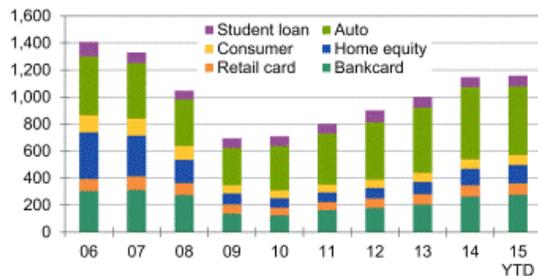
Supporting this optimism are other financial tailwinds at the back of consumers. The record stock market and the strong and consistent gains in house prices have significantly lifted household wealth. While there is good reason to think the wealth effect—the impact on consumer spending from changing household wealth—isn't as potent as it was before the recession, there is no reason to think it is inoperable.

Household debt service burdens are also as low as they have been in the available data back to 1980. Deleveraging combined with low interest rates and mortgage refinancing has put debtors on favorable financial ground. Since nearly all the refinancing has been into long-term fixed rate mortgages, households' debt burdens are well insulated from any increase in interest rates.

Credit availability is also much improved. Auto credit is ample, and credit and retail card lending is back to normal. Even home equity lending has come back to life, as the higher house prices have increased homeowners' equity and lenders are more comfortable extending loans given much-improved credit quality. Originations of household credit, excluding first mortgages, are back to prerecession levels.

Household Credit Flows More Freely

Household loan origination volume x first mortgages, \$ bil



Sources: Equifax, Moody's Analytics

There is also evidence that it is getting a bit easier to qualify for a first mortgage loan to purchase a home. The FHA's decision to lower its insurance premiums at the start of the year, and Fannie Mae and Freddie Mac's new 97% loan-to-value ratio loan program appear to be having some effect.

Lenders also appear more comfortable in selling loans to Fannie and Freddie since the mortgage giants made recent changes to their policies reducing the risk that lenders will need to repurchase loans that eventually get into trouble. The FHA is still working on similar policies which, if done well and in a timely way, will also help.

A normalization of mortgage credit availability is vital to the full return of the first-time homebuyer to the housing market. And first-timers are essential to getting the housing recovery back on track.

Risks, but not that risky

There are risks to this sanguine economic outlook. Most obvious are the end of ultra-low interest rates, a Greek exit from the Economic and Monetary Union, and a major misstep by the Chinese as they work to address the various imbalances in their economy. There are also numerous and hard-to-handicap geopolitical threats. But there are always risks, and the risks today appear less threatening than they have in many years. Odds are good that the recovery has a long way to run.

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