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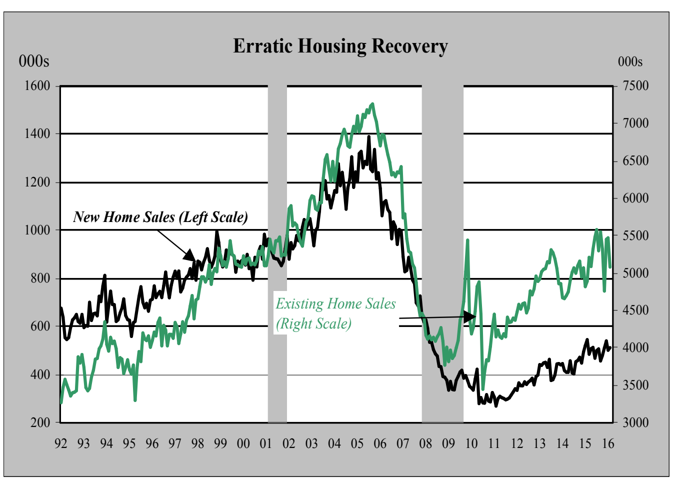
Weekly Economic Commentary- Week of March 25, 2016

It still looks like the economy will stage a respectable rebound from the fourth-quarter's tepid showing. But some key cyclical drivers are sputtering, and their erratic behavior is likely to sap some of the strength from the first-quarter's growth rate. Make no mistake; the consumer is still the critical cylinder that will determine how fast the economy's engine revs up. By all accounts, households are continuing to provide decent support, maintaining a good deal of enthusiasm for autos and SUVs while upping outlays for most other items that enter into the GDP accounts. We will have more detail on the strength and breadth of consumer purchases for February in next week's personal income and consumption report.

But the bedrock support provided by consumers will not be enough to push overall growth above its long-term trend, much less the lackluster 2-2.5% pace seen over the 6.5 years of the recovery. For that to happen, you would need heavier lifting from sectors of the economy whose outlays are much smaller than consumers but provide a bigger cyclical kick to growth. The most conspicuous of these is the swing in inventory accumulations, which can greatly amplify the headline GDP growth rate in any given quarter. But big inventory swings usually don't have more than a one- or two-quarter effect, as companies eventually feel comfortable with the volume of merchandise on hand relative to sales.

A more lasting impact on growth comes from business capital spending and housing activity. Like inventories, these sectors account for a small fraction of GDP - 6.5% for capital spending and 3.2% for residential outlays - but their influence is much more pervasive and can put the economy on a more sustainable path, either faster or slower than the one in train. Unfortunately, neither is showing enough muscle to jump-start the economy's growth engine over the near term. Of the two, housing is showing the most vigor, thanks to a steadily improving job market that is spurring household formations, and historically low mortgage rates that makes financing a home purchase more affordable. Since hitting bottom in early 2011 following the worst housing bust in modern times, home sales have advanced considerably, if erratically.



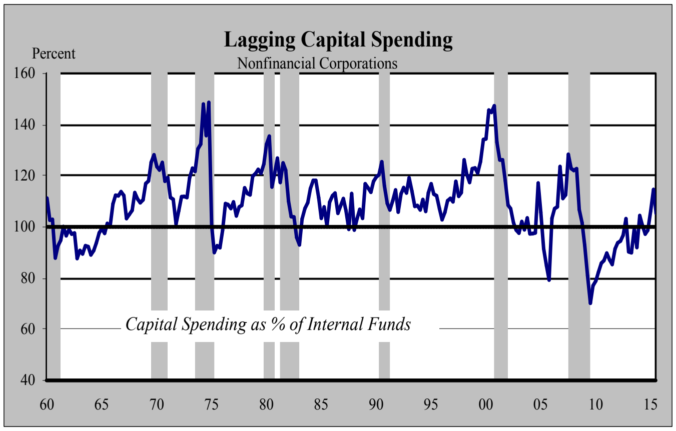
The biggest gains have been for previously owned homes, thanks to a wave of distressed and short-sales earlier in the recovery that lured an army of institutional buyers into the market, as well as other investors able to make all-cash purchases. As prices rose over time, these transactions became less profitable and more conventional sales gained momentum. Sales of newly built homes, meanwhile, traveled a rockier path. Low mortgage rates and growing employment underpinned demand by credit-worthy buyers, stimulating sales of higher-priced homes. But a much larger segment of potential homeowners, particularly first-time buyers, struggled to obtain financing amidst tougher lending standards. Lean inventories of unsold homes also constrained sales in this sector, as well as in the market for previously owned homes.

Reflecting these as well as other obstacles, the housing sector never lived up to its time-honored cyclical role of propelling the economy out of recession. The scars of the housing bust lingered for two years after the Great Recession ended in mid-2009, and the revival since then pales in comparison to past cyclical rebounds. Still, residential outlays have contributed to economic growth in all but three quarters since mid-2011, including the last seven consecutive quarters. That positive influence is continuing in this year's first quarter, albeit the thrust is modest at best. As reported this week, new home sales - which has more significance than existing home sales on economic output since they bear directly on construction activity - increased 2% to a 512,000 annual rate, and the January's sales pace was revised up from 494,000 to 502,000.

These are not blockbuster outcomes by any means. The 507,000 average sales pace over the first two months of the year is just a tad higher than the 503,000 for all of 2015. Looking ahead, the crosscurrents that have buffeted the market throughout the recovery remain very much in evidence. On the positive side, continuing improvement in the job market and rising incomes should sustain the growth in household formations, spurring housing demand. Mortgage rates, despite a recent uptick, remain low by historical standards, and applications for home purchases are rising. On the negative side, inventories remain low, particularly for first-time home buyers, and many homeowners are stymied in their attempts to trade up because of surging prices of homes in the upper tiers of the housing market. This lack of upward mobility, meanwhile, keeps the more modestly priced homes off the market, exacerbating the plight of first-time buyers. The good news is that there is still considerably room for growth in the market for new homes, as the sales pace is well below the 600,000-800,000 normally seen in a healthy housing market. The bad news is that the sales restraints are still in place, suggesting that it will be a slog to meet the upside potential.

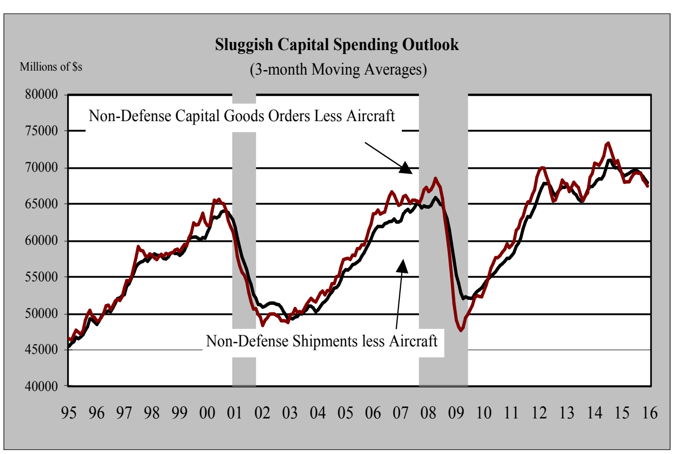
That said, the near-term outlook for the other cyclical growth driver is much bleaker. Unlike housing activity, which usually kicks in early in a recovery, capital spending tends to become a key growth driver in the later stages of an upturn. That's because the need to expand capacity becomes more urgent as productive facilities become more fully utilized over time. Meanwhile, aging equipment and software require replacement and updating to maintain productivity and incorporate the latest technological advances. But like the lagged behavior of the housing sector, capital spending has also contributed much less to the recovery than in past cycles. That shortfall has been all the more striking because businesses have racked up hefty profits during the recovery and, hence, had little problem financing investment spending with internal funds.

Indeed, this is first recovery since at least 1960 that nonfinancial corporations have plowed less than 100% of internal funds back into plant and equipment. On average, they used up 93% of cash flow for this purpose, compared to a 111% average over the previous seven recoveries. There are several reasons for this shortfall. For one, the astonishing plunge in production during the Great Recession left industry with a huge amount of excess capacity. With growth during the recovery averaging about half the pace of previous postwar upturns, the slack was never fully used up. Even now, nearly seven years into the recovery, the capacity utilization rate, at 76.7%, is 3.3% below its long-run average and well below the 83-85% typical of the mature stage of a recovery when supply bottlenecks spur companies to rev up expansion plans.



For another, companies alter the mix of capital and labor to generate output according to the relative cost of these inputs. When labor is cheap, as has been the case throughout the recovery, it is more cost effective to substitute labor for capital. This tradeoff, of course, has its limits. As companies dig deeper into the pool of unused labor, they are forced to offer higher wages to attract new workers. At some point, rising labor costs prompt companies to recalculate the advantage of substituting labor for capital. Over the past six months or so, unit labor costs have accelerated, thanks to larger pay increases and declining productivity. So far, however, this has not translated into increased capital spending.

Indeed, the revised GDP data for the fourth quarter, released on Friday, suggests that just the opposite is happening. In an otherwise upbeat third estimate, which lifted the overall growth rate to 1.4% from a previously reported 1.0%, the one component that was revised down to any meaningful extent was capital spending. Instead of a decline of 1.8%, spending on equipment now shows a fall of 2.1% during the fourth quarter. Nor does that dispiriting decline seem like a temporary aberration. If this week's durable goods report for February is any indication, the economy will not be getting any lift from capital spending in the first quarter. Shipments of nondefense capital goods excluding aircraft - a proxy for equipment spending in the GDP accounts - declined by 1.1% during the month, following 1.3% decline in January.



Nor do things look ripe for a turnaround anytime soon. In that same report, orders for these capital goods fell in February for the third time in the past four months. As the chart shows, new orders and shipments are tracking a path that is more indicative of the onset of a recession than the late stages of an expansion. We doubt the economy is close to such a turning point in the cycle, but the drag from capital spending is clearly an impediment that is clogging the growth engine. Indeed, following the durable goods report, the Federal Reserve Bank of Atlanta's GDP tracking model lowered its first-quarter growth estimate to 1.4% from 1.9%. That would be spot-on with the 1.4% revised growth rate for the fourth quarter of last year, which casts doubts on the much-ballyhooed first-quarter rebound.

We suspect that growth will come in closer to 2%, thanks to the ongoing improvement in the job market that is providing continuing support to consumer spending. Indeed, a bright spot in the revised GDP report was a 0.4% upward revision in personal consumption, which now shows a respectable growth rate of 2.4%. Interestingly, all of the upward revisions were in spending on recreational services, which indicates that households may indeed be finally spending their savings from lowered gasoline prices. As long as consumers continue to flex their spending muscles, the recovery will have staying power. More than anything, sustained increases in consumer demand would eventually boost output enough to eliminate slack in industrial capacity. That, in turn, could well be the catalyst that finally jump-starts capital spending.