

# U.S. Economic Forecast

## Monthly Summary

### July 2010

#### Caution Signs

By David Wyss and Beth Ann Bovino

Recent economic data continue to indicate recovery, though the pace of the recovery has slowed considerably. Although we are not surprised, given that we have been forecasting a half-speed recovery, the recent data have increased market fears of a double dip, particularly now that stimulus spending is ending. Indicating just how dramatic the lost stimulus can impact growth, new home sales dropped to record lows, and consumer spending slowed. With the boost from stimulus funds fading and the possibility of an extra fiscal stimulus from Congress becoming less likely, the question now is whether private demand can take over where the government has left off. We expect the recovery to continue, though at a sluggish pace, and it won't feel like one to most.

Consumers are becoming more cautious about borrowing, and spending has softened. U.S. retail sales revealed an even bigger unwind from the stimulus-related splurge earlier this year. The outlook for June sales doesn't look promising, as the soft auto sales data already have indicated. Businesses are spending more on capital equipment, following improved demand, though sentiment suggests slowing growth. Construction remains a weak point. The residential market is showing signs of fatigue, with concerns about the after-rebate housing market. Nonresidential construction continues to drop, except for stimulus-related spending.

The global outlook has improved, according to the International Monetary Fund (IMF), which raised its outlook for global real GDP growth to 4.6% in 2010 (previously 4.2%) in its April World Economic Report. Despite the improvement, the report focused on downside risks. It emphasized that a rapid fiscal consolidation could threaten the still-weak domestic demand in the industrialized world, but it also stated that the lack of government control could threaten financial stability. We think that increased turbulence in international markets and the government's next moves are big concerns going forward. The massive stimulus package aided growth this year, but the U.S. government will have to withdraw that stimulus over the next year or two. These changes are necessary to control the deficit, but they likely will slow the economy.

The sovereign debt crisis in the EU also increases the risk of a slowdown in the U.S. The direct impact that it could have on U.S. exports is a minor problem. But, the major risk is that the Greek debt issues could escalate into a major financial panic worldwide, similar to the falls of Lehman Brothers and American International Group (AIG) in 2008, and could derail the fragile recovery in financial markets and weigh on U.S. growth. With inflation still at the low end of the Federal Reserve's "comfort zone," concerns in Europe will likely keep the Fed from raising rates **into** 2011, despite a loud dissent from one member of the Federal Open Market Committee (FOMC).

#### On Shaky Ground

The housing market has weakened after a promising winter. Home sales plunged in May, suggesting that tax credits had more to do with the earlier recovery than we had thought. Existing home sales were down 2.2% from a year earlier, but new homes plummeted 32.7% to a record-low 300,000 (annual rate). In both reports, the major weakness was in the west. The percentage of first-time homebuyers fell to 46% in May from 49% in April. Distressed sales fell to 33% from 36%. In contrast, the S&P/Case-Shiller home price index (20 cities) confirmed the improved trend of home prices seen in other releases, up 3.8% from a year earlier in April, the third consecutive year-over-year increase after three years of decline. However, the rush to close before the tax-credit expires likely explained the price strength, which we expect to reverse once the support is gone.

The drop in new home sales to a record low is disturbing. New home sales lead existing home sales because of the way they are counted. New home sales are counted when the contract is

signed, while existing home sales aren't counted until final settlement. We had expected a sharp drop in new home sales in May because anyone intending to buy a new home should have bought in April and saved some money. But the size of the decline was still a surprise and suggests that the underlying demand could be weaker than we had thought.

Improvements in the housing market have clearly stalled. Although we had expected sales to fall off after the end of the tax rebate program, the drop has been more severe than we had expected. We need a few more months of data to determine whether this is just a temporary reaction to the higher sales during the program or whether the housing market could drop more than we had expected. For now, we will stick with our forecast for a moderate sales decline later this year, with prices falling another 4% following the end of the tax credit, bringing them back to the lows seen in April 2009. Sales are also likely to drop over the summer, at least on a seasonally adjusted basis.

The overhang of unsold homes, including those in the process of foreclosure, will bring prices down. Mortgage default rates are declining significantly--to 3.5% in May from 3.7% in April and 5.7% last May--according to the S&P/Experian default indices. However, long delays in the foreclosure process will keep bringing these foreclosed homes into the market for at least another 18 months. Although the number of homes that will eventually be foreclosed remains uncertain, difficulties in restructuring first-lien holders suggest a sizable amount will end up for sale.

The tax credit expiration explains much of the weak sales data and, together with excess inventory, the likely drop in prices. However, housing remains very affordable. Mortgage rates have declined as the European financial turmoil has sent funds into the U.S. The Fed's withdrawal from purchasing mortgage-backed securities does not appear to have had any impact on mortgage rates, and risks of a double-dip recession will likely keep the Fed on the sideline until the second quarter of next year. Low Treasury bond yields will keep mortgage rates under 5% over the next 12 months, before climbing in the second half of 2011 on expected interest rate hikes.

## **Cutting Back**

Consumers are keeping their wallets closed. Consumer credit outstanding dropped \$9.1 billion in May, the fourth consecutive decline. The real surprise is the sharp downward revision in April, now down a hefty \$14.9 billion (previously up \$1 billion). Household debt has dropped for seven consecutive quarters, though mostly because banks are writing off mortgage debt rather than because people are paying the money back. However, that's not the whole story. Consumers are cautious about taking on debt, so they are likely to spend somewhat less freely than in past recoveries. The saving rate is now at 4% after rising to 3.8% in March (revised from 3.6%) but is expected to drop below 3% into 2012 on higher taxes.

After an early Easter and better weather ignited a March shopping spree, consumers have slowed down. May personal consumption expenditures (PCE) rose 0.2% after a flat reading in April. However, low energy prices remained a factor in May's tame PCE, with nondurable purchases down 0.9% in May. This is a good thing, improving consumer purchasing power, since less money spent at the gas pump is more money available at the mall. Services were up 0.3%, while durable purchases were strong (up 0.8%), with half from auto purchases, despite the drop in auto retail sales. This was expected because the GDP durable purchases follow the unit sales (which jumped 3.7% in May) more closely than the retail sales auto component (only net used car sales count). Still, consumer sentiment indicators remain in recessionary territory, suggesting a still-reluctant consumer.

Data indicate that household finances continue to improve. The S&P/Experian first-mortgage default index fell sharply in May. Every other sector in the index fell, with the lowest default rate for auto loans (1.8%, down from 1.9% in April) and the highest for credit cards (8.9% from 9.1%). Household defaults appear to have peaked this past summer overall, with mortgage defaults peaking first and credit cards last. Charge-off rates for both credit cards and auto loans have dropped in recent months, suggesting the decline was from consumer caution, not write-offs. Some of the drop in revolving credit may be from adjustments to the new credit card regulations as banks have reduced credit card issuance and credit limits. But most is likely from consumers' newfound caution, which is good in the long run but will make coming out of the recession in the near term much more difficult.

The weak job market add to consumers' wariness to run up debt. Nonfarm payrolls lost 125,000 jobs in June, which was largely from 225,000 jobs lost from temporary Census jobs. Excluding the Census, the U.S. gained 100,000 jobs. Private payrolls gained just 83,000 new jobs in June and are 7.9 million below their December 2007 level, but they remain ahead of their performance in the past two recessions (1991 and 2001). The overall data are distorted by the huge swings in Census jobs, which will come back out of the data at the end of the summer. These jobs were temporary, and the people who held them worked few hours, implying that should be ignored in the analysis, though they can be good supplementary income for college students and retirees.

## **Construction Concerns**

The end of the tax rebates in April had a big impact on housing starts, which plunged 10.0% in May to an annual rate of 593,000. Starts remain up from 550,000 a year earlier, but the level is the lowest since May 2009. The drop shows that the recent strength was heavily influenced by the tax benefits, as we thought, but it mostly reflects homebuilders'

assessment of the impact, not the actual behavior. We need to see how much sales drop to assess what buyers are actually doing, and that will take a few months because existing home sales made in May and June will still qualify for the tax rebate as long as the contract was signed before April 30.

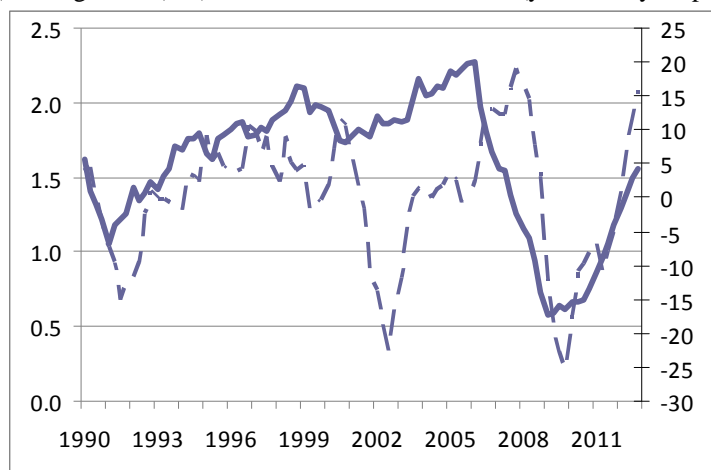
The report is still discouraging for the housing sector, suggesting the tax credit dominated recent buying decisions. The picture is supported by the National Association of Homebuilders/Wells Fargo Housing Market Index, a gauge of builder confidence, which fell to 17 in June from 22 in May. The only mildly encouraging component of that report is that prospective buyer traffic dropped only slightly in June, to 14 from 16, and was actually above the April level of 13. Certainly anyone intending to buy a home during the summer probably was convinced to do so, but we believe that the timing was probably moved only a few months and that sales will start to recover during the winter unless something else goes wrong. Lower housing starts will be another factor holding down GDP and employment growth later this year.

Nonresidential construction is an even bigger concern for the economy. Construction spending fell 0.2% in May after two consecutive gains. This is partially a result of the end of the homebuyer tax credit, as builders pull back after the rush to finish homes in time to qualify (though settlement is not required until June). Residential construction also was down, by 0.4%, after two consecutive gains. Public nonresidential construction rose 0.4% in May for the third straight month, led by a 2.7% increase in highway construction and a 5.2% jump in water. We believe this reflects the infrastructure spending finally kicking in, but the drop in construction employment in June suggests it might not be as big a jump as we had hoped for. Private nonresidential construction fell 0.5% and is down 25% from May 2009. Private nonresidential construction has posted declines in 13 of the past 14 months.

### Chart 1

#### Construction Prospects Dim

(housing starts (mil), nonresidential construction (year-over-year percent change, right))



Source: Census, S&P projections

We expect nonresidential construction to continue to decline. The massive job losses and retail store closings of the past two years have created high vacancy rates. Although we think commercial real estate prices may have bottomed out, there is still no good reason to build more buildings in most of the U.S. Last year's 20% drop in activity will be followed by another 12% decline this year and a 7.5% drop the next. We do not expect growth from this sector until 2012.

### Is Enough, Enough?

The massive stimulus package aided growth this year, but the U.S. government will have to withdraw the stimulus over the next year or two. We have lowered our estimate of future stimulus. Election results and the new of Europe's sovereign debt crisis have reduced the ability of Congress to pass a stimulus program for fiscal 2011. We also expect the Bush tax cuts to expire, with the exception of some of the lower-income cuts, which will be a drag on the economy in 2011. These changes are necessary to control the deficit, but they will tend to slow the economy. We expect the budget gap to diminish slowly, on improvement in tax collections as the economy turns upward, but remain high. By 2013, the deficit will be cut in half from its 2009 record, but the level would still have been a record at any time before 2009.

The high unemployment rate and continued financial turmoil in Europe will likely keep the Federal Reserve on hold into 2011. The market-based PCE price index, excluding food and energy, is up just 1% from a year ago and is at the low end of the Fed's "comfort zone," giving the Fed more reason to wait. The timing of the first Fed rate hike will depend both on the economic data and on the health of the world financial system, but it seems unlikely before next year.

## S&P Economic Outlook

July 2010	2010				2008	2009	2010e	2011e	2012e	2013e
	Q1	Q2e	Q3e	Q4e						
	<b>Percent Change</b>									
Real GDP	2.7	3.4	2.5	2.5	0.4	-2.4	3.1	2.7	3.0	2.8
Cons. Spending	3.0	2.6	2.8	3.4	-0.3	-0.6	2.4	2.8	2.4	1.6
Equip. Invest.	11.4	16.2	15.2	12.2	-2.6	-16.6	11.9	12.8	9.7	8.1
Nonres. Const.	-15.5	11.9	-14.3	-12.6	10.3	-19.8	-11.7	-7.5	8.9	13.4
Res. Const.	-10.9	12.7	-14.2	6.3	-23.2	-20.8	-1.0	13.4	24.4	13.0
Fed. Gov	1.2	6.8	2.1	1.5	7.7	5.2	3.6	0.1	-3.5	-2.7
S&L Gov	-3.8	2.5	-0.2	0.3	0.5	-0.2	-0.8	0.5	0.4	1.3
Exports	11.3	8.0	8.5	6.5	5.4	-9.6	11.8	6.6	7.3	8.4
Imports	14.8	12.3	9.1	7.5	-3.2	-13.9	12.0	7.1	5.7	4.5
CPI	1.5	-0.6	1.8	1.3	3.8	-0.3	1.6	1.4	2.0	2.2
Core CPI	0.0	0.8	0.9	0.8	2.3	1.7	0.9	1.2	1.7	2.0
Nonfarm Unit Labor Costs	-1.3	-0.5	1.2	1.5	1.0	-1.9	-2.7	2.1	2.3	2.4
Nonfarm Productivity	2.8	1.6	0.8	0.9	1.8	3.8	3.7	0.6	0.5	0.7
	<b>Levels</b>									
Unemployment Rate	9.7	9.7	9.7	9.6	5.8	9.3	9.7	9.3	8.6	7.8
Payroll Employment (mn)	129.7	130.4	130.2	130.4	137.0	130.9	130.2	131.9	135.2	138.3
Federal Funds Rate	0.1	0.2	0.2	0.2	1.9	0.2	0.2	0.6	2.5	3.5
10-Yr. T-Note Yield	3.7	3.5	3.1	3.2	3.7	3.3	3.4	3.6	4.2	4.7
Aaa Corporate Bond Yield	5.3	5.1	4.8	4.9	5.6	5.3	5.0	5.3	5.6	6.0
Mortgage rate (30-year conventional)	5.0	4.9	4.6	4.7	6.0	5.0	4.8	5.0	5.7	6.1
3-month T-Bill Rate	0.1	0.1	0.2	0.2	1.4	0.2	0.2	0.8	2.6	3.5
S&P 500 Index	1122	1135	1050	1110	1221	947	1104	1172	1268	1348
S&P Operating Earnings (\$/share)	\$19.37	\$17.42	\$17.96	\$18.57	\$49.51	\$56.64	\$73.32	\$76.43	\$79.55	\$82.97
Current Account (\$bn)	-\$436	-\$420	-\$409	-\$447	-\$706	-\$378	-\$428	-\$494	-\$533	-\$561
Exchange rate (maj trade part)	95.0	94.0	94.0	94.0	93.0	93.0	94.0	92.0	90.0	89.0
Crude Oil (\$/bbl, WTI)	\$78.80	\$77.89	\$76.24	\$79.05	\$99.76	\$61.77	\$77.99	\$82.56	\$89.15	\$93.02
Saving Rate	3.5	4.0	4.1	3.9	2.6	4.2	3.9	3.1	2.4	2.1
Housing Starts (mn)	0.62	0.61	0.62	0.69	0.90	0.55	0.64	0.95	1.34	1.56
Unit Sales of Light Vehicles (mn)	11.0	11.3	11.5	12.1	13.2	10.3	11.5	13.1	15.1	16.4
Federal Surplus (FY. unified, \$bn)	-\$329	-\$273	-\$334	-\$412	-\$455	-\$1,416	-\$1,324	-\$1,200	-\$935	-\$733

Forecasts are constructed using the Global Insight Model of the U.S. Economy.

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