

Macro Trends

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Overview

1. The U.S. economy appears to be transitioning from recession to recovery. Several sectors seem to be turning up at the same time. As a result, third quarter economic growth could be slightly above the long-term average.
2. The housing market is showing promising signs of an upturn for the first time in three years. In addition, manufacturing orders are rising, suggesting that production is poised to increase.
3. The Fed is keeping interest rates low despite these encouraging indicators because the economy still faces headwinds from mortgage foreclosures and commercial real estate problems.

Leading indicators increase again

The index of leading economic indicators increased in July, posting the fourth consecutive monthly gain. More importantly, the percentage increase in the leading index during the past four months is the second strongest in the past 25 years. The only larger increase was in late 2001 and early 2002 when the U.S. economy was coming out of the last recession. The latest increase in the leading indicator index was even stronger than the rise in the index at the end of the 1991 recession. No indicator is perfect but the increase in the leading economic indicator index is a positive sign that the recession probably ended this summer.

Third quarter growth could surprise on the up side

The 2008-2009 recession was deep and widespread because most sectors of the economy contracted at the same time. The previous two recessions were mild in comparison to the current cycle because not all the sectors were weak at once. During the post World War II period, the two most similar downturns that were both deep and widespread like the current one were the 1958 and the 1981-82 recessions. Most sectors of the economy declined together and then increased together during those two cycles, causing the economic recovery to be very strong. If most sectors of the U.S. economy turn up at the same time during this cycle, then economic growth could be better than most people expect at least temporarily. This may be what the leading indicator index is suggesting. Currently, many parts of the economy appear to be doing better this quarter than last quarter including housing, consumer spending, manufacturing, government spending, inventory investment and capital spending. As a result, third quarter economic growth could be slightly above average. However, economic growth may settle down to a more modest rate in future quarters because of lingering problems from mortgage foreclosures and commercial real estate.

Housing turns up

Housing data are looking much more encouraging. Both new and existing home sales have increased for four consecutive months through July. In addition, pending home sales have increased for six consecutive months through July. Even home prices appear to be stabilizing.

The Case/Shiller 20-metropolitan home price index increased on a month-to-month basis in both May and June. Housing is very affordable given low home prices and attractive interest rates. Therefore, potential home buyers appear to be moving back into the market instead of sitting on the sidelines waiting for even lower home prices.

Manufacturing orders increase

The cash-for-clunkers program provided a good boost to the economy. Car sales surged in August to the highest rate in 15 months. As a result, manufacturing activity has turned up again, and it may not be just in autos. The new orders component of the Institute for Supply Management manufacturing survey increased in August to the highest level since December 2004. This means that orders have not been growing this broadly in four and a half years. At the same time, the inventories component of the index is up only slightly from its lowest level in more than a quarter century. Together, these two indicators suggest that companies probably cut inventories to minimal levels and now need to increase production again in order to prevent inventories from dropping too far.

Fed maintains easy money policy

The Federal Reserve continues to pump liquidity into the economy. Historically, the Fed does not begin to remove its stimulus policy until the recovery is well established. The economy is not there yet. At this point, the transition to recovery is still tentative. Many things are starting to fall into place but the economy is still vulnerable to setbacks. Therefore, it would be pre-mature for policymakers to assume that the economy no longer needs help. It does. That is why the Fed continues to say that it will keep interest rates low for an extended period of time.

Lingering problems

The commercial real estate market continues to face difficult times. Vacancies are rising and rents are declining. As a result, property values are also decreasing. This will make it harder for property owners to roll over loans. In fact, if owners cannot not refinance, they may be forced to sell or default. This is likely to cause problems for many lenders, especially smaller institutions with big commercial real estate portfolios. Fortunately, these commercial real estate problems are coming at a better point in the economic cycle than the residential real estate problems. Residential real estate turned down when credit was drying up. At least the credit markets are working better now when the commercial real estate problems are escalating. This means that commercial real estate prices may not be forced down as much as residential real estate. Nevertheless, this will be a major headwind for the economy as the recovery unfolds.

Risks

The biggest risk to the economy at this point in the economic cycle would be any unexpected shocks that would derail consumer and business confidence. Going forward, consumer spending is likely to be more restrained than during a typical recovery. Consumers will probably not want to take on a lot of debt. Instead, consumer spending is likely to be more in line with income growth. Similarly, business spending is also likely to be more modest with less use of leverage than during a typical expansion. Therefore, any shock that would depress already low sentiment could set the economy back again. Unfortunately, there is no way to know if or when something unexpected could happen. If the economy can avoid any major shocks, then an economic recovery is likely to extend into next year as the global economy works through the left over problems from the credit crisis.

Conclusion

The U.S. economy is transitioning from recession to recovery. Housing is starting to strengthen and manufacturers are increasing production in order to prevent further declines in inventories. The economy still faces many problems, but if there are no unexpected shocks, the recovery could grow into next year.

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