

ECONOMICS: US PERSPECTIVES—JUNE 18, 2010

Changing Growth Dynamics Unfold as Manufacturing Offsets Housing Weakness

■ Joseph G. Carson

US Economist and Director—Global Economic Research, (212) 969 6886

Recessions are often followed by significant changes in economic growth dynamics. Today, the housing sector is taking a backseat, while manufacturing production steams ahead. We think these trends will increasingly differentiate the current economic recovery from previous post-recession periods.

Housing has always been one of the first sectors of the US economy to recover after a recession, driving strong gains in residential construction activity, employment and overall real GDP growth. Yet, in the first year of the current economic rebound, the housing rebound has been anemic, and even substantial fiscal support has failed to revive the sector.

Despite its poor performance, the housing market has not foiled a broader recovery of the US economy. This marks a precedent in modern US economic history, as it represents the first time in the postwar period that economic growth has rebounded without substantial support from one of the country's largest cyclical sectors. Housing weakness has been offset mainly by an unprecedented growth in exports, as manufacturing production steams ahead, generating momentum for investment and inventory building. We believe these trends highlight a new mix in the sources of US growth that will increasingly differentiate the current economic recovery from previous post-recession periods.

Housing Stuck in Slump

In May, housing starts fell 10% to the lowest level of the year (**Display 1**). Part of this sharp decline was triggered by the expiration of a government incentive worth up to \$8,000 on contracts signed by April 30 and closed by the end of June.

But even though the May figures may overstate weakness in the sector, housing remains troubled and has hardly contributed to the recovery. Indeed, when we exclude volatility in housing starts over recent months and look at the contribution from the sector since the recession ended in mid-2009, the rebound in residential investment is a fraction of what typically has occurred during the initial stages of an economic recovery (**Display 2**).

Since the start of the economic recovery in June 2009, new housing construction has increased by about 3%, well below the sector's historical average growth of nearly 20% in the first year of the recovery. Even in 1991, when the US economy was recovering from a saving and loans

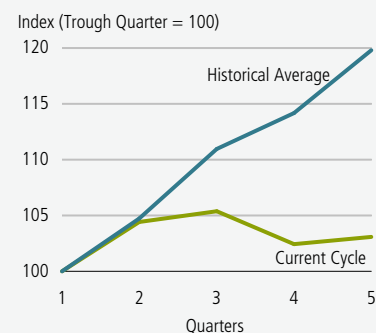
Display 1
Housing Struggles to Recover...



Source: Census Bureau and Haver Analytics

Display 2
...Housing Lags the Cycle

Residential Investment During the First Year of Economic Recovery: Historical vs. Current Cycle



Source: Bureau of Economic Analysis and Haver Analytics

banking crisis, residential investment rebounded by 14% during the first four quarters of the recovery.

But housing no longer tips the scales for the US economy. The sector accounts for a postwar low of 2.5% of real GDP, compared with its historical average of about 6% to 7%. Of course, the sector can have a marginal impact on the economy—for better or for worse—as excess housing inventory is worked through amid property foreclosures and tighter bank lending standards. However, we think the underlying direction of the housing sector will be determined by other trends in the general economy, in a reversal of its historical role as an impetus for broader economic trends.

The Export Factor

The good news for housing, therefore, will be derived from strength in other parts of the economy, as improvements in production, investment and inventory building create jobs and wealth that will ultimately revive the housing sector. In May, as housing starts declined, industrial production increased 1.2%, matching the largest monthly gain since the recovery started in mid-2009. As we have argued previously, the manufacturing sector is benefiting directly from the strong rebound in the global economy. In particular, US companies are enjoying rising demand from emerging markets, and these economies are playing a much bigger role in fueling the global economic recovery than in the past (**Display 3**).

Since the US economic recovery began, manufacturing shipments have increased 15%, compared with an average increase of 11% in previous post-recession

rebounds. These gains are even more impressive than meets the eye, as the current low-inflation environment is driving robust volume gains. The strong increase in manufacturing shipments is being driven almost entirely by unprecedented growth in manufacturing exports over the past year. Exports from US manufacturing firms jumped by 25% in the past 12 months, the largest year-on-year increase since 1988.

Recent corporate reports bolster our view that there is more positive momentum in the export pipeline. For example, FedEx Chief Executive Officer Frederick Smith this week said there was an “undue sense of pessimism” about economic conditions, and shipping demand was improving very quickly due to strong growth in India, Brazil and China. “The largest economy in the world is the economy of global trade, and the fastest part of the economy is the movement of high tech and high value added items,” he added. Like FedEx, US manufacturing firms are increasingly tapping into the fastest growing pockets of the global economy, as shown in shipments and exports data.

Aircraft Industry Turns the Corner

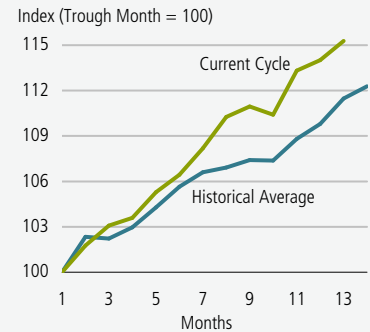
Global economic growth is also spurring demand for commercial aircraft, a US manufacturing sector that has trailed the broader rebound. This week, Boeing announced that it was increasing the production rate of its next generation 737 program to 35 planes a month, marking the second announced increase in two months, from 31.5 a month previously.

Most of the demand for commercial aircraft is coming from overseas customers. Until now, exports of commercial aircraft

Display 3

New Mix: Manufacturing Leads Cycle...

Manufacturing Shipments During First Year of Economic Recovery: Historical Average vs. Current Cycle



Source: Census Bureau and Haver Analytics

have been fairly soft, expanding only 3%, far below the 25% gain for overall manufacturing exports. In our view, increased orders and production of commercial aircraft will help power US shipments and exports in coming months and allow the US manufacturing sector to continue to lead the economy toward sustainable recovery.

Following every recession, economic growth dynamics often change substantially. For the US economy, the housing sector is taking a backseat in the current economic recovery, and its recovery will piggyback the rebound in the general economy. In contrast, the manufacturing sector, driven by consumer and business demand outside the US, is becoming an increasingly crucial driver of the growth cycle. In our view, the changes that are unfolding this year represent a transformational shift that will redefine the role of key sectors in the US economy's growth profile. ■

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