May 20, 2011

Paul Edelstein, Ph.D.
Vice President and Sr. Economist
Li Tan
Research Associate

Boston
+1 617 994 0524
pedelstein@decisioneconomicsinc.com

With Oil Prices Down, Can We Get Back to +3% Growth?

MARKET DATA ND THE OUTLOOK

Earlier this year, DE, the Fed, and many professional forecasters tempered GDP growth expectations for this year primarily because of the spike in oil prices. The concern was consumers, already fragile from a weak jobs market, who would now have to shell out $4 at the pump for a gallon of gasoline. In recent weeks, however, oil prices have retraced about $15 (on a WTI basis). Can we add back in the growth that was expected to be lost? Not really.

Conventional wisdom that says that oil-price declines matter less than oil price increases because volatility of any kind is bad. Uncertainty causes households to increase precautionary savings even as disposable income improves, leaving no discernable change in spending habits. Given the general air of uncertainty hanging over markets and the economy, this could be the case. Yet there is also ample evidence that consumers do respond to falling oil prices, particularly when the economy isn't heading into recession. For instance, in 1985/86 oil prices fell by 63% from $32 a barrel to $12 in a matter of months. During this time, consumption growth climbed from +0.9% to +7.2%.

Nevertheless, DE believes that the damage has been done and that the salutary effects of lower oil prices will be mild. Q2 will likely bear the brunt of the impact, while any potential upside from the retrace in prices won't appear until H2. So the car will have driven over the pothole before it can be filled. We have already seen some of the impact in last week's disappointing April retail sales report, which showed declines in some key discretionary spending categories. The personal income and spending report out next week will tell the full story. A $15 decline in oil prices, if it sticks, should translate into a 40 cent decline in gasoline prices (roughly -10% based on current peaks of $4 a gallon). The savings would amount to about $6B annually, which if added to Q1 would have boosted the consumption growth rate by about 25 bps and the GDP growth rate by about 10 bps. That leaves DE's 2011 real GDP growth projections well below +3%.

THE OUTLOOK

The April Jobs Report was better than expected on some dimensions, but the up tick in the unemployment rate is what will stand out for the Fed:

- *Growth: The U.S. and global expansions are sustainable despite risks from higher commodity prices, Eurozone debt problems, and fallout from the Japan earthquake. Some of these factors may drag on the overall economy, but the economy isn't expected to sink back into recession.* ***DE maintains its U.S. GDP growth projections of 2.5-3% for 2011 and to 3-3.5% for 2012.***

- *Inflation: Permanently higher energy prices will boost headline rates of inflation. But the effects should be temporary unless oil prices continue to increase. DE further sees core rates of inflation bottoming and turning higher against a backdrop of falling unemployment, continued economic growth, and higher commodity prices.* ***Core PCE inflation is forecast at 1.5% this year and 2.5% next year.***

- *Markets: Payrolls growth is a plus for the recovery and equities. But the increase in the unemployment rate likely means a later policy tightening – a negative for the dollar. No changes to* ***S&P500 forecasts of 1,450 by the end of this year, and 1,500 by the end of 2012.***

- *Policy: The Fed will remain accommodative for much of the remainder of 2011 – maintaining the balance sheet and zero fed funds rate. Fiscal policy could turn to austerity as Congress grapples with debt and deficits.* ***Initial rate hike at beginning of 2012. Federal budget deficit to grow to $1.4T (9.4% of GDP) this year, but shrink to $1.2T (7.2% of GDP) in 2012.***

WEEK AHEAD (May 23 – May 27)

- **Second Q1 Real GDP**: DE expects a +0.2 percentage point revision to Q1 growth, to +2.0% in annualized terms. But the slowdown in growth in the first quarter – from oil prices, and declines in government spending – remains with no apparent change in the outlook for the remainder of the year. The upward revision reflects a narrower trade deficit over the quarter, and stronger-than-expected build-up of inventories. Inflation is also likely to be revised slightly higher.
- **Personal Income and Spending**: The April data will provide a first glimpse of Q2 consumption, its growth trend, and the strength of the overall recovery. Personal incomes are forecast to rise by +0.4%, supported by the improving labor market, while consumption is expected to register a small increase of +0.3%. But rising food and fuel costs are crimping household budgets, so spending could be down in key discretionary categories (as in the April Retail Sales report), and overall inflation-adjusted spending growth will be weaker. Core PCE inflation is forecast to remain relatively subdued at a +0.2% pace, which would see inflation from a year ago tick up to +1.0% by this measure.
- **Consumer Sentiment**: Confidence recovered in early May as oil prices came off their highs. DE expects the late-month reading to edge up another 0.1 point to 72.5, resulting in a 5-point cumulative gain from the March trough. Near-term inflation is likely to pick up marginally, to 4.5%, while long-term expectations remain unchanged at 3.0%.
- **New Home Sales and Pending (Existing) Home Sales**: DE expects sales of new homes to continue to rebound from the historic February low, rising another +3.7% to 311K units in April. Similarly, pending home sales are forecast to lift +2.0% in the same month. Nevertheless, both series continue to bounce around their average since late 2010, suggesting broad stability at a bottom, but no firm recovery in housing demand.

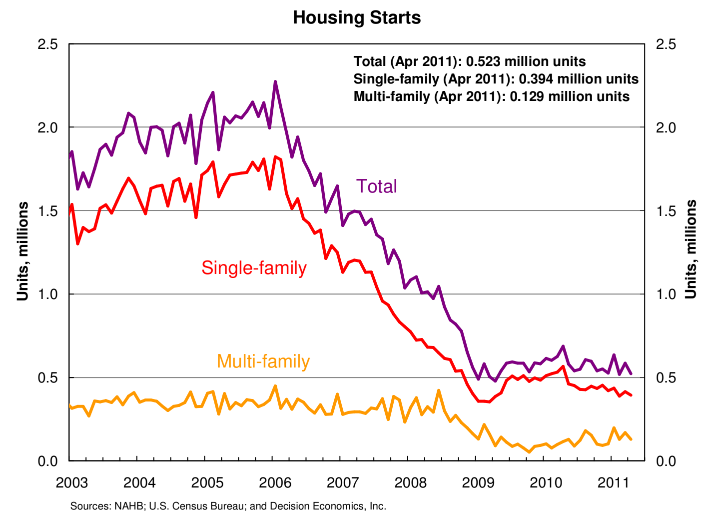
PAST WEEK'S ECONOMIC INDICATORS IN DETAIL

Housing Starts:

Assessment: Housing starts surprised the market in April with a -10.6% plunge to 523K units. However, the previous months' data were revised upward. Permits were also disappointing, falling -4.0% to 551K units.

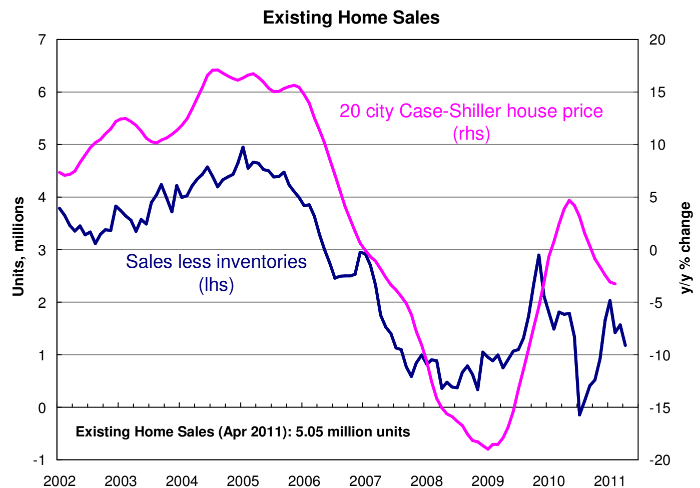
Major Points: Single-family starts fell -5.1% to 394K, while the volatile multi-family segment recorded a -24.1% decrease. In aggregate, housings starts have tracked sideways since 2009, and show no signs of recovery as falling house prices and weak demand discourage builders.

Bottom line: Construction remains historically weak – the separate NAHB measure of builders' confidence was flat for May, at a very low 16 – and likely to remain so for some time. But home builders are responding appropriately to weak demand – keeping inventories lean. On the upside, housing now accounts for a mere 2½% of real GDP, so the drag on overall growth will be minor this quarter.



Existing Home Sales:

Assessment: Home sales in the largest sector of the housing market unexpectedly slipped -0.8% in April, to an annualized rate of 5.05 million units.

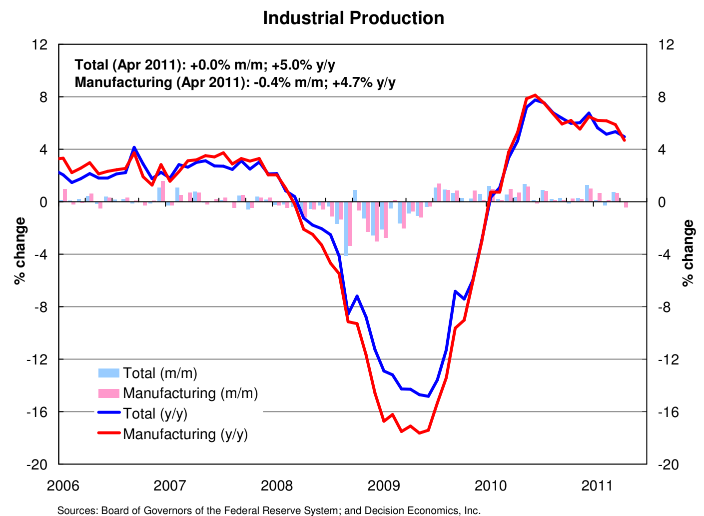


Major Points: Sales of single family homes and condos/co-ops fell in the month, by -0.5% and -3.1% respectively. Although sales are around 30 percent above the lows reached in mid 2010, they remain restrained by falling prices – with a reportedly significant proportion of contracts being delayed due to low appraisals – and generally lackluster demand exacerbated by tight credit. A +9.9% pick-up in total inventory saw months of supply increase to 9.2 months.

Bottom Line: Weak April sales dampen any hopes that the housing market imbalance would be corrected soon. The market continues to struggle to gain momentum despite improving employment and affordability.

Industrial Production:

Assessment: Output was unchanged in April, against expectations of an increase, largely due to falling auto production. The previous two months' data were also revised weaker.



Major points: Manufacturing output fell -0.4% – the first decline in ten months – offsetting higher output in the utility (+1.7%) and mining industries (+0.8%). The decline in manufacturing was primarily due to a sharp drop in the motor vehicle sector, hampered by parts shortages following the March earthquake/tsunami in Japan. Excluding motor vehicles, manufacturing output rose +0.2% in the month. Capacity utilization unexpectedly edged down 0.1 percentage point to 76.9%, but remains around 10 percentage points higher than the recession trough.

Bottom line: There have been some less-than-positive manufacturing data recently, with several purchasing managers surveys declining. Production should recover from some of the current supply chains issues; however; the latest data question the sustainability of manufacturing strength to date.

© 2011. Decision Economics, Inc. All rights reserved. Reproduction in whole or in part without the written permission of the copyright owner is prohibited.