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U.S. Macro Outlook: Nearing the Threshold

BY MARK ZANDI — AUGUST 6, 2013

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- Reported GDP growth has lagged U.S. job creation, but this unusual discrepancy is unlikely to continue.
- Weak productivity growth post-recession is part of the explanation, as investment in structures has waned.
- The revival of homebuilding will help kick the U.S. expansion into a higher gear.
- Slow household formation has created pent-up demand that could push housing starts well above trend.
- Lenders are poised to open the credit spigot, if regulatory uncertainties are cleared up soon.
- The Federal Reserve must carefully handle the normalization of monetary policy to avoid knocking the recovery off track.

The pace of U.S. GDP expansion has flagged in recent quarters, but job growth has held firm. If history is a guide, this discrepancy will not continue for long. Either GDP growth will rebound or job growth will founder. The Moody's Analytics outlook is predicated on the former view: We think the job market will maintain its pace, and that GDP growth will pick up going into next year. The expansion should be in full swing by 2015.

GDP vs. jobs

That recent GDP growth has been so weak is surprising. New comprehensive revisions to historical GDP data show the Great Recession was a bit less severe than previously estimated and the subsequent recovery somewhat stronger, but growth over the past year has still been paltry at 1.4%. This seems at odds with stronger growth in gross domestic income, which is, at least in theory, equal to GDP. Yet growth in GDI often presages upward revisions to GDP.

The GDP numbers also run counter to the stronger job numbers. Looking past some of the noise in the jobs data, U.S. businesses are adding almost 200,000 jobs per month. Historical relationships suggest this kind of growth is consistent with a GDP growth rate as high as 3%. The disconnect between GDP growth and job growth may eventually be bridged by revisions, showing GDP growth meaningfully stronger than the current data say.

Falling into place

More fundamentally, weak GDP reflects temporarily weaker productivity growth, as businesses have invested cautiously since the recession. Investment in intellectual property (an addition to the GDP data) and information processing equipment has held up, but spending on industrial equipment and structures, which includes everything from factories to office buildings, has lagged significantly. While businesses have had plenty of reasons to hold back, the necessary ingredients for stronger investment are coming together: juicy profit margins, more ample credit, lots of cash, and reduced uncertainty as the nightmares of the recession and Washington's bitter politics fade.

Large government spending cuts also explain the difference between GDP and job growth. Defense spending reductions have subtracted substantially from GDP growth, but since defense is so capital- and technology-intensive, the cuts cost proportionately fewer jobs. Reductions related to Congress' budget sequestration also show up largely as furloughs and lost hours, not lost jobs. Most encouragingly, employers appear to be looking past the current policy of fiscal austerity when making payroll decisions. Business managers understand that the government's cutbacks are temporary, and that as they fade, the private economy's strength will power larger gains in both output and jobs.

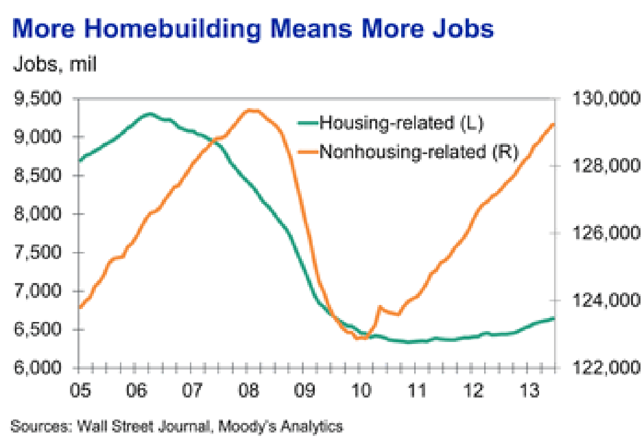
Housing and jobs

Nowhere is this clearer than in housing. Homebuilding and house prices have risen strongly since they hit bottom almost two years ago, but the housing recovery has only begun. Housing starts are still running well below 1 million units per year, while the underlying demand for new homes supports an annual building rate closer to 1.7 million. This is equal to the sum of 1.15 million household formations per year, 350,000 in homes destroyed by natural disasters and normal obsolescence, plus some 200,000 household decisions to purchase vacation or second homes.

Thus, at a minimum, homebuilding is set to reach a 1.7 million-unit pace over the next several years. But the rate could be even higher for a time, because the housing market will soon be undersupplied. This seems extraordinary given the massive overbuilding that took place during the housing bubble, but so little has been built since the recession that the excess has disappeared. Inventories of new single-family homes for sale are especially tight.

Exacerbating the housing shortage will be several years of outsize household formation growth. An unusually small number of households were formed in recent years because of the tough economy. Fewer immigrants came to the country and some who came earlier left. More importantly, young people unable to find work stayed in school or moved in with their parents. Out of this group, more than 1 million new households will be formed as the job market improves. Annual homebuilding could reach an annual pace above 2 million units sometime in the next few years.

More homebuilding means more jobs. Every new single-family home supports more than four jobs in construction, manufacturing, transportation, financial services, retail, and a range of other services in the year the home is put up. Each multifamily unit supports slightly more than one job. The anticipated increase in homebuilding through mid-decade should thus add some 3 million jobs to the nation's payrolls, a key to returning the economy to full employment.

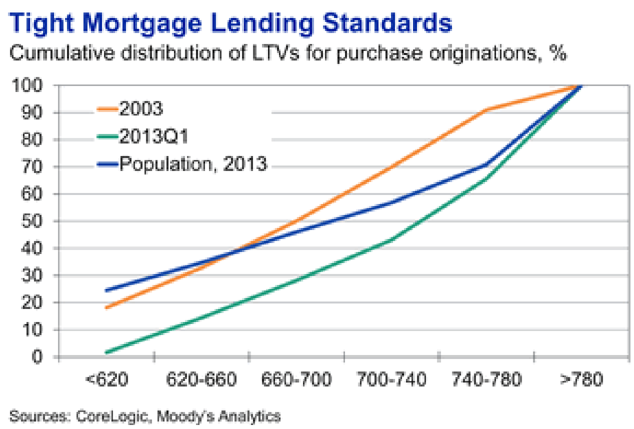


The housing revival faces several hurdles, however. Homebuilders are having difficulty tooling up quickly enough to meet demand. The hottest markets lack enough usable building lots, labor shortages are a problem in some areas, and smaller builders are at pains to obtain construction and land development loans from the smaller banks they rely on. To build lots of new homes, resources left idle for years after the housing bust will have to be mobilized. This could take more time than anticipated.

Builders are responding to tight supplies by aggressively raising prices for new homes. This reinforces the strong price gains in the existing-home market, where inventories are also tight. Potential sellers appear to be waiting for prices to rise even more before listing their properties. Some may still be under water and have little choice but to wait; others are probably remembering the bubble-era market and think current prices are much too low.

Tight credit

Rising house prices bring significant benefits to the economy via the wealth effect, but reduce housing affordability for first-time homebuyers, many of whom are already struggling to obtain mortgage loans. Lending standards are especially stringent, particularly regarding credit scores. Only about 15% of home purchase loans originated in early 2013 went to borrowers with scores below 660. A decade ago, before the housing boom and bust, the share was closer to a third. Well more than half of mortgage borrowers today have scores above 740, compared with less than one-fourth a decade ago. For context, the average credit score is close to 700.



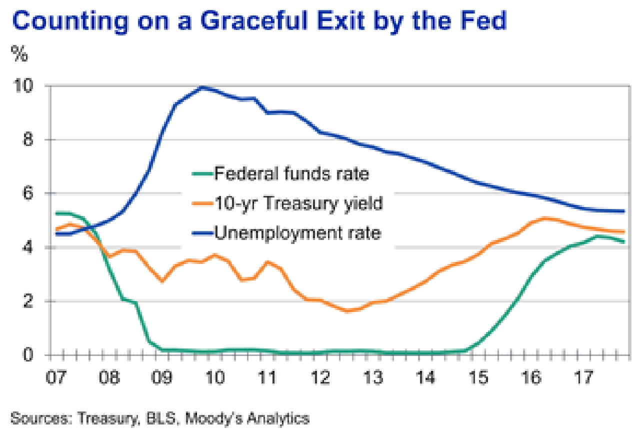
Lenders are likely to ease standards as the mortgage refinancing boom fades and market-share pressures induce more purchase lending. But banks won't open the credit taps completely until regulatory issues are addressed. Most notable is the "put-back" risk lenders face when reselling loans to Fannie Mae, Freddie Mac and the FHA. These institutions own or back about 85% of all purchase loans made, and they have required lenders to take back loans found to have been originated improperly. The finance agencies can exercise this right for a range of reasons, which lenders want clarified. Unless they fully understand the government's rules, they will remain cautious about extending credit to borrowers.

More housing demand from first-timers is vital for the recovery of the single-family housing market. Much of the market's improvement to date has come from investors who bought mainly distressed property with cash. These bargains are largely gone, however, and investor demand will soon wane. Without more households stepping into the market to buy their first homes, the housing recovery could falter.

Graceful exit

A recovery in housing and beyond also critically depends on how gracefully the Federal Reserve can unwind its extraordinary monetary stance, including quantitative easing and near-zero interest rates. The Fed must keep the increase in short- and long-term rates consistent with an improving economy and job market. If rates rise because unemployment is declining, and normalize soon after the economy is back to full employment, then policymakers will have succeeded.

The rise in long-term interest rates—10-year Treasury yields and fixed mortgage rates are up about a percentage point since the start of the year—shows how difficult the Fed's exit could be. Rates rose too fast, too soon, and policymakers worked aggressively to stem the increase. The Fed succeeded by laying out a clear set of economic thresholds, saying unemployment would have to fall below 7% for the central bank to end quantitative easing, and below 6.5% for it to begin raising short-term rates.



Using the Fed's unemployment rate forecast, which is consistent with the Moody's Analytics outlook, QE will end by summer 2014 and rates will rise by summer 2015. These thresholds are subject to change given the economy's performance and other factors, but they should anchor bond traders' expectations. Nonetheless, traders are a fickle group and it will take more creative moves by the Fed to ensure markets stick to their script.

Assuming the Fed is up to the task, the economy will soon be in full stride. While the expansion appeared ready to launch only to falter several times before, the economy is now in a much better place. There are risks, but they feel much less risky than at any time since the recovery began.

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