



ECONOMICS: US PERSPECTIVES

# MARKET TURBULENCE AND US ECONOMIC OUTLOOK

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The sharp and sudden sell-off in equity markets worldwide raises growth fears once again. But the economic foundation in the US today is much stronger and broader than it was during prior equity sell-offs. This leads us to conclude that the recovery is on a sustainable path—and could even tolerate the normalization of official interest rates.

### US Economy Status Update

Second-quarter real gross domestic product (GDP) growth now stands at 3.7%, up from the initial estimate of 2.3%, according to the Bureau of Economic Analysis (*Display 1*). The 1.4 percentage point revision is relatively large. Over the past two decades, the average quarterly revision from the advance estimate to the second estimate, whether positive or negative, has been 0.5%. So, the 2Q revision is nearly three times the historic average. The size and direction of the revisions are important, because history shows that revisions tend to be procyclical—upward when the economy is growing faster, and downward when the economy is doing less well.

### Impressive 2Q Sector Revisions

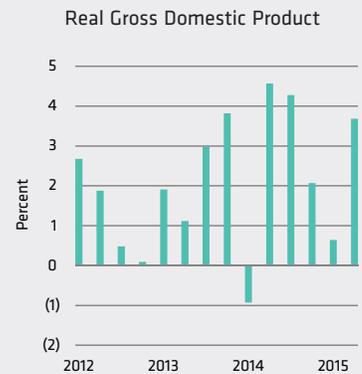
In addition, the details of the revisions paint a much more robust picture of US domestic demand. Among the highlights, real consumer spending was revised to a gain of 3.1% annualized, up from the initial estimate of 2.9%; and business investment posted a respectable gain of 3.2%, versus the prior estimate of -0.6%. What makes that moderate business investment gain

even more notable is that it occurred despite energy sector capital spending collapsing 68% in the quarter. That offers strong evidence that the underlying strength in the broader US economy is sufficient to overcome a sharp and sudden drop in spending by the energy sector. Residential investment was also revised higher, rising an estimated 7.8%; the initial estimate showed a gain of 6.2%. That's the fifth consecutive quarterly gain in residential investment, and more strong gains in the pipeline seem evident—a strong rebound in housing starts and building permits, and the increased appetite by households to spend more on renovation and remodeling.

### Continued Momentum in 3Q

As impressive as the revisions appear to be for 2Q real GDP, what's more telling for the future is that the positive growth momentum is being maintained—if not improved—so far in 3Q. For example, payroll employment increased 235,000 in July, alongside low levels of jobless claims and a near-record level of job openings. All of this suggests a robust outlook for job creation over the foreseeable future.

Display 1  
2Q GDP Revised Sharply Higher



Through June 30, 2015  
Source: Bureau of Economic Analysis and Haver Analytics

Display 2  
Households Have Large Wealth Cushion



Through March 31, 2015  
Source: Federal Reserve Board and Haver Analytics

The Conference Board's August survey of consumer confidence reflects the improved job trends and the brighter outlook. Indeed, the August survey shows consumers becoming markedly more upbeat on the labor market and job prospects. In fact, the number of people saying that jobs were plentiful rose to its highest level since early 2008, while those saying jobs were hard to get fell to its lowest level since early 2008.

The improving employment outlook has spilled over into other sectors. We see that in vehicle sales, which have topped 17 million units annualized for three consecutive months for the first time since 2000. July housing data show existing home sales hitting 5.59 million, their highest level since 2009; and new housing starts of 1.21 million annualized in July, the best monthly rate since 2007, are up 10% from year-earlier levels. Business optimism seems to be improving, too, as evidenced by durable goods orders rising 2% in July, following an upwardly revised gain of 4.1% (initial estimate of 3.4%) in June.

#### Keep Financial Markets in Perspective

Although the current financial market difficulties have captured everyone's attention, it is important to keep things in perspective. At midyear, household wealth stood at an estimated \$85 trillion (*Display 2, previous page*). It has increased every year since the financial crisis, and over the past three years, the cumulative gain has been roughly \$20 trillion. Moreover, in the past five years, households have experienced only one meaningful quarterly setback in wealth creation. That drop

occurred in 3Q:2011, a period marked by concern over the US debt ceiling and the US credit-rating downgrade by Standard & Poor's Ratings Services. The wealth loss in that quarter totaled \$2.4 trillion, and almost all of that loss was recovered in the following quarter.

We don't think the daily and weekly wiggles in the equity markets impact the consumer or the economy in a meaningful way. The negative feedback to the economy from sharp sell-offs in the financial markets tends to be more serious and deeper when the economy is weak and there's a lot of uncertainty about the future.

However, consumer confidence in August jumped 10 points, to 101.5—the second-highest level since 2007 and almost twice the level in 3Q:2011 (the last time the equity market stumbled). Other positive consumer fundamentals include the steady and consistent creation of over 200,000 jobs per month, a record number of job openings, a jobless rate of 5.3% and sharply lower oil prices—a boon that will grow cumulatively more important for consumers in the next several quarters.

In terms of monetary policy, the data-dependent policy framework needs to be rethought, since initial data reports often paint a far bleaker picture of the economy than what is actually the case. For example, the Atlanta Fed's "nowcast" model, which is designed to provide an up-to-the-minute running tally of the current quarter growth rate, was fore-

casting 2Q real GDP growth at less than 1% annualized in May and only a little over 2% in mid-July. This model's output is only as good as the initial data. But recent revisions should tell policymakers that the data are subject to substantial revisions at times, so they need to look at a broad range of data—and not be fooled by the initial reports.

In terms of the outlook, consumers clearly gave the economy a "thumbs up" in the last confidence poll, and business optimism is seen in order bookings and commercial and residential construction commitments. In light of this, a 25-basis-point hike in official rates at the Fed's September 16–17 meeting would be seen as a sign of confidence on the part of policymakers. It would also be consistent with their recent policy script—that is, to start normalizing official rates if the labor market showed continued improvement.

However, the current set of policymakers has a history of standing pat when there is even a whiff of concern on growth, or uneasiness in the financial markets. Indeed, the well-telegraphed tapering in September 2013 was delayed for three months following a couple of weak job reports. In hindsight, that was a bad decision, as the job numbers were revised substantially higher and the real economy expanded 3.5% in the second half of 2013. If policymakers decide to delay once again, they run the risk of doing what the Fed Chair wants to avoid—waiting too long and then needing to lift rates at a faster clip later. ■

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