

The Worst Is Over

The economy shrank at an annualized rate of 5.7 percent in the first quarter, a slight improvement from the 6.1 percent drop reported earlier. The 5.7 percent decline followed a 6.3 percent drop in the fourth quarter, marking the worst back-to-back plunges in real gross domestic product (GDP) since 1958. Incoming data continued to indicate that the worst contraction in real GDP was behind us. But while the recession is moderating, the economy will face a slow road to recovery.

Consumer spending, which accounts for about 70 percent of GDP, is not about to act as an engine to economic growth (as it did in previous economic recoveries) anytime soon. Real consumer spending grew 1.5 percent in the first quarter, a downward revision from an initial report of a 2.2 percent gain. Consumer spending growth will weaken significantly in the current quarter, given declining retail sales in April. However, the large drop in spending seen in the second half of 2008 appeared to be over. Two surveys of consumer confidence continued to show a rebound in sentiment in May for the third consecutive month, sending confidence to the highest levels since last September.

April durable goods orders indicated improving manufacturing activity. Overall orders jumped 1.9 percent, led by a surge in orders of defense capital goods. The details, combined with the large downward revision of the March figure, were less encouraging, as they suggested that business investment will continue to decline sharply in the current quarter and remain weak in the third quarter.

Several reports on housing and mortgage performance suggested that total home sales, which appeared to have troughed, are likely to bounce along the bottom for a while. While inventories are declining, the months' supply has remained at over ten months, compared with a long-term average of about six months. It's likely that a considerable amount of shadow inventory exists, as some homeowners (including some investors who have snapped up distressed sales) may have held off selling until market conditions improve. In addition, record high foreclosure rates and a projected rising trend will continue to add to inventories for the foreseeable future, especially with the lengthening time between foreclosure and REOs as well as time remaining in REOs witnessed in recent months.

Meanwhile home price declines have shown few signs of slowing. The elevated inventory levels and the large share of distressed sales in many markets will continue to put downward pressure on home prices for some time. Adding to the challenge facing the housing and mortgage markets is the recent increase in mortgage rates if continued.

Interest Rates:

Treasury yields rose again this week as investors were more concerned about the forthcoming supply of Treasury debt to fund a rapidly growing federal budget deficit. The yield on the 10-year Treasury note rose to 3.7 percent on Wednesday -- the highest level since mid-November. The 10-year yield pared back the increase on Thursday and dropped further on Friday, hovering around 3.50 percent by mid-Friday afternoon -- five basis points higher than the rate on the previous Friday.

Housing Indicators:

Standard and Poor's/Case-Shiller National Home Price Index fell 19.1 percent from a year earlier, the biggest quarterly decline since the inception of the series in 1988. Since its peak in the first quarter of 2006, the national index has declined about 32 percent. S&P/Case-Shiller reports 10-city and 20-city indices on a monthly basis but publishes a broader national index on a quarterly basis.

The 10-metropolitan area composite index was down 18.6 percent in March from a year ago, moderating from an 18.9 percent year-over-year drop in the prior month. The broader 20-metropolitan area composite index showed a year-over-year drop of 18.7 percent, the same as the prior month's year-over-year decline.

A month-to-month comparison showed no moderation in home price declines. The 10-metropolitan area composite index fell 2.0 percent in March, accelerating from a 1.9 percent drop in February. The 20-metropolitan area composite index fell 2.1 percent in March, compared with a 2.0 percent drop in the prior month.

The Federal Housing Finance Agency (FHFA) Purchase-only Home Price Index declined 1.1 percent following a 0.2 percent gain in February and a 0.9 percent gain in January. As a result of better performance in January and February, home prices in the first quarter showed a much more moderate decline of 0.5 percent, compared with a 3.3 percent drop in the fourth quarter. From a year ago, the index fell 7.1 percent in the first quarter, modestly slowing from 8.4 percent in the prior quarter.

The FHFA home price measure showed a better performance than the Standard and Poor's/Case Shiller National Home Price Index. The FHFA uses mortgage data from Fannie Mae and Freddie Mac, which exclude jumbo loans and have relatively fewer adjustable rate and subprime loans than the rest of the markets, which is covered by the S&P/Case-Shiller measure.

Total existing home sales were up 2.9 percent in April to a seasonally-adjusted annualized rate (SAAR) of 4.68 million, according to the National Association of Realtors (NAR). The increase followed a 3.4 percent drop in March. Existing single-family home sales rose 2.5 percent, compared with a 6.4 percent gain for condo sales.

Sales had stayed in a narrow range of 4.9 million to 5.1 million between October 2007 and October 2008. Since then, sales have stabilized in a lower range of between 4.5 million and 4.7 million.

Sales of single-family homes during the first four months of this year were down 5.3 percent from those during the same period last year. The year-to-date decline was much steeper for condo sales, with sales 16.1 percent below last year's pace.

Existing home sales increased in three regions, led by an 11.6 percent increase in the Northeast. Sales increased 3.5 percent in the West and 1.8 percent in the South. Sales dropped 2.0 percent in the Midwest. Supported by strong foreclosure sales activity, the West continued to be the only region where sales have increased from a year ago. NAR reported that the median home price in the West fell 21.8 percent from April 2008, much bigger than the drops in the other regions. For the nation, the median home price fell 15.4 percent from a year ago.

The elevated inventory levels and the large share of distressed sales will continue to put downward pressure on home prices. The number of total homes available for sale rose 8.8 percent in April but fell 12.8 percent from a year ago. (The data are not seasonally-adjusted and sales generally increase strongly in April from March.) The months' supply of existing single-family homes rose to 9.6 months from 9.0 months in March, while the months' supply for condos edged up to 15.1 months from 15.0 months. The performance from a year ago was mixed: the months' supply was about one month lower for single-family homes but one month higher for condos.

New home sales edged up 0.3 percent in April to a seasonally-adjusted annualized rate (SAAR) of 352,000 units, remaining above the record low reached in January. The sideways movement from March to April was disappointing given that home builders' sentiment jumped in April, as builders saw marked improvements in their assessment of current sales, traffic of potential buyers, and projected sales over the next six months.

Based on actual sales that are not seasonally adjusted, an estimated 33,000 of new homes were sold in April, unchanged from March. This is the second lowest level for April sales since the inception of the series in 1963. The record low of 32,000 was established in April 1982. Sales of new homes during the first four months of this year were down 37.4 percent from those during the same period last year.

Regionally, new home sales rose 1.9 percent in the South and dropped 3.8 percent in the West. Sales were flat in the Northeast and the Midwest.

One piece of good news in the new home sales report is that inventories continued to decline. The number of new homes available for sale fell 4.2 percent from March and 35.4 percent from last April -- a record year-over-year drop. Since their peak in August 2006, inventories have declined by about 48 percent, reaching the lowest level since May 2001. The drop in the number of homes available for sale amid flat sales pushed down the months' supply to 10.1 months in April from 10.6 months in March, down measurably from the record high of 12.9 months set in January. While this is the lowest level since July 2008, it is still much higher than its long-term average of about six months.

With the still-elevated months' supply and fierce competition from distressed sales of existing homes, new home prices continued to drop sharply. The median price for new homes was down 14.9 percent in April from a year ago, nearly matching the biggest drop on record of 15.0 percent in February. Record high foreclosure rates and a projected rising trend pointed to more foreclosure properties in the pipeline that will hamper a meaningful recovery in the new home market this year.

The Mortgage Bankers Association National Delinquency Survey showed that foreclosure actions were initiated on 1.37 percent of first mortgages during the first quarter of 2009. This was a 29 basis point increase over the fourth quarter of 2008 and a 36 basis point increase from one year ago. Both the level of foreclosures started and the size of the quarter over quarter increase are record highs.

The delinquency rate for mortgage loans on one-to-four-unit residential properties was 8.22 percent on a non-seasonally adjusted basis, a record high, down 41 basis points from 8.63 percent in the fourth quarter of 2008. The seasonally adjusted delinquency rate was 9.12 percent, also a record high, up 124 basis points from the fourth quarter of 2008, and up 277 basis points from one year ago.

The percentage of loans in the foreclosure process at the end of the first quarter was 3.85 percent, an increase of 55 basis points from the fourth quarter of 2008 and up 138 basis points from one year ago. Both the foreclosure inventory percentage and the quarter to quarter increase are record highs.

Economic Indicators:

The Conference Board's Consumer Confidence Index rose from 40.8 in April to 54.9 in May, the highest reading since September 2008. The 14.1 point surge followed a 13.9 point jump in April, marking the largest back-to-back jumps since the monthly series began in 1977. While the recent improvement is large, the level of the index remains depressed -- well below the lows in the 2001 recession and comparable to the lows seen in the early 1980s recessions.

For the second consecutive month, the expectations component led the increase. The component of the index associated with respondents' assessment of the outlook over the next six months surged 21.3 points to 72.3. Consumers' appraisal of current conditions was up modestly, with the present conditions component rising 3.4 points to 28.9.

Consumers' assessment of the current labor market improved for the second consecutive month and only for the third time in the last 16 months. The share of consumers finding jobs plentiful increased to 5.7 percent from 4.9 percent in April. The share finding jobs hard to get decreased to 44.7 percent from 46.6 percent. Expectations for the labor market improved significantly: the share expecting fewer jobs in the coming months fell to 25.2 percent in May from 32.5 percent in April, down measurably from a record high of 47.0 percent in February. Consumers' views of the labor markets are consistent with moderating job losses going forward.

Plans to buy homes fell to 2.3 percent from 2.6 percent in April, despite increased affordability as a result of declining home prices and low mortgage rates. Plans to buy autos and appliances increased, however.

Overall, consumers continued to see a modest improvement in current conditions and have become much more upbeat about the outlook. This is consistent with recent economic data pointing to a moderating recession. According to the Conference Board, the worst is already behind us, as far as consumers are concerned.

New orders for manufactured durable goods were up 1.9 percent in April, led by an increase in defense orders and a rebound in motor vehicle orders for the first time in six months. However, March's durable goods orders were revised sharply lower to show a decline of 2.1 percent, compared with the previously reported drop of 0.8 percent.

Some categories in the report tempered the encouraging headline, however. Shipments for nondefense capital goods excluding aircraft -- a component used as an input for business investment in equipment and software in the gross domestic product (GDP) in the current quarter -- fell 2.1 percent, the sixth drop in the last seven months. Nondefense capital goods orders excluding aircraft -- a proxy for business investment in equipment and software in the following quarter -- dropped 1.5 percent. In addition, March's increase of 0.4 percent was revised to a drop of 1.4 percent.

While these components continued to decline as the economy entered the second quarter, the pace of decline was more moderate than those seen during the first quarter. Overall, the durable goods orders report suggested that business investment will likely decline through the third quarter but at a much slower pace than in the first quarter – confirming the view that the recession is easing.

The University of Michigan Consumer Sentiment Index rose 3.6 points to 68.7 in May, according to final data, coming in at 68.7, compared with the preliminary 67.9 and April's 65.1. This was the third consecutive monthly gain and fifth in the last six months. This index has reached its highest level since September 2008.

The gain was led by the expectations component of the index, which 6.3 points from April. The current conditions component fell 0.6 points from April.

Real gross domestic product (GDP) fell 5.7 percent at an annualized rate in the first quarter, according to the Bureau of Economic Analysis' preliminary release, an upward revision from 6.1 percent in the advance release. An upward revision to exports and a small reduction in inventories, which added to GDP, offset a downward revision to consumer spending on nondurable goods.

Next Week:

Monday — Personal income and personal consumption spending for April; April construction spending; and the Institute for Survey Management (ISM) Manufacturing Survey for May

Tuesday — The National Association of Realtors Pending Home Sales Index for April

Wednesday — April factory orders and the ISM Nonmanufacturing Survey for May

Friday — May employment

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May 29, 2009