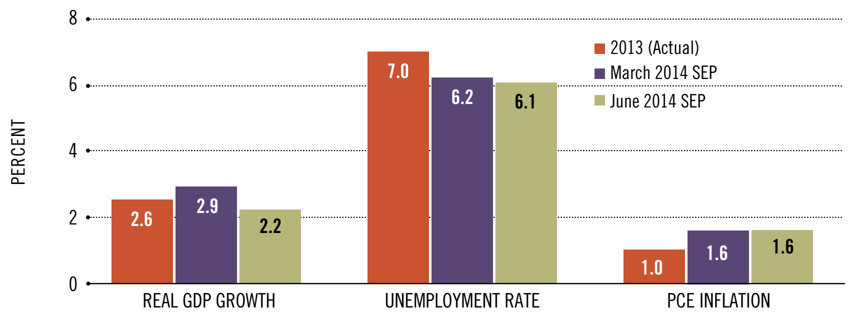
# Recovery Seems To Have Finally Taken Root

By Kevin L. Kliesen

The forward momentum exhibited by the U.S. economy over the second half of 2013 came to a screeching halt in the first quarter of 2014. Real gross domestic product (GDP), after increasing at a 3.4 percent annual rate over the second half of 2013, unexpectedly declined at a 2.9 percent annual rate in the first quarter of 2014. Few forecasters believe that the first-quarter dip in economic activity is a precursor to the next recession. Rather, most attribute the poor economic performance to temporary factors. Indeed, strength was evident elsewhere. The pace of consumer spending and job growth both registered solid gains in the first quarter, while the unemployment rate edged lower, inflation remained tame, and stock prices surged to record highs. Accordingly, most professional forecasters and Federal Open Market Committee (FOMC) participants expect a solid rebound in the second quarter—and good growth into the second half of the year, as well.

Is the elusive recovery finally here to stay?

**The FOMC's Summary of Economic Projections (SEP) for 2014**




NOTE: Projections are the midpoints of the central tendencies. The projections for real GDP growth and inflation are the percentage change from the fourth quarter of the previous year to the fourth quarter of the indicated year. Inflation is measured by the personal consumption expenditures (PCE) chain-price index. The projection for the unemployment rate is the average for the fourth quarter of the year indicated.

### Weak GDP: It Wasn't Just the Weather

The GDP weakness stemmed largely from adverse weather conditions, which affected housing activity, certain categories of retail sales and the shipment of goods across a large portion of the country. However, first-quarter growth was also weak because of sizable declines in business spending on equipment, a sharp fall in U.S. exports and a paring of inventories—suggesting that factors besides weather were at work. These other factors may be related to concerns about a less-accommodative monetary policy (the Federal Reserve's "taper") and doubts about the underlying strength of the U.S. housing sector in the face of a modest uptick in mortgage interest rates and higher house prices. Some people have also been worried that the global economy would not grow as fast in 2014 as earlier projections had suggested.

The consensus of professional forecasters as of early July was that real GDP growth would rebound to about 3.3 percent in the second quarter. Despite some mixed signals, the April and May data are generally consistent with this forecast. In particular, sales of motor vehicles thus far in 2014 are on pace to be the highest in several years, the housing data in April looked a bit better, industrial production was strong in May, and confidence among businesses and consumers is steadily improving.

As evident by the surge in equity prices and the below-average levels in the St. Louis Fed's Financial Stress Index, financial market conditions are also supportive of growth. Interest rates on 10-year Treasury securities remain low, helping to support expenditures on interest-sensitive goods like automobiles, appliances and housing. Indeed, many housing economists and industry analysts continue to foresee a considerable pickup in housing starts and home sales over the second half of 2014.

The strong pace of job gains this year has added to the optimism. Through the first six months of 2014, nonfarm payroll employment gains averaged about 231,000, noticeably higher than last year's average monthly gain of 194,000. Similarly, the unemployment rate dropped from an average of 7 percent in the fourth quarter of 2013 to 6.1 percent in June 2014, and the annualized growth of hours worked through the first six months of 2014 (3.6 percent) was nearly double its year-earlier pace (1.9 percent). Most forecasters expect continued solid job growth and a falling unemployment rate throughout the remainder of 2014.

Despite healthy job growth, other aspects of U.S. labor market conditions bear close watching. First, growth of real labor compensation (wages, salaries and benefits) has averaged 0.1 percent per year from 2010 to 2013. Second, labor productivity growth—a primary determinant of how fast living standards rise over time—has averaged 1 percent over the past three years. Most forecasters see this as a temporary dip. If not, strong, sustainable real GDP growth will be elusive.

### Inflation: Stirring, Not Shaking

In late 2011, the FOMC's preferred inflation measure, the year-to-year percentage change in the personal consumption expenditures price index, began to slow unexpectedly. From September 2011 to October 2013, inflation declined from a little less than 3 percent to 0.8 percent. Since then, inflation has begun to creep up—rising to about 1.8 percent in May 2014. For the most part, forecasters and financial market participants expect inflation to inch upward in 2014 but remain below the Fed's 2 percent inflation target. One risk is that crude oil prices, which have been steadily strengthening since the first of the year, will rise even further if global growth begins to accelerate. However, the U.S. Energy Information Administration is projecting that—in view of rising domestic production of crude oil—gasoline prices will fall from an average of $3.67 per gallon in May to $3.61 per gallon by September. Ω

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