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ECONOMIC TALKING POINTS

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Economic Rebound: With Winter Becoming A Distant Memory, Prepare for a Stronger Spring and Summer

Stop over thinking what the latest softness in the economy means!

That's what we have been advising clients following a series of disappointing economic reports. There is no doubt that 1Q GDP will be unimpressive. Our own forecast for the quarter has reduced growth from a 2.3% rate made in December, to 1.2% now.

However anyone arguing that this weakness clearly reveals the cracks and strains of an aging recovery is way over intellectualizing the significance of these numbers.

Yes, consumers have been inactive so far this year. Personal spending in February was up a mere 0.1%, marginally better than the declines of 0.2% in each of the two previous months. Other reports have corroborated how households stayed away from stores lately. Retail sales, for example, fell the last two months. On the business side, builders started work on fewer homes, and factories scaled back output as firms slashed orders for capital goods.

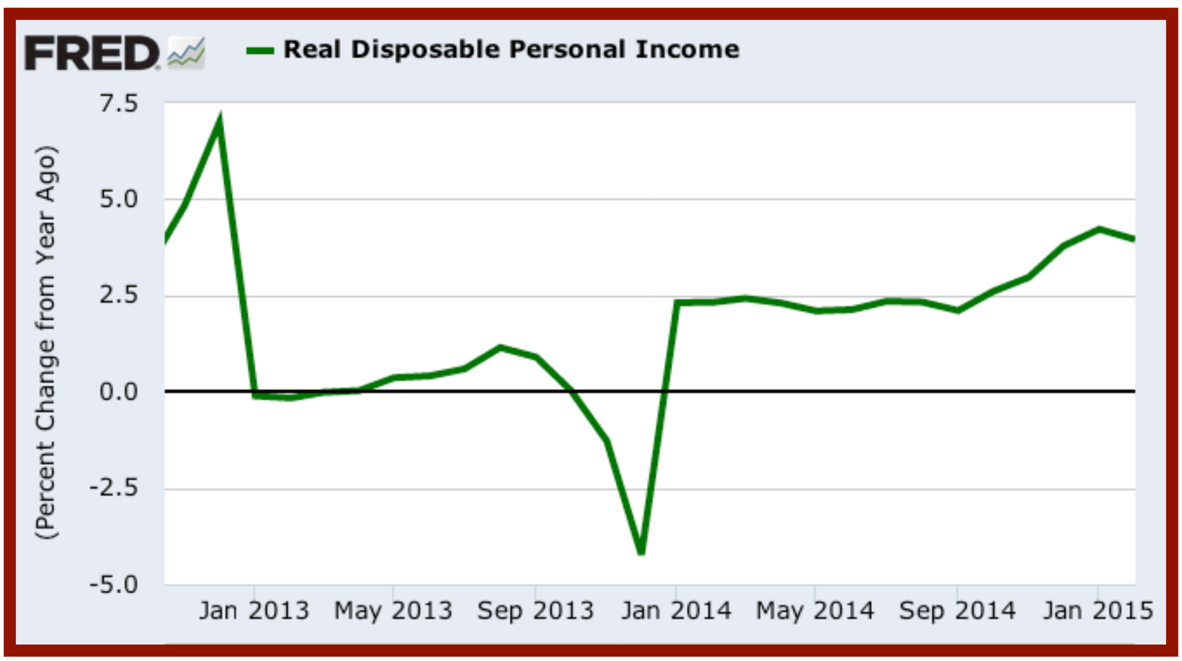
While these sluggish data points lead some analysts to argue the economy is sputtering and at risk of slipping into recession, we couldn't disagree more.

These tepid reports are a consequence of factors that will prove to be transitory. They include a crippling, record-breaking winter across much of the country, the deceleration in exports due to the strong the dollar, and a post-holiday pull back in spending. Again, these are largely brief, episodic events. The economy should bounce back nicely in the second and third quarters.

What is the source of this optimism?

Aside from the impressive acceleration in hiring, job postings, and the sharp declines in filings for unemployment benefits, we continue to see more signs that employee pay is on the rise. That was apparent again in today's personal income and spending report. Real disposable personal income --- which shows changes in purchasing power --- jumped an average of 4% the last two months, the highest in more than two years! In February alone, nominal wages and salaries increased 4.5% from a year ago (Chart 1). At the same time, inflation (i.e., personal consumption price index) rose just 0.3% over the last 12 months, which means households have the ability to significantly ramp up shopping this year. Moreover, by not spending much during the winter months, Americans have managed to stash away funds for future spending. The savings rate leaped to 5.8% last month, the most we have seen since 2012. So the resources to significantly increase expenditures are there.

Chart 1.

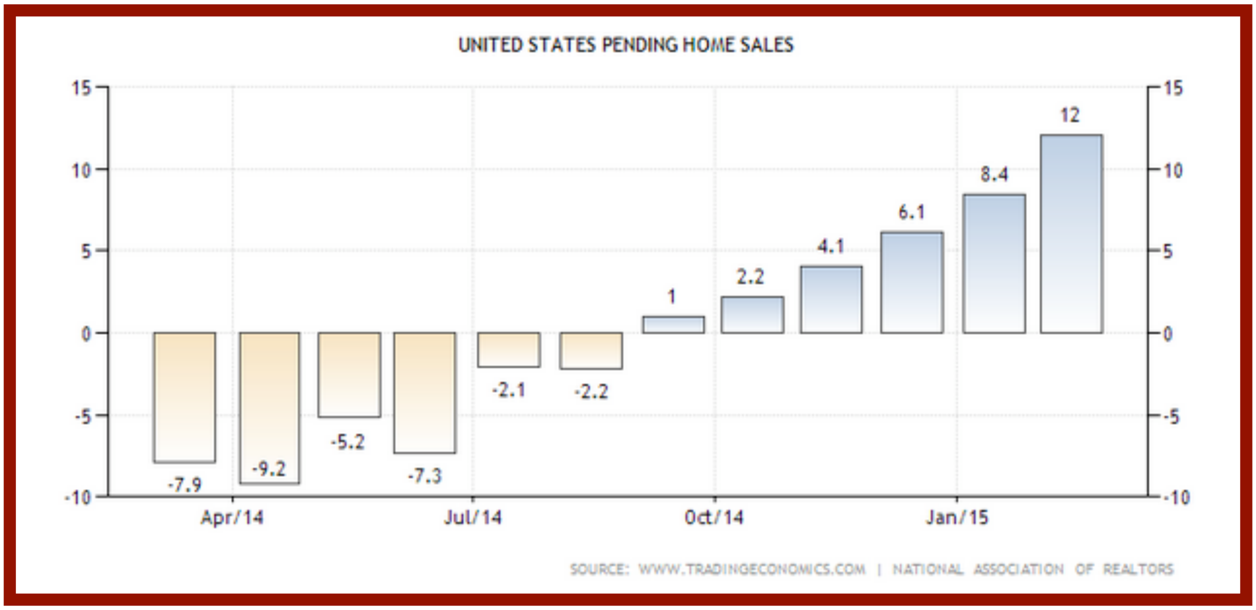


Will Americans boost spending as winter becomes a distant memory?

They should. Last Friday, the University of Michigan's Consumer Sentiment survey showed that as bad as the winter was, it did not puncture the confidence of Americans. Instead, the improvement in job and income security lifted confidence in the first quarter to their highest level in a decade! (The average sentiment index from January through March was the best since the third quarter of 2004.)

And that optimism should also bring more vitality to the housing market. The National Association of Realtors reported today that Pending Home Sales, which tallies contracts signed to buy an existing home, jumped in February to its highest level since June 2013, and stood 12% above the year ago level (Chart 2.0). Annual per cent increases have been rising for 6 straight months!

Chart 2 (Monthly year-over-year, % change)



Now, such an announcement may be a head-scratcher at first. After all, this increase in households signing to purchase a home occurred the very same month when virtually all other metrics showed a very subdued consumer.

How does one reconcile the two conflicting trends?

We think the sharp contrast between the pick up in pending home sales and tepid consumer spending numbers are the result of several factors.
(1) Realtors warned home seekers to act quickly given the lack of inventory expected in the housing market this year.
(2) There were concerns that mortgage rates would soon march higher as speculation grew the Federal Reserve was about to end its zero bound rate policy.
(3) Many Americans were growing increasingly uncomfortable watching annual rental contracts go up in price, yet these payments were not earning them any equity in their homes.
(4) Federal Reserve data show lenders were also more willing to issue mortgages in January and February. Such loans increased at the quickest pace on more than six months.

Bottom line:
We continue to believe the fundamentals of the economy are strong and this will become evident as we move well into spring. Our expectation still holds for the Fed to begin lifting rates in June. The only viable threats to the US business cycle at this time come from abroad, with the expanding Middle East conflict and fighting in Eastern Europe posing the greatest geopolitical risks.

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