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Economic Research note

US economy faces an intensifying trio of drags

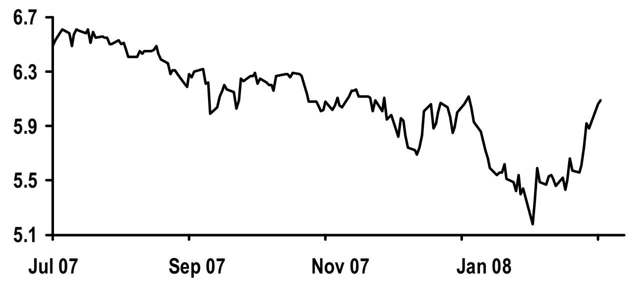
- **Three drags—weak housing, high energy prices, and tight credit—are holding growth to a standstill in 1Q**
- **The recent move up in crude oil prices suggests that overall drag will not soon abate**
- **Credit market conditions have also deteriorated, further delaying any stabilization in housing**

The US economy has slowed to a standstill and is teetering on the verge of recession. While the JPMorgan forecast still looks for the economy to avoid the substantial declines in payrolls and increases in unemployment associated with an economic downturn, there is little question that the economy will remain very weak through the first half of this year. The current forecast calls for real GDP growth of only 1.0% at an annual rate in 1H08, before the economy strengthens with the help of policy stimulus in 2H.

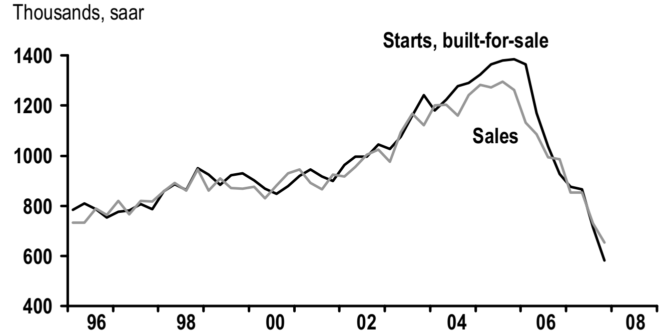
JPMorgan commentary has emphasized for some time that the shift, from better than 4% growth in the middle two quarters of last year to weakness now, is the not the result of any single influence. Instead, three separate but reinforcing drags on growth are to blame. The first influence is the continued sharp downturn in housing activity. Real residential construction declined more than 20% at an annual rate in 2H07. The second influence is the sharp increase in energy prices which has been squeezing real incomes and restraining real consumer spending since last October. Finally, the tightening of credit conditions is holding back all types of activity related to real estate or regarded as risky.

The forecast for a second-half rebound growth is largely related to the effect of policy help, both fiscal stimulus and the lagged effect of Fed easing. But it also is conditioned by expectations that the three drags on growth will ease by midyear. The downturn in housing is likely to run its course over the next several months. Slower global growth will bring some softening in the price of oil and other commodities that will help bring down headline inflation. And Fed easing and time will help to diminish the fear in the credit markets. While the 2H growth forecast still holds, these drags on growth have not eased yet. Indeed, the recent rises in long-term mortgage rates, the price of oil and other commodities, and credit spreads have prolonged the drags on growth.

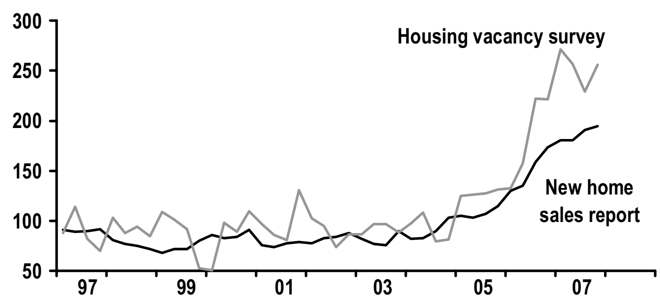
Conventional 30-year residential mortgage rate
Percent p.a.



Single-family housing supply and demand
Thousands, saar



New single-family homes for sale
Thousands



Mortgage rates have backed up

The longest-lasting drag on the economy has been the sustained downturn in homebuilding activity. Real residential construction has been declining at a double-digit pace since 2Q06. The latest report shows that single-family housing starts declined 5.2%m/m in January and have plunged an average 6.0% per month since the middle of last year. Moreover, the downturn has further to run. Inventories of unsold homes are still elevated, house prices are falling, and many homebuilders have trouble financing new supply.

The big headache, of course, is that new home sales have been falling every bit as fast as housing starts through most of the past two years. Recently, however, builders have made progress in bringing starts low enough in relation to sales to work off inventories. The decline in single-family starts and in the share of starts that are built for sale has brought housing starts building for sale an estimated 11.6% below the pace of sales in December 2007. If starts were to continue to decline 6.0% per month through June, and sales were to stabilize near the December sales pace, supply and demand in the housing market would begin to come into much better balance.

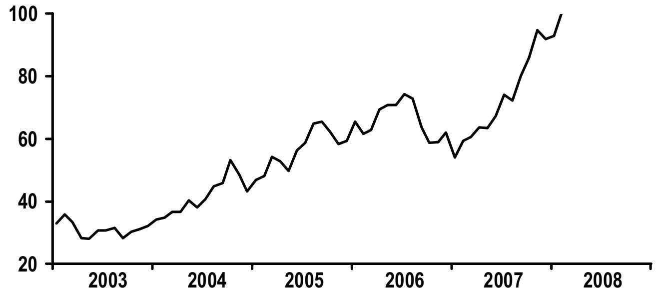
The forecast of stabilization of new home sales looked like a reasonable prospect a few months ago. Declines in mortgage rates and house prices had made housing more affordable. And numerous surveys over the past few weeks, including the national Homebuilders survey, suggested that sales were holding near their recent depressed pace.

However, it increasingly looks that the forecast for near-term stabilization of home sales will not be realized. Conventional mortgage rates are a key influence on home sales, and they have risen more than 50 basis points over the past month. Some of this increase may reflect temporary problems in the mortgage market, which should partly normalize in the next weeks. However, other problems in the mortgage market appear more lasting. And the March increase in fees announced by the housing agencies is likely to further boost mortgage rates relative to Treasuries. Mortgage applications for home purchase have not been a reliable guide to near-term home sales over the past year, but such applications over the past couple of weeks have averaged close to 10% below their December-January pace, a hint that the higher rates are biting. Significant further declines in home sales would obviously delay the forecasted stabilization of homebuilding activity.

The inability of home sales to find a bottom has prevented inventories of unsold homes from being worked down. Inventories as measured in the Census's new home sales report have only recently plateaued. The situation could be even worse than the Census data indicate: because contract cancellations are not recorded in the Census survey, inventories may be understated. Inventories as measured by an alternative source, the Housing Vacancy Survey, do not suffer from this data collection problem and show an even larger overhang of unsold homes. Absent a pickup in housing demand—which doesn't look imminent given the state of the mortgage market—this overhang will continue to weigh on home prices.

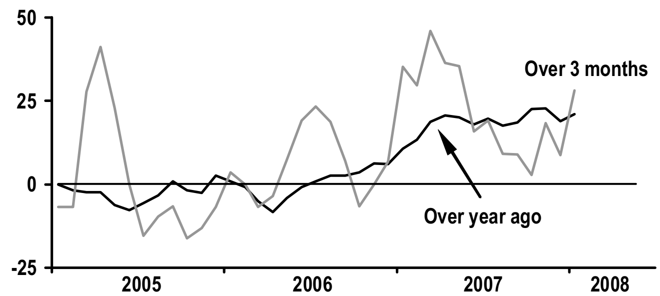
Price of crude oil.

$ per barrel, WTI, monthly average and latest



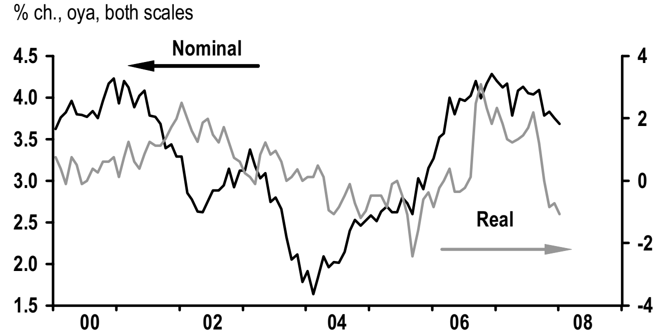
Prices received by farmers

%ch, nsa ar



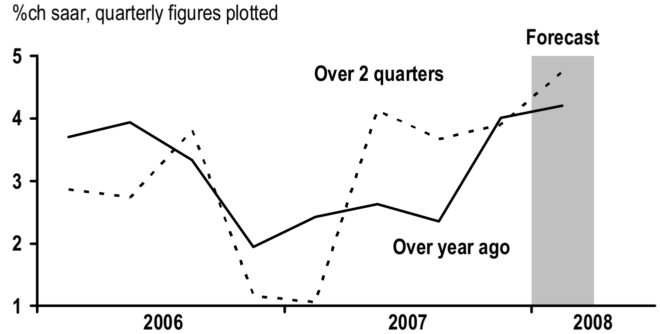
Average hourly earnings

% ch., oya, both scales



Consumer price index

%ch saar, quarterly figures plotted



Oil at $100 per barrel

Soaring headline inflation over the past few months has put a brake on real income growth and held down real consumer spending, whose growth has slowed from 2.8%q/q, saar in 3Q07 to 2.0% in 4Q07 and a forecasted 0.5% this quarter.

The headline CPI increased 0.4%m/m in the latest January reading; and it is up 4.7% at an annual rate over the past six months and 4.3%oya—well in advance of gains in hourly compensation. The resulting squeeze on real income has been mainly caused by rapid increases in the price of food (up at a 4.7% annualized pace over the past six months) and especially energy (up at a 21.4% pace).

Soaring prices for food and energy, in turn, have been fueled by soaring commodity prices, especially for oil and agricultural products. The average January price of crude oil was up more than 70%oya to $93.00 per barrel, and the price received by farmers of all products was up 20%.

The forecast has expected commodity prices to level off or even decline, bringing some near-term easing in headline inflation. Commodity prices have historically been sensitive to the pace of global growth, and North America, Europe, and Japan have all slowed substantially; growth in the Emerging Market countries is moderating as well. Still, this price forecast has not materialized as yet. The price of crude oil is up near $100 per barrel, 52% at an annual rare above its 4Q07 average. The CRB commodity price index for foodstuffs is some 90% at an annual rate above its 4Q07 average. Prices received by farmers in the latest January reading were up 21.0%oya, and up 28.1% at an annual rate over the latest three months.

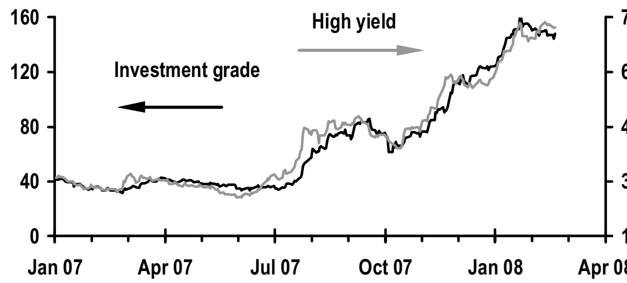
In short, there is every reason to expect that recent increases in commodity prices will continue to boost headline inflation over the next few months, further restraining growth of real income and real consumer spending. The forecast for CPI inflation in 1Q08 is now at 4.5%q/q, saar, up from a 2.8% forecast recently.

Credit conditions are tighter

The third change in the environment that is weighing on growth prospects is a further tightening of credit conditions. Investors continue to shun structured products—with the turmoil recently spreading to the auction-rate notes in the municipal market—and are favoring liquid and safe homes for their assets. The result is much tougher financing conditions for riskier borrowers and tougher financing con-

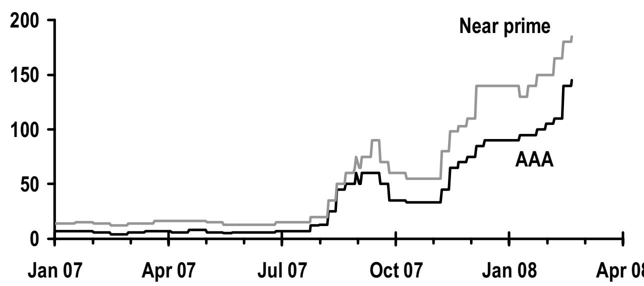
Corporate bond spreads

Basis points over Treasuries, both scales



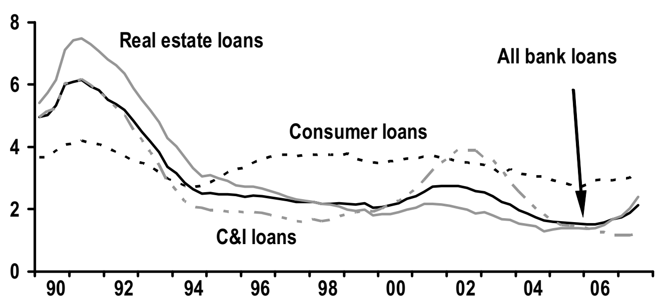
ABS 3-year auto loans, spread to swaps

Basis points



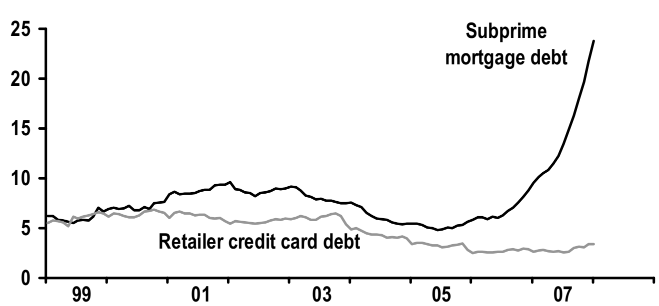
Delinquency rates on bank loans

Percent, Fed series through 4Q07, more than 30 days past due



Delinquency rates on securitized loans

Percent 60 days or more past due



ditions even for investment-grade firms and many creditworthy households.

It is not easy to quantify the extent of credit market tightening. But the latest Fed survey of bank senior loan officers shows a fairly abrupt and general turn to tighter credit conditions, most dramatically for lending for commercial real estate. Credit spreads have also continued to trend much wider for high-grade and high-yield corporate bonds as well as for a wide variety of consumer loans.

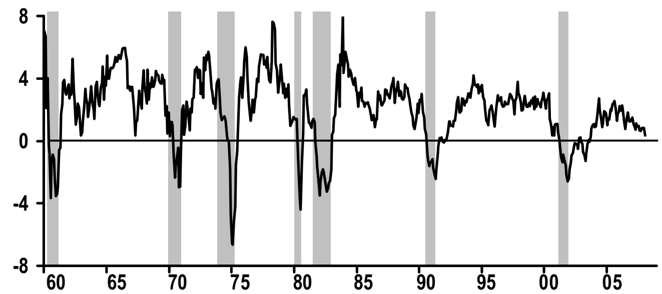
The tightening of credit conditions has occurred against the backdrop of low unemployment rates and relatively low delinquency rates in most categories of loans so far. This week's release of Fed data on bank problem loans for 4Q07 showed an overall delinquency rate of 2.49%—up from 1.68% a year earlier but still relatively low, and well within the norms of the past decade. Credit tightening partly reflects justifiable concerns that the current period of slow growth will only bring further increases in problem loans.

What obviously account for the severity of trouble in the credit markets broadly are the enormous problems in the market for subprime mortgages and other risky housing loans. The delinquency rate on securitized subprime mortgages (60 days or more past due) reached 23.8% in early January, up from 5.8% two years earlier and an earlier peak of 9.1% following the 2001 recession. Enormous losses on these loans, and distrust of the bond ratings that supported their purchase in the first place, has shifted the credit markets from extremely easy financing through 2006 to the extremely tight conditions now.

Recent surveys indicate that credit tightening is a relatively minor problem for small business and for most households.

Nonfarm payrolls

%ch saar, over 3 months



However, credit market tightening and concerns about financing are doubtless a source of considerable anxiety and uncertainty for many larger corporations. They will make these firms more cautious in their hiring and spending decisions.

The key issue for the economic forecast is whether the intensified drags from higher mortgage rates, higher headline inflation, and deteriorating credit market conditions will affect the labor markets. Substantial declines in payrolls are probably the most important defining characteristic of recessions. Even in the relatively mild recession of 2001, nonfarm payrolls averaged declines of 200,000 per month (and 150,000 per month in the months before the September 11 attacks.) So far, at least, the combination of rising mortgage rates, higher headline inflation, and tighter credit conditions has not prompted such pronounced job cutbacks, judging by either payroll reports through January or the weekly readings on initial jobless claims through the middle of February. But these intensified drags are, at a minimum, a source of downside risks to the 2.0%q/q, saar GDP forecast for next quarter.