THE CANADIAN CHAMBER OF COMMERCE
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Policy Brief

Economic Policy Series – August 2013

The U.S. Economy—Poised to Shift Into Higher Gear

Introduction

The U.S. economic recovery remains slow four years after the recession ended. (See Chart 1). Real gross domestic product (GDP) grew at an annualized rate of 1.7 per cent in the second quarter of 2013, up from 1.1 per cent in the January-to-March period.

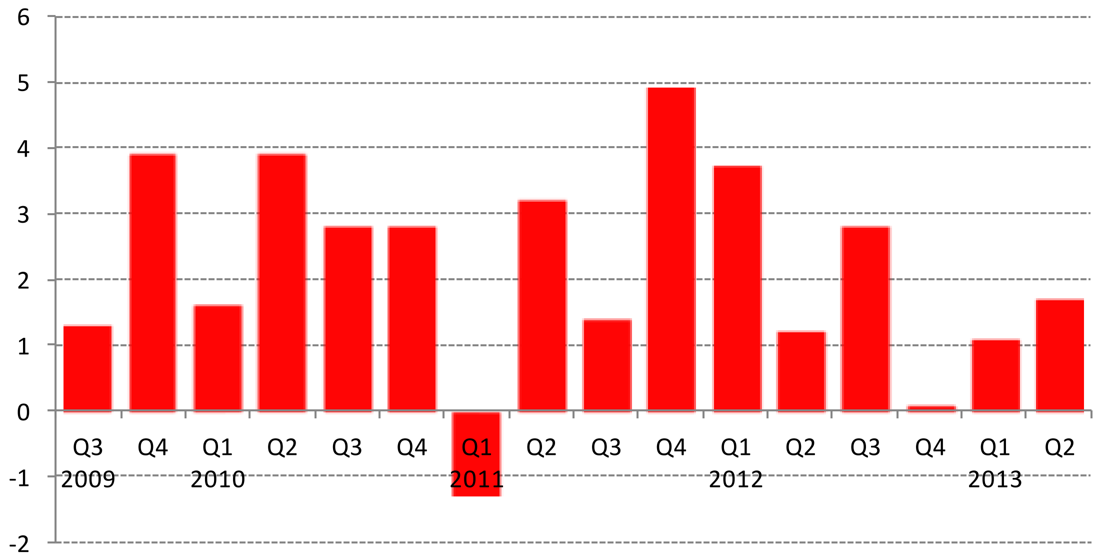
The biggest restraint on growth this year is largely self-inflicted, most notably the significant payroll tax increases that took effect in January and the automatic deep cuts to federal spending which began in March after Congress failed to reach a deficit-reduction deal.

The good news: Some of the headwinds that have held back the economic recovery—low consumer confidence, a weak job market, a severely depressed housing market and tight credit conditions—have diminished, setting the stage for stronger growth over the second half of 2013 and in 2014.

The Canadian Chamber is committed to fostering a strong, competitive and profitable economic environment that benefits all Canadians. This paper is one of a series of independent research reports covering key public policy issues facing Canada today.

We hope this analysis will raise public understanding and help decision-makers make informed choices. The papers are not designed to recommend specific policy solutions, but to stimulate public discussion and debate about the nation's challenges.

Chart 1: U.S. Real Gross Domestic Product (GDP)
(quarter-to-quarter % change at seasonally adjusted annual rates)



Source of data: U.S. Department of Commerce: U.S. Bureau of Economic Analysis.

Economic Headwinds Have Begun to Dissipate

American consumers are more upbeat,[1] and not without reason. Thanks to improving labour market conditions, recovering real estate values and this year's impressive rally in U.S. equity markets, many are feeling wealthier and more confident about making big purchases. New home sales vaulted to a five-year high in June and existing home sales rose to a three-and-a-half-year high.[2] Auto sales are on track for the best year since 2007.

Businesses also appear to have more confidence in the economy. In the second quarter of 2013 they accelerated spending on both equipment and structures.[3] Forward-looking indicators have also turned up. New orders for core capital goods—a closely watched proxy for business investment plans—are at their highest level on record.[4] Additionally, the manufacturing ISM New Orders Index has registered its highest reading since April 2011,[5] pointing to acceleration in manufacturing activity in the second half of 2013.

It is important to note that credit conditions are improving gradually, which bodes well for the broader economy. Demand for business loans has strengthened in recent months—a signal that businesses are poised to make further investments in plants, equipment and inventories—and banks are showing an increased willingness to lend. Demand for consumer loans has also strengthened.

Canada will benefit from ongoing improvements in U.S. private demand, residential construction and business investment. The U.S. continues to be the largest destination for Canadian merchandise exports, accounting for 74 per cent of the total.

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1 According to The Conference Board, consumers' confidence in the economy is close to a five-and-a-half-year high. See "July 2013 Consumer Confidence Survey®." July 30, 2013.

2 U.S. Department of Commerce: U.S. Census Bureau. "New Residential Sales in June 2013." July 24, 2013. Also, The National Association of Realtors®. "June Existing-Home Sales Slip but Prices Continue to Roll at Double-Digit Rates." *News Release*. July 22, 2013.

3 U.S. Department of Commerce: U.S. Bureau of Economic Analysis. "National Income and Product Accounts: Gross Domestic Product, second quarter 2013 (advance estimate); Comprehensive Revision: 1929 through first quarter 2013." July 31, 2013.

4 U.S. Department of Commerce: U.S. Census Bureau. "Full Report on Manufacturers' Shipments, Inventories and Orders June 2013." August 2, 2013. Data for this series was first published in 1992.

5 Institute for Supply Management (ISM). "July 2013 Manufacturing ISM Report On Business®." *News Release*. August 1, 2013.

Labour Market Conditions Are Improving Gradually

The U.S. economy added roughly 192,000 net new jobs per month in the first seven months of 2013, marking the best stretch of hiring to start a year since 2006.[6] As of July 2013, 6.7 million (or 77 per cent) of the 8.7 million net jobs lost during the most recent employment downturn[7] had been recovered. (See Chart 2).

The national unemployment rate fell to 7.4 per cent in July—a four-and-a-half-year low—and is down from its peak of 10.0 per cent in October of 2009.

An improving job market has been an important factor in supporting income growth, confidence and spending power.

Still, as U.S. Federal Reserve Chairman Ben Bernanke noted, "the jobs situation is far from satisfactory."[8] Approximately 11.5 million Americans are looking for work, and, while the number of long-term unemployed (those jobless for 27 weeks or more) has declined by close to 1.0 million over the past year, it is still too high at 4.2 million. These individuals account for 36.9 per cent of the unemployed.

Another 8.2 million workers are classified as "part-time for economic reasons," meaning their hours have been cut back or they are unable to find a full-time job.

Additionally, the national unemployment rate is still well above levels prevailing prior to the recent recession—in December 2007, the unemployment rate was 5.0 per cent, and it had been at or below that rate for the previous 30 months.

"A prolonged time is needed to rebuild the job-worker relationships destroyed in a severe recession. If history is any guide, the U.S. unemployment rate should not be expected to fall back to pre-recession levels for many years."[9]

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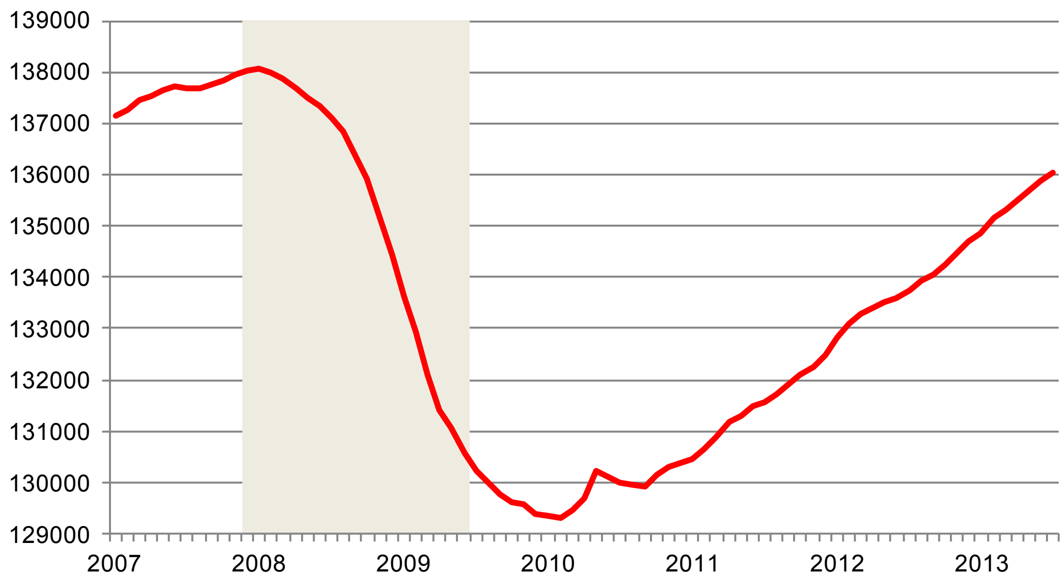
6 Source of data in this section: United States Department of Labor: U.S. Bureau of Labor Statistics. "The Employment Situation—July 2013." August 2, 2013.

7 An employment downturn is defined as the period after employment has peaked until it reaches an employment trough. The most recent employment downturn lasted from January 2008 to February 2010.

8 Chairman Ben S. Bernanke *Semiannual Monetary Policy Report to the Congress* before the Committee on Financial Services, U.S. House of Representatives. Washington, D.C. July 17, 2013.

9 Andolfatto David and Marcela M. Williams. "Many Moving Parts: A Look Inside the U.S. Labor Market." *Inside the Vault*. The Federal Reserve Bank of St. Louis. Spring 2012.

Chart 2: U.S. Total Nonfarm Employment (seasonally adjusted, thousands)



Source of data: U.S. Department of Labor: U.S. Bureau of Labor Statistics. Shaded area represents recession as determined by the National Bureau of Economic Research.

A Sustained Housing Market Recovery Appears to be Underway

A resurgent housing sector is serving as a key anchor to the U.S. economic recovery. Home sales, house prices and residential construction have accelerated, supported by pent-up demand, low mortgage rates and improved confidence in both the housing market and the economy. A very tight supply of unsold homes and strong investor purchases are contributing to the rise in prices.[10]

Approximately 1.7 million homeowners with mortgages have regained positive equity over the past year after the sharp rise in home prices.[11] As a result, owners' equity as a percentage of household real estate has significantly improved.[12] (See Chart 3). This positive wealth effect has undoubtedly contributed to the improvement in consumer confidence and has bolstered access to credit and consumer spending.

Looking ahead, thinning inventories of unsold homes and significant pent-up demand point to a further pick up in residential construction activity. It is no coincidence the a survey of home builders indicates "improvement in builder confidence across every region as well as solid gains in current sales conditions, traffic of prospective buyers and sales expectations for the next six months."[13]

However, it will take some time for the housing market to regain full health. National home prices remain 19 per cent below their pre-recession peak of April 2006.[14] In cities like Las Vegas, Phoenix and Miami, average house prices have rebounded sharply, but are still 40 per cent to 50 per cent below their pre-recession highs.[15]

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10 Attracted by relatively high rental yields, investors are rushing into the market to buy lower priced homes and convert them into rental units. According to the National Association of Realtors, all-cash sales represented 31 per cent of total transactions in June, and individual investors accounted for many of these purchases.

11 CoreLogic®. "CoreLogic Reports 850,000 More Residential Properties Return to Positive Equity in First Quarter of 2012." *News Release*. July 12, 2013. Also, CoreLogic®. "CoreLogic Reports June Home Prices Rise by 11.9 per cent Year Over Year." *News Release*. August 6, 2013.

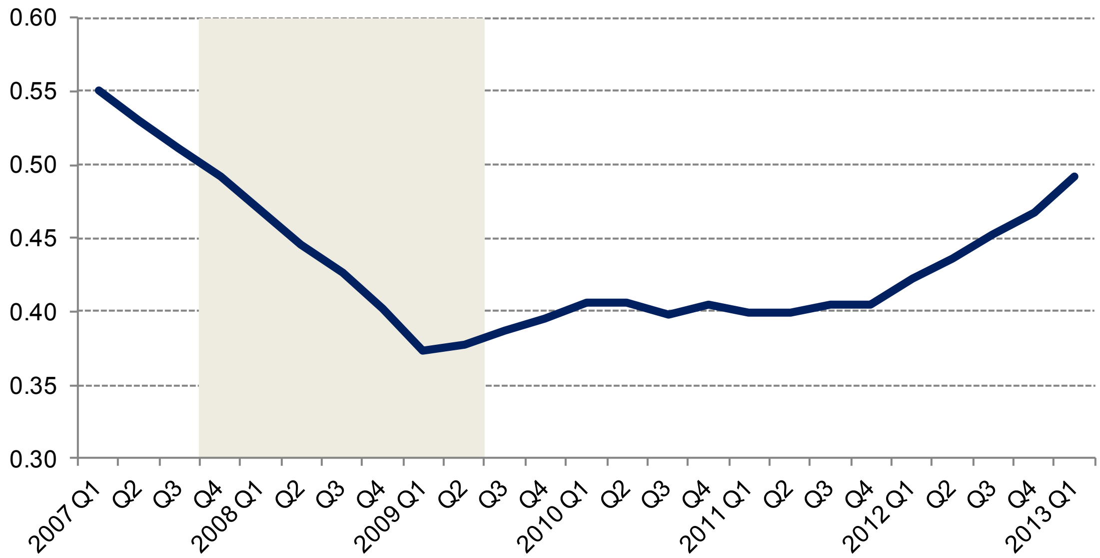
12 Board of Governors of the Federal Reserve System. "Financial Accounts of the United States-First Quarter 2013." June 6, 2013. Calculated as homeowners' equity in real estate divided by the market value of their real estate holdings.

13 National Association of Home Builders. "Builder Confidence Rises Six Points in July." *News Release*. July 16, 2013.

14 CoreLogic®. "CoreLogic Reports June Home Prices Rise by 11.9 Percent Year Over Year." *News Release*. August 6, 2013.

15 S&P/Case-Shiller Home Price Indices.

Chart 3: U.S. Homeowners' Equity as a Percentage of Household Real Estate



Source of data: Federal Reserve Bank of St. Louis. Shaded area represents recession as determined by the National Bureau of Economic Research.

U.S. Household Net Worth Is at an All-time High

Americans have made great progress in repairing their balance sheets. Total household debt has been reduced by $1 trillion since 2008.

In the first quarter of 2013, U.S. household net worth (i.e. the value of households' assets minus liabilities) soared to $70.3 trillion—an all-time high—bolstered by rising home valuations and the gain in equity markets. More than $3 trillion in net worth was added in the first quarter of 2013 alone.[16]

Many Americans are feeling richer and are more likely to spend—what economists refer to as the "wealth effect." This bodes well for the recovery going forward because consumer spending is a major driver of the U.S. economy, accounting for roughly 70 per cent of U.S. GDP.

16 Board of Governors of the Federal Reserve System. "Financial Accounts of the United States-First Quarter 2013." June 6, 2013

Credit Conditions Are Improving Gradually

Banks have gradually eased their lending standards and have experienced stronger demand for in most loan categories.[17]

In the business sector, strong balance sheets have contributed to solid credit quality. Banks have generally eased standards and pricing terms for commercial and industrial loans to firms of all sizes and demand for these types of loans continues to expand. Stronger demand is attributed to businesses' desire to invest in plants, equipment and inventories. Credit standards have also eased on commercial real estate loans and banks have experienced stronger demand for such loans. Some indicators of borrowing conditions for small businesses have also improved since the end of 2012.

The easing of lending conditions, low cost of capital and strong financial position of corporations will continue to support business investment going forward.

Consumer credit, including auto and student loans, is increasing at a robust pace. Demand has also increased for prime mortgage loans. In general, banks are moving more slowly to ease their standards on consumer loans. Credit conditions remain relatively tight for households with lower credit scores and especially for such households seeking mortgage loans.

17 Board of Governors of the Federal Reserve System. "Senior Loan Officer Opinion Survey on Bank Lending Practices." August 5, 2013.

The Drag From Fiscal Policy Is Likely to Fade Over the Next Few Quarters

Fiscal policy at the federal level tightened significantly in the first half of 2013. The expiration of the two percentage-point payroll tax cut in January, the enactment of other tax increases, the effects of budget caps on discretionary spending and the onset of mandated government spending cuts (i.e. sequestration) in March have dragged on the economy.

According to U.S. Bureau of Economic Analysis data[18], cuts to defence spending alone subtracted 1.2 percentage points from growth in the fourth quarter of 2012 and 0.6 percentage points from growth in the first three months of 2013. The good news is cuts in defence spending subtracted just 0.02 percentage points from growth in the second quarter.

Federal government cuts in areas other than defence spending subtracted only a tenth of a percentage point from GDP growth in both the first and second quarters.

These developments suggest that cuts to federal spending were frontloaded and that growth should pick up over the next several quarters as the fiscal drag subsides.

18 U.S. Department of Commerce: U.S. Bureau of Economic Analysis. "National Income and Product Accounts: Gross Domestic Product, second quarter 2013 (advance estimate); Comprehensive Revision: 1929 through 1st quarter 2013." July 31, 2013.

In Summary

Factors that had hindered growth—low consumer confidence, a weak job market, a severely depressed housing market and tight credit conditions—have turned the corner. The U.S. economy has gained momentum and a stronger recovery should materialize in the second half of 2013 and into 2014.

Improving economic conditions south of the border should stimulate demand for Canadian exports, in particular, lumber, raw materials and consumer durables (related to rising homebuilding activity in the U.S.), machinery and equipment (as business investment picks up), and autos (where there is considerable pent-up demand). A weaker Canadian dollar—expected to trade in the US$0.90 to US$0.95 range over the next year after averaging around parity against the U.S. dollar over the past two and a half years—will also help exporters.

Indirectly, the ramp-up in U.S. economic activity will be positive for Canada's business sector confidence, supporting stronger investment and expansion of productive capacity here at home.

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