Market Analysis, Research & Education
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March 2010 U.S. Economic Update

Focus on Consumer Spending & Residential Housing

The State of the U.S. Consumer

The American consumer's faith in the U.S. economy is very low. In February, the Conference Board's consumer confidence survey fell to 46—its lowest reading since April 2009, and remained at a slightly higher but still pessimistic level of 53 in March. Although the overall confidence data during the past two months was still up from the record low levels seen during the first quarter of 2009, details showed that consumers' views regarding current economic conditions and the outlook for the economy remain well below pre-recession levels.[i] These weak sentiment readings have caused some observers to question the sustainability of consumer spending in the economic recovery.

Reaction to Recent Duress

Why is the U.S. consumer feeling glum? During the past two years, the unemployment rate surpassed 10%, and the combination of record-high debt levels and the drop in home and stock prices caused the most significant decline in U.S. household net worth during the post-WWII era. In addition, the financial crisis caused access to credit to dry up, and real personal incomes fell during 2009 at the steepest annual rate ever. Consumers responded by ratcheting up their savings to a 15-year high of 6.4% in May 2009, and spending declined for five quarters in a row through Q3 2009.[ii]

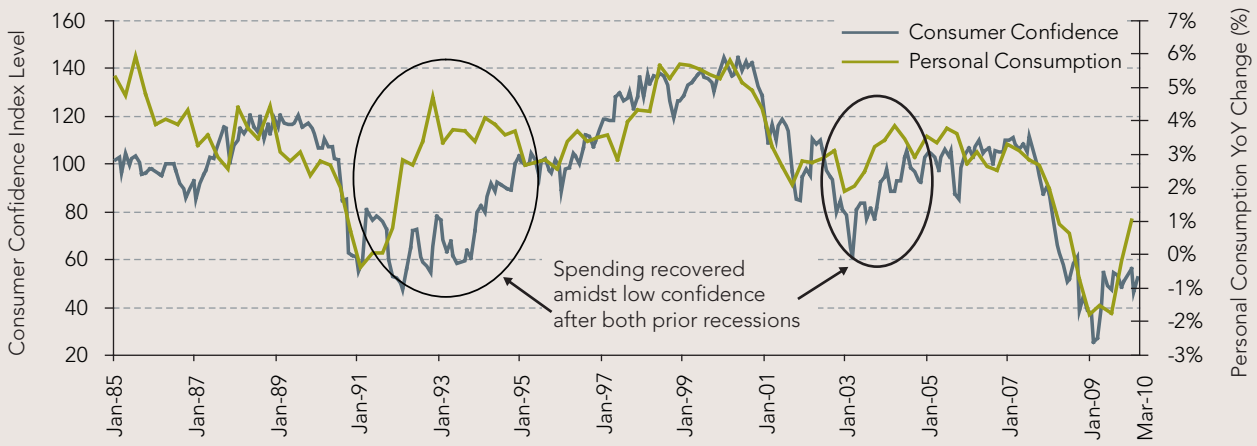
It's What They Do, Not What They Say

While the latest consumer confidence survey data were disappointing, investors should keep in mind that what consumers are doing is often more important than what they are saying. In February, retail sales grew for the fourth consecutive month and the rate of growth was significantly ahead of economists' expectations. Overall consumer spending grew on a year-over-year basis during Q4 2009 for the first time in six quarters. Though income growth remained meager, household net worth rose 11.5% ($5.5 trillion) in 2009, due largely to rising stock and bond prices, a reduction in consumer debt, and stabilizing home prices.[ii] Savings rates have nudged back down. This recent shift in consumers' greater willingness to spend belies their overall confidence level, a contradiction that may reflect some pent-up demand for products and services in the aftermath of a severe recession.

Confidence Often Lags Spending Turnaround

A recovery in consumer spending that coincides with gloomy consumer moods is not a new phenomenon. After the fallout of the 1990 recession, it took consumers a full three years to show a sustained recovery in confidence, while real spending expanded by an annualized rate of 3.5% during the same period. Elsewhere, in the aftermath of the 2001 recession, confidence figures were volatile for a full two years while spending expanded by an annualized rate of 2.7% (see Exhibit 1, above). Perhaps consumers have been prone to maintain a pessimistic mindset in the post-recession aftermath due to ongoing media reports of ▶

EXHIBIT 1: Following previous recessions in 1990 and 2001, consumer confidence lagged an increase in consumer spending, a pattern that has been emerging once again this year.



Source: The Conference Board, Bureau of Economic Analysis, Haver Analytics, FMRCo (MARE) as of 3/31/10. YoY= year over year.

KEY TAKEAWAYS

- **Consumers have been saying they are less confident in the economy, but have increased spending.**
- **Oversupply in the housing market and lurking "shadow" inventory may pressure home prices for some time, but these supply issues are now being partially offset by other positive factors.**
- **Sustained strength across many leading indicators points toward general economic improvement.**

high unemployment. Whatever the reason, the divergence between the American consumer's sentiment and spending resembles what's transpired in prior economic cycles.

What to watch: jobs and income

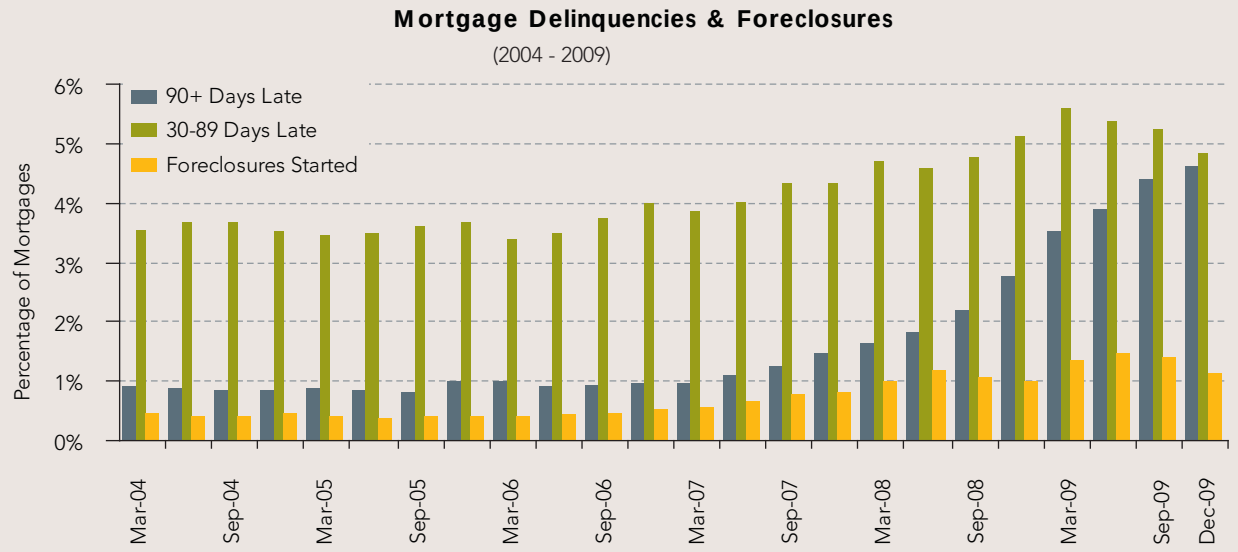
While consumers may be more willing to spend than confidence suggests, it will be their ability to spend that will dictate whether the recent strengthening trend is sustainable. Spending generally follows income growth, so going forward, both job and income growth will be critical to the consumer's outlook. [*See MARE's "February Economic Update" for insight on labor market conditions*.] Personal incomes are still lower than their peak set in 2008, but grew modestly for six straight months ending in January 2010.[ii] With consumers accounting for roughly 70% of U.S. economic growth, it may be difficult for the economy to expand significantly without spending growth. However, if recent labor market improvements continue, consumer spending may end up being better than expected and make a contribution to overall economic growth.

Housing: Oversupply and "shadow" inventory

Demand and mortgage rates will continue to be important factors in the outlook for U.S. housing, but any analysis of the broader real estate market must also focus on supply and the lurking "shadow" inventory of homes. Shadow inventory is seen as homes that haven't yet hit the open market due to concerns about oversupply and depressed market prices, either because lending institutions have chosen not to put already foreclosed properties up for sale or because they are reluctant to foreclose on highly delinquent mortgages. As the rate of delinquencies has increased in recent years, the rate of foreclosures has lagged behind—implying there could be delayed foreclosures rolling in with the tide in the months ahead.

If the pace at which homes with 90-day mortgage delinquencies are foreclosed (now about one quarter) reverts to its historical average (about half), the inventory of unsold homes on the market would increase by one month to 9.7 months, which would fall shy of the 2008 peak (11.2 months).

EXHIBIT 2: While late-stage mortgage delinquencies (90+ days) are still trending higher and a greater percentage of them are expected to move into foreclosure, early-stage (30-89 days) delinquencies are decreasing—a signal that offers hope for some future relief in the supply pipeline.



Source: Mortgage Bankers Association, Haver Analytics, FMRCo (MARE) as of 12/31/09.

MARE analyzed the historic relationship between delinquency rates and rates of foreclosure to gauge the future impact that this potential shadow inventory might have on U.S. housing supply. During the two decades prior to 2007, roughly half of all mortgages that were delinquent for 90 days or more entered foreclosure in the subsequent quarter. At the end of 2009, only about one quarter of all 90-day delinquencies was turning into foreclosures—about half the historical pace (see Exhibit 2, above). If the relationship between 90-day delinquencies and foreclosures were to revert to its historical average (meaning the foreclosures would move from about 1% to about 2% of outstanding mortgages), it would add another month of supply onto the market on an ongoing basis. [*At the current rate of sales, the inventory of unsold homes on the market is equal to 8.6 months of supply, and would rise to 9.7*]. That increase in supply is potentially troubling for the market to absorb, but it would still fall shy of the mid-2008 supply peak of 11.2 months. To get an idea of the scope of the overall late-delinquency problem, if all the current 90-day delinquent loans were foreclosed on immediately, it would add a total of five months of housing inventory to the market, pushing the supply to an all-time record.[iii] It's reasonable to expect further supply pressure going forward as the backlog of late-stage delinquencies continues to gradually drip a stream of foreclosed properties into the market.

However, there are also some positive factors influencing housing supply that may partially offset any future "shadow" inventory pressures. Specifically, the overall rate of mortgage delinquencies slowed in Q4 2009 for the first time since the beginning of 2007 (see Exhibit 2).

Although highly late (90+ day) mortgage delinquencies are still rising (giving credence to the theory of "shadow" inventory), the rate of earlier-stage delinquencies (30-89 ▶

days late) shows several quarters of decline—a sign of a potential improvement (mortgages become slightly delinquent before highly delinquent). This is important because it suggests the potential for supply relief in the early stages of the pipeline, as the rate of shorter-term delinquencies typically slows before later-stage, 90-day delinquencies and foreclosures. Meanwhile, at the current rate of building, the housing stock is only expanding at a 0.5% rate per year, which is below the country's rate of population growth (1% per year) and the rate of home obsolescence (tear downs and other supply depletion).[iv] Thus, while residential housing market remains distressed and the backlog of supply could put a limit on upside price movements for residential housing in coming years, there are some positive housing inventory dynamics that are helping to improve the supply picture.

Trends and Outlook

The number of leading economic indicators rising on a one-month basis fell from six out of 10 in January to four out of 10 in February (see Exhibit 3, right, and below for descriptions of each leading indicator). However, on a more sustained six-month basis, all 10 indicators rose in February. Short-term volatility in economic indicators is typical, and the slack in one-month indicators may have been exacerbated by severe winter weather across the United States in February. Two of the indicators that fell during the month—initial unemployment claims and stock market performance—have improved during the first several weeks of March. Overall, leading indicators point to continued economic improvement in the coming months, though short-term movements bear watching to see if the recent drop was due to inclement weather or the beginning of a new trend. ■

EXHIBIT 3: Leading economic indicators continue to point toward economic improvement.

February Leading Indicators	1-Month Trend	6-Month Trend
Avg. Weekly Mfg. Hours Worked	↓	↑
Initial Jobless Claims	↓	↑
Mfg. New Orders, Consumer Goods	↑	↑
Vendor Performance	↑	↑
Mfg. New Orders, Capital Goods	↓	↑
Building Permits	↓	↑
Stock Market Performance	↓	↑
Money Supply	↑	↑
Yield Curve	↑	↑
Consumer Expectations	↓	↑
Total Indicators Rising:	4/10	10/10

Source: The Conference Board, Haver Analytics, FMRCo (MARE) as of 2/28/10.

Leading Indicator Definitions

Indicator	Description
Yield Curve	The difference between long-term (10-year Treasury bonds) and short-term (federal funds) interest rates. Large positive differences in the yield curve create profitable environments for banks and other lenders.
Money Supply	The total amount of money available in an economy. Increasing money supply (M2) helps support financial market liquidity and economic activity.
Avg. Manufacturing Workweek	A measure of labor market health. Companies tend to adjust hours worked before firing or hiring workers to cope with fluctuations in business activity.
Manufacturer's New Orders for Consumer Goods	A measure of new orders for manufactured (consumer) goods and materials. Increasing new orders of consumer goods tend to lead consumer spending increases.
S&P 500 Index	An index that measures the performance of the U.S. stock market. Is seen as a proxy for investor and business confidence.
Initial Unemployment Claims	Weekly measure of people filing for unemployment benefits for the first time.
Vendor Performance	A measure of how timely vendors deliver components of production to manufacturers. Increased delivery time implies increased demand as vendors struggle to keep up with increasing orders.
Housing Permits	The number of permits issued to build new homes earmarked for construction. An increase in newly issued permits can indicate an expected increase in construction.
Consumer Expectations	A component of a consumer sentiment survey that measures expectations for the economy over the next six months.
Manufacturer's New Orders for Non-Defense Capital Goods	A measurement of business investment. An increase in capital spending often suggests companies are expanding their operations in anticipation of greater growth.

Source: FMRCo. (MARE)

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Investment decisions should be based on an individual's own goals, time horizon, and tolerance for risk.
Past performance is no guarantee of future results.

[i] Source: The Conference Board, Haver Analytics, FMRCo (MARE) as of 3/31/10. The Conference Board is a private, non-profit business membership and research organization that creates and disseminates knowledge about management and the marketplace.
[ii] Source: Bureau of Economic Analysis, Haver Analytics, FMRCo (MARE) as of 2/28/10.
[iii] Housing inventory and sales rate data from the National Association of Realtors as of 2/28/10; mortgage delinquency and mortgage inventory data from the Mortgage Bankers Association as of 12/31/09. Source: National Association of Realtors, Mortgage Bankers Association, Haver Analytics, FMRCo (MARE) as of 2/28/10.
[iv] Source: Census Bureau, Haver Analytics, FMRCo (MARE) as of 2/28/10.

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