Wait For It …
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The economic recovery has faked us out before and the big question now is will it fool us again this year?

BY CHARLIE HALL

The economy seems to have done an about-face during the first few months of this year and after the hoopla otherwise known as the fiscal cliff came to an end.

Housing is rebounding, businesses are starting to hire and shoppers are, well, shopping. Even the normally reserved Federal Reserve acknowledges that the economy is experiencing "moderate growth."

But we've been to this rodeo twice already. In 2011 and 2012, seemingly strong momentum in the first half of the year gave way to summer slumps. Will this third year be the charm or is this just another prank (one that's getting old fast). Let's examine the evidence we have thus far.

What's Happening in the Housing Industry?

Housing is the most-cited reason as to why "this time is different." Ultra-low mortgage rates have helped spur demand in the long-overdue housing market. Meanwhile, the number of homes for sale remains below average. Those factors have helped boost prices by double digits compared to last year. Rising prices should help homeowners who are underwater, eventually allowing them to sell. They also help create a "wealth effect" that contributes to rebuilding household financial security.

The key driver for new residential construction, both single family and rental property, is household formation. And household formation is mostly driven by jobs. So jobs are the key driver for new residential construction. But wait, there are about 3 million fewer payroll jobs now than at the start of the recession. So why do we need any new housing units right now?

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Two frequently mentioned reasons are more foreign buying and that housing is not transportable, so some areas will need more housing while others may not.

Fortunately, many areas are seeing a pickup in construction (and not just areas with better job growth). There is more foreign buying going on, especially in the gateway cities like New York and Miami and in California, but these factors don't explain all of the apparent disconnect between total jobs and households.

Changing Demographics

Personally, I think the real reason for the changing ratio between total jobs and households is demographics. In the decade from 1994 through 2003, the BLS reported the number of people "55 and over" and "not in the labor force" increased by 4.3 million. But in the last 9+ years, from January 2004 until February 2013, the BLS reports the number of people over 55 and not in the labor force increased by 8.1 million. So a greater number of older people are retiring and leaving the work force, a trend clearly explained by demographics.

Older people tend to live in smaller households (according to the U.S. Census Bureau report "America's Families and Living Arrangements: 2012") and this has pushed down the overall household size. The overall mean household size in America is 2.55, but that falls to 2.29 for householders in the 55 to 59 age group, and 2.07 in the 60 to 64 age group, 1.91 in the 65 to 74 age group, and to 1.60 for those 75 and older.

This increase in the number of retired Americans with smaller household sizes means the relationship between jobs and households has changed over time. Historical models analyzing the relationship of number of households to jobs now have to be modified to include changing demographics and this is one reason why the U.S. needs more housing.

What's Happening in Manufacturing?

Another stalwart of the economy, the manufacturing sector has been considered one of the bright spots in the economy since the recession ended. It has added about half a million jobs since 2009, driven in large part by automakers. Manufacturing was clutch in the early years of this drawn-out recovery and it is still holding its own.

Construction, however, has outpaced the manufacturing sector recently. The number of construction jobs added over the past three months is roughly triple that of manufacturing. Because the construction industry is closely tied to housing, that trend is expected to hold through the end of the year.

Two of the most closely watched stock market indicators, the Dow Jones Industrial Average and the broader Standard & Poor's 500 stock index, hit all-time highs recently. The gains most closely mirror the record profits enjoyed by some of the country's largest companies, but they also amount to a vote of confidence by investors in the U.S. economy. The surging stock market has also helped restore many Americans' retirement savings.

There is no doubt that the stock markets have regained much of their value since bottoming out in 2009. But if you factor in inflation, the Dow actually would have to cross 16,000 to reach a true record high. In addition, the bull market has been supported in part by the Federal Reserve's easy money policies. Specifically, its massive bond-buying program has pushed down yields on Treasuries, forcing investors into stocks to increase their returns.

If Americans like to do one thing, it is to shop and that is a good thing for the economy because consumer spending fuels about two-thirds of the nation's gross domestic output. Their resiliency was tested this winter as the threat of the fiscal cliff (higher taxes combined with severe spending cuts) loomed over the country, but the fight barely seemed to register with consumers, who didn't hold back for Christmas and kept right on spending in 2013.

This is one area that economists have differed significantly. Many had predicted spending already would have dropped off due to the increase in the payroll tax that began showing up in paychecks at the start of the year. Now many economists are saying that the effects are simply delayed as the weekly shortfalls begin to pile up. One compelling piece of evidence supporting that theory is the substantial decline in the personal savings rate. After reaching as high as 8 percent during the turbulent days of the financial crisis, it dropped to 2.6 percent earlier in the year. That is the same rate as when the recession began.

Of course, a robust job market could trump a lot of problems. (Though, to be fair, a robust job market would probably be the result of the resolution of those other problems.) The good news is that the number of jobs created has topped 200,000 for three of the past four months across a broad swath of industries. The bad news is that the sequestration-related cuts have not been factored in yet, and the across-the-board government spending cuts are certain to dampen the results over the next few months.

If the labor market can indeed withstand sequestration, it will send a strong signal that the recovery really is getting traction. ■

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