Market & Investment Insights

Why the economy's winter blues won't last

Timothy Hopper, Ph.D., Chief Economist

Article Highlights:

- Economic data releases have been mixed in early 2014, causing renewed anxiety over the resiliency of the U.S. economic recovery.
- Underlying fundamentals remain strong, however, and growth should continue to strengthen and accelerate throughout 2014.
- Our current economic forecast calls for 2.9% GDP growth in Q1 and 3.5% annualized, by the end of the year.
- There are no serious threats to economic growth, which means the Federal Reserve will continue to taper its bond purchasing in the coming months.

The U.S. economy gained momentum in 2013, fueling expectations for an even better 2014. Since the start of the year, however, economic data has been soft, mixed and generally confusing. This has caused much consternation, especially in the U.S. equity markets, which endured a 5% pullback in January before snapping back in early February.

Despite widespread handwringing over the resiliency of the economy, the underpinnings of the U.S. recovery are solid and we continue to expect gross domestic product (GDP) growth of 2.9% in the first quarter, with growth accelerating throughout the year. We estimate annualized growth will approach 3.5% by the end of 2014.

Skeptics should bear in mind that fourth quarter GDP in 2013 actually surprised slightly to the upside, coming in at an annualized 3.2% thanks to healthy consumer and inventory spending. The economy managed this performance despite the government shutdown in October. Without that drag, the economy would have grown close to 4% annualized.

Bad weather and seasonal weakness

All that said, evidence suggests the economy decelerated somewhat by the end of the year. December was a weaker month than October and November and that weaker momentum carried into January. This is partially because of cold weather and partially due to lower inventory spending—which was all but inevitable given the staggering size of the inventory build during October and November. This effect alone will lead to a drop-off in orders and activity along the production chain.

Financial Services

Add to these factors the seasonal weakness in consumption in January (following the holidays), and the effect bad weather has on hiring, and the soft data from December and January start to make sense. Durable goods orders fell over 4% in December while capital goods orders and sales (excluding aircraft and defense) fell 1.3% and 0.2% respectively. Also in December, sales of new homes fell 7%, while sales of existing homes (pending sales) were down nearly 9% for the month and down over 6% on a year-over-year basis. On a more positive note for housing, the Case Shiller 20-city home index registered a 13.7% year-over-year rise in prices.

Cloudy with a chance of sunshine

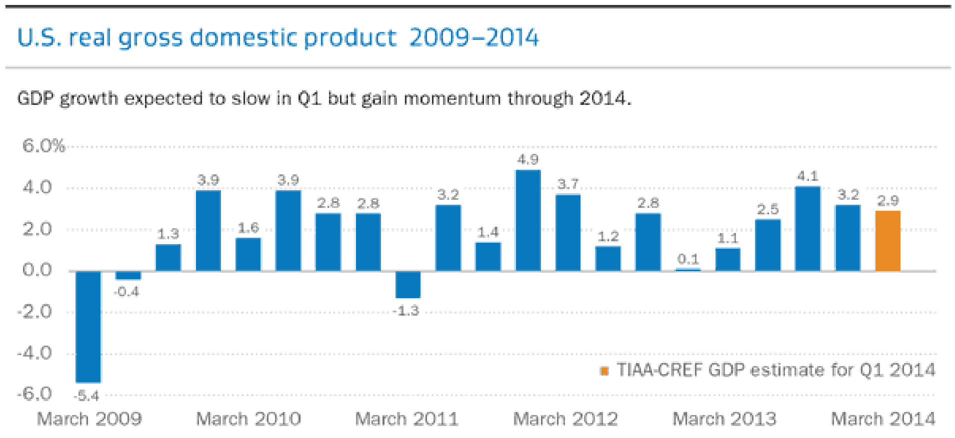
In January, the cloudy picture only got murkier. Consider this trove of industrial data: The Markit Purchasing Manager's Index (PMI) held steady in January, the manufacturing ISM fell sharply to 51.3, while the non-manufacturing survey increased to 54.0 (readings over 50 indicate expansion).

At the same time, construction spending increased by a meager 0.1%, auto sales slowed and factory orders fell by 1.5%.

It's enough to make the most confident economist recheck assumptions. However, we believe the retrenchment in this economic data is not a trend, but rather seasonal and weather-related. The economy remains on track for continued improving growth as consumer spending increases. In the fourth quarter of 2013, U.S. consumers drove the largest quarterly increase in credit outstanding since the third quarter of 2007, according to the Federal Reserve Bank of New York. Household debt, which includes mortgages, auto loans and student debt, jumped $241 billion in the quarter to $11.52 trillion.

Given that consumer spending accounts for 60-70% of GDP, that surge in spending bodes very well for the economy. But let's also take a closer look at some of the other previously cited data. Durable goods orders, which fell in December, tend to be volatile on a month-to-month basis. Quarterly averages, however, show that businesses are still spending at an increasing clip. In fact, capital expenditures should accelerate into 2014 as businesses spend more on inventories and capacity becomes increasingly stretched. This trend will also help employment and wage gains in coming quarters.

Figure 1



Source: Haver Analytics, TIAA-CREF as of 2/21/14

As for the decline in housing, colder-than-usual weather, rising mortgage rates, and to some extent low housing inventories have kept buyers away. I expect this trend to reverse toward the end of the first quarter and steadily improve throughout the year. Prices will move upward again this year, but at a slower pace than last year. The colder weather is also not helping industrial production, which even in the best of times doesn't increase smoothly or linearly. However, the fundamental trends in the industrial sector are still intact, and positive.

Tapering will continue, though rates should remain stable

Clearly the Federal Reserve believes the recovery remains on track. Its decision to continue to taper its bond-purchase program by another $10 billion in February is a noteworthy vote of confidence. Although some fear that the taper could lead to a spike in interest rates that could hurt growth, which seems extraordinarily unlikely given the Fed's commitment to keep the federal funds rate at near zero into 2015. Additionally, rate competition across the globe should help keep a lid on interest rates in the U.S. Japan will likely stimulate its economy further this year, keeping rates low there, while deflationary pressures in Europe increase the chance the European Central Bank will follow suit.

Fewer risks should lead to stronger growth

Ultimately, much of the soft data in December and January was to be expected, and the longer-term growth story for the U.S. still holds. Nothing has changed in our basic economic forecast—the U.S. economy is still trending higher and we expect GDP growth to strengthen throughout the year. As colder and snowier conditions continued into February across much of the country, however, the uneven data may continue as well. Employment, housing, retail sales, and manufacturing are all areas that have been hampered by the weather, though these should all rebound significantly in the spring.

There are few if any serious threats to long-term economic growth at the present time. If something were to materialize, interest rates and the economic outlook would deteriorate significantly and the Fed would be forced to change course on its taper. As it currently stands, the major risks that investors were faced with last year have either improved or evaporated. Congress, for example, has decided to avoid further debate on the debt ceiling. Europe's economy is slowly progressing and China (along with the rest of emerging markets) is stabilizing. This implies that U.S. growth and the Fed's taper will continue and the long-term growth rate will eventually shift course and move up again.

TIAA CREF

Financial Services

The information provided herein is as of February 27, 2014.

The material is for informational purposes only and should not be regarded as a recommendation or an offer to buy or sell any product or service to which this information may relate. Certain products and services may not be available to all entities or persons.

TIAA-CREF Asset Management provides investment advice and portfolio management services to the TIAA-CREF group of companies through the following entities: Teachers Advisors, Inc., TIAA-CREF Investment Management, LLC, and Teachers Insurance and Annuity Association® (TIAA®). Teachers Advisors, Inc., is a registered investment advisor and wholly owned subsidiary of Teachers Insurance and Annuity Association (TIAA). Past performance is no guarantee of future results. Please note that equity and fixed income investing involve risk.

© 2014 Teachers Insurance and Annuity Association-College Retirement Equities Fund (TIAA-CREF), 730 Third Avenue, New York, NY 10017