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Housing Stirs, but Economy Slows

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The U.S. economy is downshifting, even as the housing sector is finally showing signs of life.

A report Wednesday showed builders broke ground for more new homes in June than in any month in nearly four years. But the upturn comes as several other pockets of relative strength for the economy have wavered. Consumer spending is sputtering, manufacturing growth has slowed, and businesses have grown cautious about splurging on new machines and computers.

Most economists now expect second-quarter growth to come in much slower than the first quarter's tepid 1.9% pace, and they say that the outlook is darkening.

This picture is putting added pressure on the Federal Reserve to take steps to boost growth. That was on display this week in Washington, where Fed Chairman Ben Bernanke testified to Congress that it was "certainly possible" the central bank could take new steps to support growth—yet offered no details of what those might be. Asked about the green shoots in housing, the chairman said they were clearly a positive. But he added that the sector still faces huge hurdles, including a backlog of homes likely to come onto the market in coming months, depressing prices, and the difficulty people have getting credit to buy houses when they do come available.

"We're trapped in this relatively modestly growing economy," said Daniel Meckstroth, chief economist at the Manufacturers Alliance for Productivity and Innovation, a research group in Arlington, Va. While the U.S.'s manufacturing sector and exports powered the recovery for the past two years, Mr. Meckstroth doesn't expect them to contribute as much to growth this year, given the economic slowdown in Europe and emerging markets such as China.

This week brought fresh evidence that the U.S. recovery is experiencing a flip-flop, with housing picking up but other areas—such as consumer spending, manufacturing and hiring—all sagging.

Wednesday's housing report from the Commerce Department showed home construction jumped 6.9% from May, to a seasonally adjusted rate of 760,000. Because builders cut back so sharply during the downturn, "if there's an increase in the number of households of any magnitude, the home builders will now benefit," says Daniel Alpert, managing director at Westwood Capital, an investment-banking firm.

The report of a jump in new-home construction came one day after an index that measures home-builder confidence rose to its highest level since March 2007, according to the National Association of Home Builders. The index jumped to 35 this month, up six points from June, the largest monthly increase in 10 years. But the index is still below historical levels—a reading above 50 means that more builders view conditions favorably than not.

Housing demand has picked up this year as low prices and low mortgage rates have made owning less expensive than renting in more markets. The Mortgage Bankers Association reported Wednesday that the average 30-year fixed-rate mortgage fell to 3.74% last week, the lowest in the history of the survey.

But an upturn in housing is a limited engine for the larger economy. Cutbacks on home construction shaved as much as a full percentage point from GDP during the darkest days of 2007 and 2008. This year, construction should turn positive—adding around 0.3 percentage points to GDP, according to Moody's Analytics.

However, housing could still weigh on the economy in other ways. Before the downturn, Americans relied on rising home equity to fix up their homes, pay for vacations, or to fund college tuitions or new businesses. With nearly $7 trillion in housing value wiped out from the market's 2006 peak, more than 11 million Americans owe more than their homes are worth.

Moody's Analytics expects that the wealth effect from housing—where people spend money based on the value of their home—will still subtract from GDP this year, offsetting some gains from revved-up construction.

This helps explain why, despite the good news about housing, the outlook for the economy has darkened. Retail sales sank for the third straight month in June, the government said Monday—resulting in the first three-month slump since the global financial crisis in 2008. And consumer confidence fell during July to its lowest level since December, a recent survey showed. Despite easing prices for gasoline at the pump, consumers appear to be saving instead of spending.

Sabina Sawahney, 48 years old, who owns High Design Jewelry, a Manhattan costume-jewelry seller, has had disappointing sales as foot traffic has dwindled. "There's no one," says Ms. Sawahney, who relies on tourists to frequent her shop. "This time last year it was busy." The customers that she does get are spending less, and going with basics like gold or silver jewelry instead of the more colorful, trendy pieces she was expecting to sell.

Economists also worry about the recent drop in investment by businesses. Spending on equipment like computers and air conditioners—a proxy for business investment—is expanding at a much slower speed this year. Spending grew at an annual rate of 3.5% in the first quarter, compared with 7.5% in the fourth quarter and 16.2% in the third. Fed Chairman Bernanke on Tuesday noted that investment slowed early this year and said he foresaw "further weakness ahead."

America's manufacturers have been hurt by weak demand at home and economic turmoil abroad. Factory output rose 0.7% in June, but slumped 0.7% the previous month, the Federal Reserve said Tuesday. Still, the larger picture is one of a slowing factory sector: Manufacturing output grew at an annual rate of just 1.4% in the second quarter, a sharp slowdown from 9.8% in the first.

A.O. Smith Corp., a Milwaukee-based water-heater maker, blames a lack of consumer confidence and overall economic instability for lackluster domestic growth. "We're seeing a flat year," says Mark Petrarca, senior vice president of human resources and public affairs, who doesn't expect a pickup in the second half of the year.

Indeed, Mr. Petrarca doesn't expect domestic conditions for manufacturing to improve until after the U.S. election, given uncertainty over regulatory and tax changes. Then, companies might be more inclined to invest in themselves he says. While Mr. Petrarca was more optimistic on countries such as China, even emerging markets are expected to slow.

Mr. Meckstroth of the Manufacturers Alliance says he expects manufacturing growth of only 2% to 3% in the second half of the year. He expects the overall U.S. economy to grow at about a 2% annualized rate, which isn't strong enough to keep unemployment from rising and harming the economy.

The latest string of disappointing reports has analysts dialing back their forecasts. Economists at J.P. Morgan Chase & Co. cut their third-quarter growth forecast to 1.5% from 2%. And the International Monetary Fund on Monday lowered its 2012 forecast for the U.S. to 2%, down 0.1 percentage point from its April forecast.

Economists say a big reason why consumers have pulled back and why U.S. factories aren't humming faster is the weak labor market. Employers added only 80,000 jobs in June, barely more than the 77,000 they added in May—capping the worst quarter of job growth since the labor market began recovering in 2010.

The Federal Reserve's latest snapshot of regional economic conditions, which was released Wednesday, captures the divide between housing and other sectors of the economy. Based on comments from businesses and other contacts collected before July 9, Fed analysts said "all District housing market reports were largely positive," but that employment levels improved "at a tepid pace for most Districts."

"Most contacts [cited] U.S. fiscal policy uncertainty or weak demand for their conservative approach to hiring," the report said.

Previously, Fed experts said economic activity expanded at a moderate pace in all 12 Federal Reserve districts in April and May. This time, however, districts in New York, Philadelphia and Cleveland are noting that activity is expanding at a slower pace. Many districts saw slower growth in retail spending, the Fed said, while several reported that new orders for manufactured goods had also dropped off since the Fed's last regional report.

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