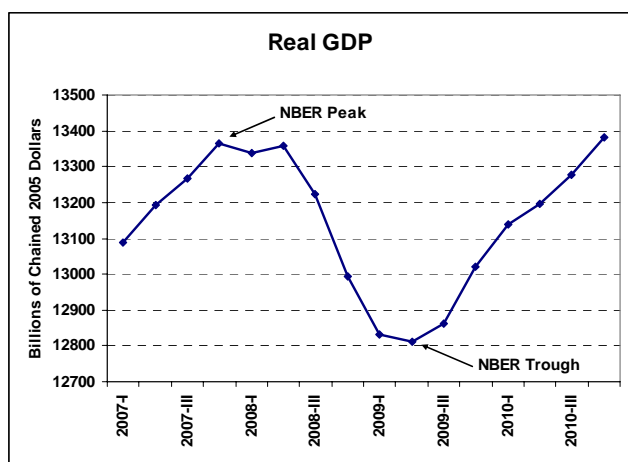


### Recovery Transitions to Expansion

Real GDP reached a milestone in the fourth quarter. Six quarters after the recession ended, real GDP finally surpassed its previous peak reached in the fourth quarter of 2007. Following previous post-war recessions, by contrast, real GDP never took more than three quarters after a trough to establish a new high. Clearly, the recovery was unusually sluggish by historical standards. Looking ahead to the expansion phase of the current upturn, the prospects for real GDP growth in 2011 have brightened modestly, but growth will still be restrained by the dismal prospects for the homebuilding sector.



From an historical perspective, fourth quarter real GDP growth was relatively tepid at a 3.2 percent annual rate. But following annual rate increases of only 1.7 percent in the second quarter and 2.6 percent in the third quarter, the latest data confirm that a pattern of modest reacceleration emerged over the second half of 2010. The composition of growth in the fourth quarter also was encouraging. Consumer spending and business fixed capital spending both increased at a robust 4.4 percent annual rate. That suggests that the transition from stimulus-led to private-sector led growth is well underway.

The pick up in consumer spending is based on a solid foundation. First and foremost, real after-tax personal income grew 2.4 percent over the four quarters of 2010

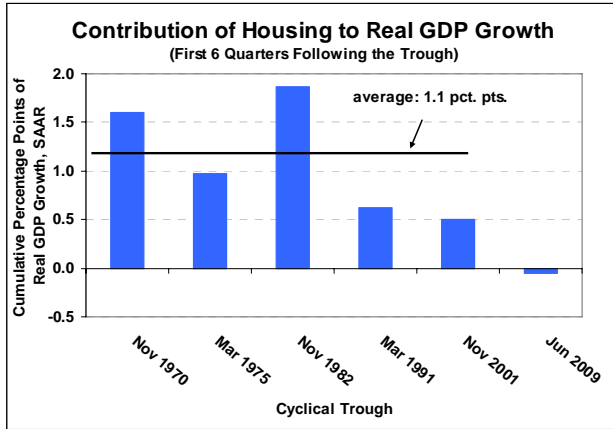
compared to only 0.4 percent in 2009. Moreover, a bigger increase in after-tax income is highly likely in 2011, as hiring accelerates and taxes decline reflecting the two percentage point cut in Social Security tax paid by employees. In addition, household balance sheets are much improved, reflecting a 15 percent gain in U.S. equities in 2010 and a slower rate of decline in house prices. Consumers also made considerable progress in reducing their debt burdens by holding their savings rate at just under six percent in 2010 and by refinancing mortgages at historically low interest rates.

Likewise, businesses are in far better financial shape to continue spending heavily on capital equipment and also to ramp up their hiring. Over the four quarters through the third quarter of 2010, corporate profits were up by 26 percent, and the earnings reports released so far for the fourth quarter of 2010 suggest another solid year-to-year gain. Business capital spending also will be boosted by the recently passed tax break that allows businesses to expense their fixed capital spending put in place by the end of 2011. Businesses also appear poised to increase their hiring. The most recent surveys of hiring intentions and of intentions to recall laid off workers have strengthened. Most companies have exhausted their ability to extract more output from their existing workers and will need to add to their payrolls in order to further increase their production. My forecast is that private payrolls will grow by about 2.5 million in 2011, double the pace of last year.

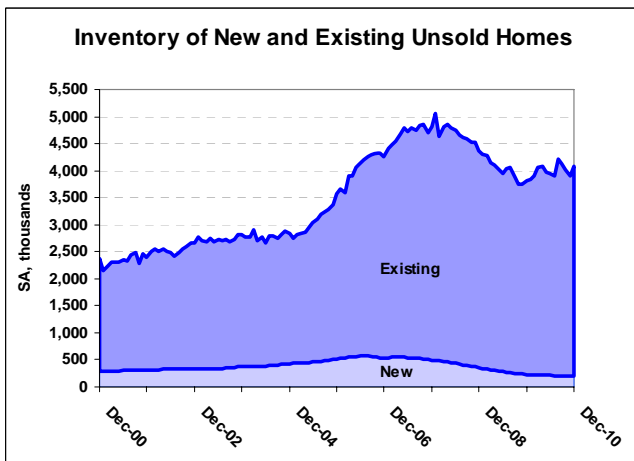
The key takeaway is that both the household and the business sectors are well positioned in terms of income and balance sheet trends to continue to support the expansion with healthy gains in spending. Nevertheless, I am not inclined to boost my forecast for real GDP growth beyond the 3.5 percent I have been forecasting for the fourth quarter of 2010 to the fourth quarter of 2011. The primary reason I am averse to react to the stronger data that has emerged recently is that homebuilding shows no sign of strengthening.

Homebuilding usually has been a key source of support to the economy in the early stages of past recoveries, as is documented in the chart following. The chart shows

the cumulative contribution of housing to real GDP growth in the first six quarters following five previous business cycle troughs. In the current upturn, housing has subtracted 0.1 percentage points over the first six quarters of growth. By contrast, in the five upturns shown in the chart, housing contributed an average of 1.1 percentage points to real GDP in the first six quarters following troughs. In the process, housing accounted for 15 percent of total real GDP growth.

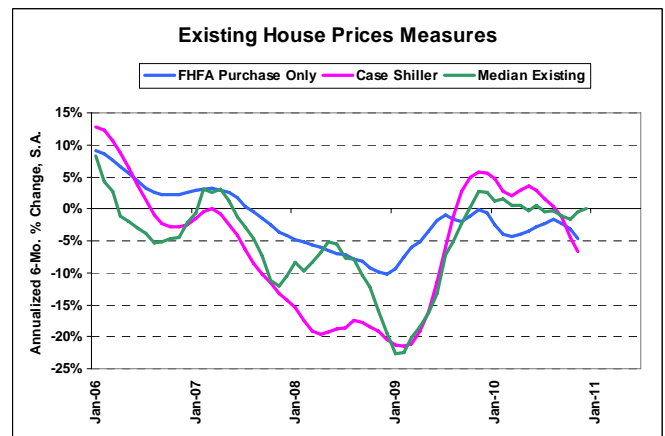


The crucial point is that so far in the current upturn, housing has contributed nothing to real GDP growth in sharp contrast to the usual pattern. Looking ahead to 2011, homebuilding looks likely to remain depressed, thereby limiting the potential for a broad-based and robust expansion in the year ahead.



The clearest indication that the housing sector is likely to remain depressed is the overhang of unsold houses. The previous chart shows the inventory of new and existing unsold homes. In recent months, total inventories have been fluctuating near 4 million. That is down from the cyclical peak of 5 million but is still at least 1 million higher than what would represent a healthy balance between supply and demand. Inventories of unsold new homes are actually the lowest since 1968, as builders have been aggressive in slashing the number of houses they are building. But unsold existing homes are still far above normal. At recent sales rates, the inventory of existing homes represents about eight months of supply. In a well-balanced market, inventories of existing homes tend to fluctuate between four- and five-months supply.

Trends in the prices of existing homes shown in the chart below confirm that the inventory of unsold houses remains excessive. Over the most recent six months, the Case-Shiller index declined at a 7 percent annual rate; the FHFA index fell at a 5 percent annual rate; and median existing house prices were essentially unchanged. Each of these indexes has shortcomings as a measure of house prices. But taken together, the overall impression is that, at best, house prices may be stabilizing. More likely they are continuing to drift lower.



Moreover, the risk is that house prices will be further depressed as foreclosure activity reaccelerates. The

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recent mortgage servicing fiasco resulted in a lull in foreclosure activity. As the major servicers complete their reviews of their paperwork processes and the courts sort out the legal issues, foreclosure activity likely will ramp up again over the course of 2011. The obvious potential is that the flow of foreclosed properties coming onto the market will press prices lower. At a minimum, the uncertainty about the impact on prices will make potential buyers more cautious, further delaying the recovery in the housing sector.

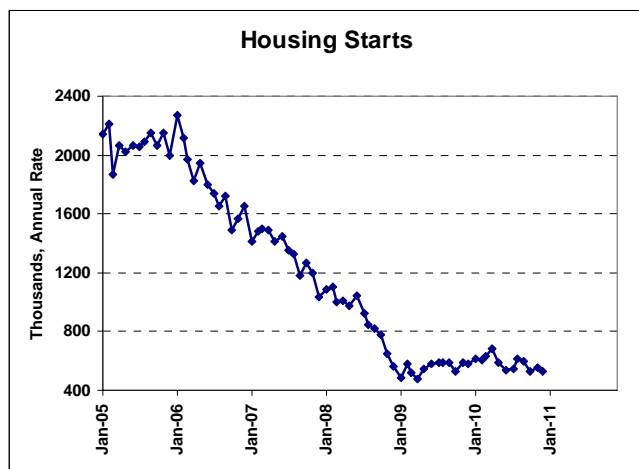
Overall, private sector growth should be somewhat stronger in 2011, but ongoing weakness in housing will prevent a robust and broad-based expansion from taking hold.

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Housing starts are the best leading indicator of the contribution of homebuilding to real GDP growth over the next few quarters. As the chart nearby shows, starts have been trending sideways at a depressed level for two full years. Despite the brighter tone of other recent economic data, there is not even a hint of the beginnings of an upturn in starts. The inventory and price data discussed above make it easy to understand why builders are playing it safe. Until builders see significantly stronger job growth, a stabilization in house prices in the context of heavier foreclosure activity, and a pick up in sales, they will minimize the number of houses built on speculation, confining themselves mostly to building in reaction to signed contracts.

The critical conclusion is that six quarters after the business cycle trough, some but not all of the major imbalances in the economy have been repaired. Household income and balance sheets are improved as is business profitability. However, the housing sector is still burdened with a huge overhang of unsold houses, and the slowdown in foreclosures is further delaying the necessary adjustments needed to clear the market.

## Comerica Forecast Worksheet

(January 31, 2011)

	Real GDP SAAR	Nonfarm Payrolls 1,000s***	Unemploy. Rate %	PCE Deflator SAAR	Core PCE Deflator SAAR
<b>Actual</b>					
2010Q3	2.6	81	9.6	0.8	0.5
2010Q4	3.2	130	9.6	1.8	0.4
<b>Forecast</b>					
2011Q1	3.2	140	9.6	3.3	0.9
2011Q2	3.4	150	9.4	1.2	1.2
2011Q3	3.6	175	9.3	1.4	1.4
2011Q4	3.8	200	9.1	1.6	1.6
	Light Veh. Sales Millions	Housing Starts Millions	Fed Funds Rate* %	Bank Prime %	3-Month Libor %
<b>Actual</b>					
2010Q3	11.6	0.59	0.19	3.25	0.39
2010Q4	12.3	0.54	0.19	3.25	0.29
<b>Forecast</b>					
2011Q1	12.5	0.56	0.18	3.25	0.30
2011Q2	13.0	0.59	0.19	3.25	0.31
2011Q3	13.6	0.61	0.20	3.25	0.32
2011Q4	14.2	0.65	0.22	3.25	0.40
	3-Month Treas. Bill** %	2-Year Treasury %	10-Year Treasury %	Conventional Mortgage %	Fed Major Currency Index Mar73=100
<b>Actual</b>					
2010Q3	0.16	0.54	2.79	4.45	75.9
2010Q4	0.14	0.48	2.86	4.60	73.0
<b>Forecast</b>					
2011Q1	0.14	0.60	3.45	4.90	73.7
2011Q2	0.15	0.65	3.55	5.05	75.0
2011Q3	0.17	0.80	3.70	5.20	76.0
2011Q4	0.25	1.10	3.90	5.40	77.0

\*We expect the Fed to cease purchasing Treasury coupon securities by June 2011. Our working assumption is that the FOMC will lift the funds rate from 0-0.25 percent to 0.50 percent at its January 2012 meeting.

\*\*Coupon Equivalent Yield.

\*\*\*Excludes temporary census workers hired to help with the decennial census. The number of such workers peaked in May 2010 and the last temporary workers were off the census payrolls by November.