

Sunbelt Versus Rustbelt in U.S. Tug-of-War

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A tale of two U.S. economies

If you've been lying awake at night worrying about Canada's split-personality economy - surging West, sputtering East - maybe it will help to know we're not the only ones on the continent tossing and turning. The United States is experiencing a Jekyll-and-Hyde economy of its own.

South of the border, the diverging growth isn't split along east-and-west lines, but north and south. More specifically, it's what Goldman Sachs has identified as "Sunbelt vs. Rustbelt." It reflects a growing "tug of war" between a rebounding manufacturing sector, which is boosting fortunes in the Great Lakes states, and a slumping housing sector, which is hitting hardest in high-growth sun states where the housing market more than boiled over - it burned, set off the smoke alarm and stuck to the bottom of the pan.

Bursting bubbles raise the R-word

U.S. manufacturers' new orders are on track for a rise of more than 3 per cent in the second quarter, while real residential investment fell more than 5 per cent - a divergence that has only happened eight previous times since the Second World War. That is weighing on regional economic performance, and in particular is showing up in the job market - an area of keen interest for Federal Reserve Board policy makers, as employment trends are closely tied to inflationary pressures.

In Florida and Nevada, where large-scale housing bubbles have burst, sharply surging numbers of new unemployment insurance claims "suggest that **outright statewide recessions have either already begun or are about to begin,**" **Goldman Sachs economist Andrew Tilton wrote in a recent report.** The jobless claims figures for Arizona and California are headed down the same road.

But the weakening labour markets in the sunbelt states are being offset by sharply falling jobless claims in rustbelt states, led by Michigan and Indiana, so the overall national picture looks reasonably healthy. This poses a conundrum for the Fed as it determines interest rate direction: How do you interpret a split-personality labour market, and its inconsistent impact on growth and inflation?

And the winner is...

Well, it's not really a contest, but if history tells us anything, it's that the housing recession is the one to watch. Goldman Sachs economist Jan Hatzius noted that in those previous eight instances of a factory-housing split, the divergence foreshadowed three recession and two sharp slowdowns; on two other occasions, they came at a recession trough. And keep in mind that manufacturing's pull on the U.S. economy isn't what it used to be; it accounts for only about 12 per cent of economic activity, down from more than 25 per cent in the 1950s.

Furthermore, the sector might not even be as healthy as the data suggest. Merrill Lynch economist David Rosenberg points out that a lot of the recent growth has been driven by production rates, as manufacturers replenish their inventories, but new orders aren't keeping pace - the ratio of orders to production is at a 13-month low. It's a pattern that typically presages a downturn in activity, which he predicts could come "by Labour Day."

The housing sector, on the other hand, remains massively oversupplied, lending standards are tightening and sale prices are declining, all of which suggest the housing downturn is far from over.

U.S. interest rates, c'mon down!

"We suspect the housing downturn is ultimately more powerful and longer lasting than the factory upturn," Mr. Tilton says. "Thus, we see risks to monetary policy as tilted toward easing rather than tightening."