Economic Notes

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Continuing Signs of Economic Recovery

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U.S. economic data reported this week, mostly covering the month of August, remained stronger than expected and pointed to continued recovery. Retail sales rose more than expected last month, even excluding the impact of the "cash for clunkers" program on auto sales. Industrial production rose more than expected in August and was revised higher for July. Housing starts and building permits both increased, although primarily due to strength in multi-family buildings. Regional surveys from the Philadelphia and New York Federal Reserve Banks pointed to a recovery in manufacturing.

The Federal Reserve also reported that household net worth had increased during the second quarter for the first time since 2007, largely due to higher stock prices but also due to a decline in mortgage debt. Stronger household balance sheets should help support consumption spending despite the somewhat weak income growth we expect over the next few quarters.

Finally, headline CPI and PPI inflation was above expectations in August, but this largely resulted from higher oil prices. Core inflation remains well controlled and we expect it to move lower over the next several months.

Retail Sales

Retail sales rose more than expected in August. While auto sales rose sharply because of the "cash for clunkers" program, non-auto sales also increased more than expected and discretionary sales were higher. July's data were revised slightly: lower in the case of total sales and higher for non-auto sales. Combined with recent data on consumer confidence, this report supports our expectation that consumer spending should continue to move gradually higher over the rest of the year.

- Retail and food service sales rose 2.7% in August, following a revised 0.2% July decline (first estimated at -0.1%). The mean forecast had been for a 1.9% increase, with individual forecasts ranging from +0.8% to +3.8%. Sales excluding autos and parts rose 1.1%, compared with a mean forecast of +0.4% and forecasts ranging from -0.1% to +1.0%. Our "core" retail sales measure, which excludes autos and parts, building materials, food and gasoline, rose 0.9%, its largest increase since February.
- Sales of motor vehicles and parts rose 10.6% in August as the "cash for clunkers" program supported new car sales. Even with this program, however, vehicle sales reached a 14 million unit annual rate in August, still nearly 18% below the 17 million average seen over the 2001-2007 period. Sales were down 1.0% year over year. Looking forward, auto sales should decline in September and beyond because the program probably pulled some demand forward. We still expect a continued gradual recovery in auto sales over the next few years, however, even if sales do not get back to a 17 million annual rate until the middle of the next decade.

Source: U.S. Census Bureau

Industrial Production

The Federal Reserve reported that industrial production had risen more than expected in August, and that production had risen more than initially estimated in July. While weather drove a spike in utility production, both manufacturing and mining production also increased last month. Capacity utilization rose and was revised higher for July. Increased auto and truck production was a major part of August's increase, but production excluding vehicles also increased. Looking forward, we expect that increases in manufacturing production to gather momentum in coming months as inventory liquidation ends.

- Industrial production rose 0.8% in August, following a 1.0% increase in July (originally estimated at +0.5%). The mean forecast had been for a 0.6% increase and individual forecasts ranged from -0.3% to +1.5%. Manufacturing production rose 0.6%, mining production rose 0.5% and production at utilities rose 1.9%, primarily due to a swing to warmer weather after a generally cool July. Revisions to total industrial production for the months from March to June were insignificant, but the decline in manufacturing production over the same period was smaller than previously estimated. Year-over-year, total industrial production was down 10.7% and manufacturing production was down 12.2%.
- About half the increase in manufacturing production resulted from motor vehicle production, which increased 5.5% following a 20% increase in July. Vehicle assemblies in August were at a 6.6 million annual run rate, still nearly 25% below their 8.7 million 2008 rate. Vehicle production may fall back in September if sales decline sharply with the end of the "cash for clunkers" program, but should still increase unevenly over the next few quarters. Production of most other types of consumer durable goods fell in August, with home electronics falling 1.4% and appliances, furniture and carpets falling 0.8%. Nevertheless, total manufacturing production excluding vehicles and parts rose 0.4% following a 0.6% increase in July.
- Capacity utilization increased for the second consecutive month, rising 0.6% to 69.6%, and capacity utilization for July was revised up to 69% from 68.5%. Capacity utilization in manufacturing rose to 66.6% form 66.1%. Total capacity fell 0.5% year over year, and manufacturing capacity fell 0.7% year over year.

Source: U.S. Federal Reserve

We continue to believe that a powerful inventory and industrial production cycle will be a major contributor to the early stages of U.S. and global economic recovery. This is primarily because the decline in manufacturing production in the fourth quarter of 2008 and the first few months of this year was much more severe than the decline in final demand. There is evidence that inventory excesses are close to being eliminated, and this should mean continued gains in industrial production over the remainder of this year and in 2010.

Housing Starts

Housing starts and permits, reported by the U.S. Census Bureau, rose essentially as forecast in August, and starts and permits for July were revised higher. Much of the strength in the August figures, however, came from multi-family buildings, which largely reversed a sharp July decline. Single-family starts were down modestly and single-family permits were flat. Nevertheless, the report confirms our view that housing activity reached a trough in the first quarter of 2009, and that residential investment on a GDP basis is likely to turn positive in the current quarter.

- Total housing starts rose 1.5% in August to a 598,000 seasonally adjusted annual rate (SAAR), in line with the consensus forecast. Individual forecasts had ranged from a low of 570,000 to 640,000. Starts for July were revised up from a 581,000 SAAR to 589,000. Total building permits rose 2.7% to a 579,000 annual run rate, slightly below the mean forecast of 584k. Permits for July were revised up to 564,000 from 560,000. Thus far in the third quarter, housing starts have come in at an average annual rate of 593,000, compared with 540,000 in the second quarter and 528,000 in the first. Starts rose most strongly in the Northeast (+24%), because of strength in multi-family buildings; they were up slightly (0.9%) in the Midwest, flat in the West and down 2.4% in the South.

Source: U.S. Census Bureau

We have emphasized in past reports that the single-family starts and permits data are the more important part of this report because single-family starts display less monthly volatility than multi-family buildings and because single-family home construction makes a larger per unit contribution to GDP. In our view, the modest weakness in single-family starts and permits in August does not represent a cause for concern. The level of home construction activity is modestly above its trough, and has a long way to go before getting anywhere close to trend levels implied by population growth and home teardowns.

Philadelphia Fed Survey

The Philadelphia Fed's business outlook index increased more than forecast in September, with a significant increase in the shipments index. Firms in the region generally expect to increase production further this quarter and in the fourth quarter. However, the new orders index in the report was down slightly, and employment indicators were mixed. Regional surveys such as this provide limited visibility into national-level activity, but the report does confirm the stronger than expected result from the New York Fed's Empire Manufacturing survey (18.9, up from 12) released earlier this week. The somewhat ambivalent behavior of the component series is typical of the early stages of economic recovery.

- The Philadelphia business activity index rose to 14.1 in September from 4.2 last month. The mean forecast had been for 8.3, with individual forecasts ranging from 2.5 to 14.4. The index level of 14 means that 33% of firms saw increased business activity in September vs. 19% who saw a decrease. Last month, 27% of firms saw stronger activity and 23% saw activity as weaker.
- The increase in the headline index was not completely confirmed by individual series in the survey, which do not go into the headline index. In particular, the new orders index fell slightly to 3.3 from 4.2 last month, as 27% of firms saw higher new orders vs. 24% who saw a decline. The shipments index, by contrast, rose to 8.2 from 0.6 as 33% of firms saw higher shipments compared with 24.5% who saw lower shipment levels. In August, 26% of firms had seen higher shipments and 25% had seen lower levels. The unfilled orders index remained negative, but increased to -7.4 from -9.3; 14% of respondents had higher levels of unfilled orders in September vs. 22% who saw lower levels.
- In a special question, companies were asked about production plans for the third and fourth quarters. For the third quarter, 48% of firms plan to increase production vs. second quarter levels, compared with 24% planning lower production levels. For the fourth quarter, 40% see some acceleration in production growth relative to the third quarter, compared with 28% who see a deceleration.

Source: Philadelphia Federal Reserve

Household Net Worth

Household net worth increased in the second quarter of this year for the first time since the third quarter of 2007. The increase was largely the result of rising stock prices, but real estate values also increased slightly. Household sector debt declined for the fourth consecutive quarter. Although high unemployment and tepid increases in income should continue to restrain consumption spending for the next few quarters, this report does confirm our view that negative wealth effects on consumption have ended and begun to reverse.

- Household net worth rose 3.9% in the second quarter to $53.1 trillion from $51.1 trillion in the first. The increase was primarily the result of rising stock prices, which contributed $1.3 trillion of the increase through direct equity and mutual fund holdings and contributed to a $736 billion increase in the market value of insurance and pension fund reserves. The aggregate value of real estate owned by the household sector rose 0.8% in the quarter to $20 trillion.
- U.S. households reduced their outstanding debt at a 1.7% annual rate in the quarter, the fourth consecutive quarterly decline. Outstanding mortgage debt fell by $326 billion and consumer credit fell by $42 billion. Combined with the slight increase in home values, this meant that owners' equity as a share of the value of real estate rose to 43.1% from a low of 41.9% in the first quarter.
- The report shows a decline in households' equity stake in small businesses, which constitutes about 10% of household sector assets. Small business equity is measured largely on a book value basis (with financial assets marked to market), rather than on a going concern basis. This value fell in the quarter largely because real estate held by small businesses declined.

Source: U.S. Federal Reserve

Looking forward, net worth is likely to increase further in the third quarter as the S&P 500 has risen a further 15% from its June 30 level and a variety of indicators point to further modest increases in home prices. A recovery in household wealth should in turn be an important support to a recovery in consumption.

CPI and PPI

The Consumer Price Index (CPI), reported by the Bureau of Labor Statistics, rose more than expected on a headline basis in August and in line with expectations excluding food and energy. We expect core inflation to remain low to moderate over at least the next 12 to 18 months.

- The total CPI rose 0.45% in August, following a nearly unchanged July reading. The mean forecast had been for a 0.3% increase and individual forecasts ranged from -0.1% to +0.6%. The core CPI rose a bit less than 0.1%, as expected, with individual forecasts ranging from -0.3% to +0.2%. Compared with August 2008, the headline index was down 1.5% and the core index was up 1.4%.
- As with the August PPI, energy price increases were a major part of the rise in the headline CPI. The total energy index rose 4.6%, spurred by a 9% increase in gasoline (3% before seasonal adjustment) and a 6% increase in fuel oil. Natural gas and electricity were flat, but declined 0.7% before seasonal adjustment. Some of these price increases may reverse in September, but the declines may not be enough to cause the seasonally adjusted energy index to fall.

Source: U.S. Department of Labor

The Bureau of Labor Statistics reported today that the Producer Price Index (PPI) rose considerably more than expected in August. As was the case two months earlier, a sharp rise in energy was a major part of the increase. The core finished goods index rose modestly more than forecast, and both intermediate and crude goods prices also rose. Price increases for intermediate and crude goods were broad-based, not confined to energy. The recent commodity price increases that have driven the PPI higher are nevertheless not likely to lead to more broad-based consumer price inflation in the foreseeable future because still-high unemployment should continue to restrain growth in unit labor costs, the primary driver of inflation in a services-based economy.

- The PPI for finished goods rose 1.7% in August, following a 0.9% decline in July. The consensus forecast had called for a 0.9% increase, with individual forecasts ranging from -0.3% to +2.0%. Compared with August 2008, the finished goods index was down 4.3%. The core PPI (excluding food and energy) was up 0.17%, a bit more than the consensus forecast of +0.1%; forecasts for the core index ranged from -0.1% to +0.4%.
- Energy price increases were responsible for about 80% of the finished goods price increase, with the total energy index up 8.0% in August after falling 2.4% in July. Wholesale gasoline prices were up 23% (10% before seasonal adjustment), and heating oil rose 21.3%. Natural gas prices, however, declined about 1%. Looking forward, we should see some reversal of these energy price increases in September's PPI. Today (September 15) is the reference date for September; between the August reference date (August 11) and today, wholesale gasoline has fallen about 5.5%, crude oil is down about 3%, and natural gas has declined a further 2%.
- Finished food prices rose 0.4% in August after falling 1.5% the month before. Individual food categories varied widely, with eggs up 10% and fresh fruit up 6%, but fresh vegetables down 5%. Meat prices were mixed, with beef and veal increasing but poultry and pork declining. Fish prices fell.

Source: U. S. Department of Labor

Today's report largely reflects rising commodity prices that have resulted from global recovery and inventory building in some categories. The relatively broad-based increases in intermediate and crude goods prices suggest that some further upward pressure on the finished goods PPI is likely in coming months. Nevertheless, as we have emphasized, the inflation rate of greatest concern to the Federal Reserve is the core personal consumption expenditures price index, which is primarily driven by services prices and thus ultimately by unit labor costs. These are not likely to be threatening in a context of high unemployment and a historically wide output gap. ■