DALLASFED Economic Update
National

Oil Price Decline Continues; Consumer Sentiment Drives Output

January 30, 2015

Economic data released since mid-December indicate robust growth in the second half of 2014. Oil prices continued to decline, boosting household real disposable income. Consumer sentiment surged in the fourth quarter and has improved since. However, the trimmed mean inflation rate—a measure of core inflation—changed little, remaining below the Federal Reserve target of 2 percent. Strong consumption dynamics driven by improved household balance sheets and consumer sentiment are likely to promote private consumption growth and strengthen output going into 2015.

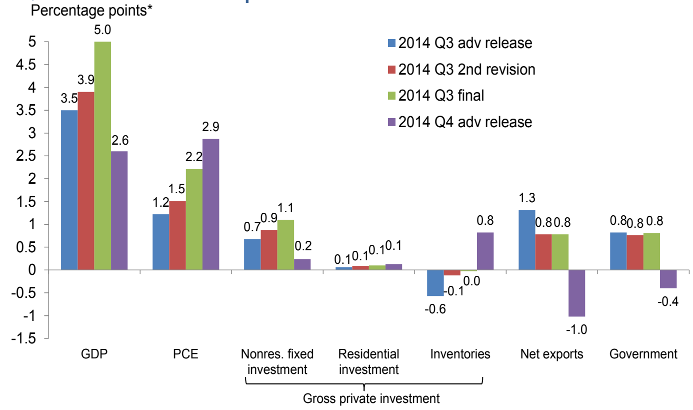
Second-Half Output Growth Robust in Latest Release

Robust personal consumption expenditure (PCE) growth in the third quarter and declining energy prices brought positive momentum to fourth quarter 2014. In its advance estimate, fourth-quarter real gross domestic product (GDP) growth undershot expectations and came in at an annualized 2.6 percent (*Chart 1*). PCE, which makes up about 68 percent of U.S. GDP, contributed 2.9 percentage points to real annualized GDP growth, driven by unexpectedly strong core retail sales in October and November. Negative contributors were net exports, subtracting a whopping 1 percentage point, and government, subtracting 0.4 percentage points.

The large drop in net exports, a volatile component of GDP, reflects the 8.9 percent increase in imports due in part from appreciation of the U.S. dollar. Looking closely, real GDP growth in the fourth quarter followed fundamental expectations of strong private consumption growth but was dragged down by increased demand for discounted foreign goods and services. The advance estimate puts second-half real GDP growth at an annualized 3.8 percent and overall 2014 growth at 2.5 percent.

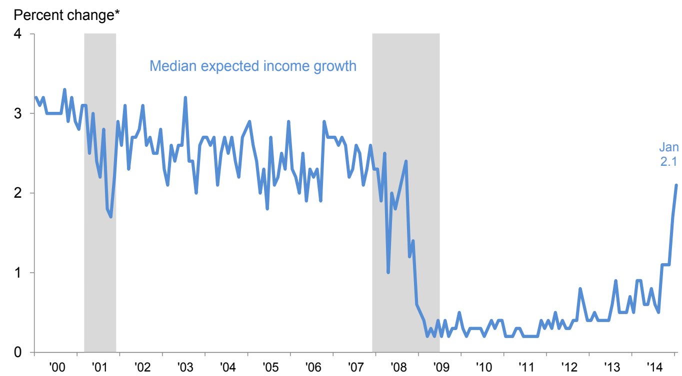
The fourth-quarter GDP release was preceded by a large upward revision to third-quarter growth. In its final estimate, third-quarter real GDP grew an annualized 5 percent—the strongest quarterly growth in more than a decade. Output growth was revised upward by 1.1 percentage points from its second estimate due to a sizable upward revision to PCE, from a

Chart 1
Third-Quarter GDP Growth Revised Upward, while Fourth-Quarter Growth Below Expectations



*Contribution to percent change in gross domestic product growth; quarter/quarter, seasonally adjusted annualized rate.
SOURCE: Bureau of Economic Analysis.

Chart 2
Expected Income Growth Suggests Strong Consumer Sentiment



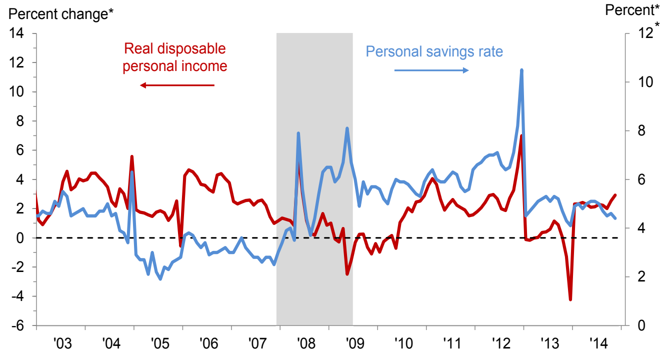
*Year/year, next 12 months.
NOTE: Shaded areas indicate recession.
SOURCES: University of Michigan; National Bureau of Economic Research.

1.5 to 2.2 percentage-point contribution to real GDP growth, and a moderate upward revision to nonresidential fixed investment.

Improving Consumer Sentiment Seen in Fourth Quarter

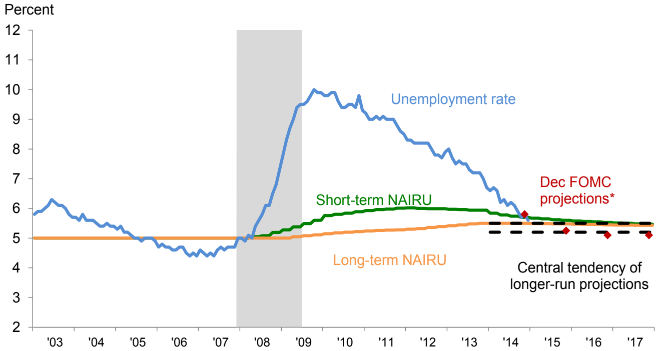
Consumer sentiment surveys from the Conference Board and the University of Michigan support the advance estimate of strong consumption growth in the fourth quarter and going into first quarter 2015. Consumer sentiment regarding expected-income growth climbed sharply in December and January. The excep-

Chart 3
Divergence of Real Income, Savings Rate Reflects Growing Consumer Confidence



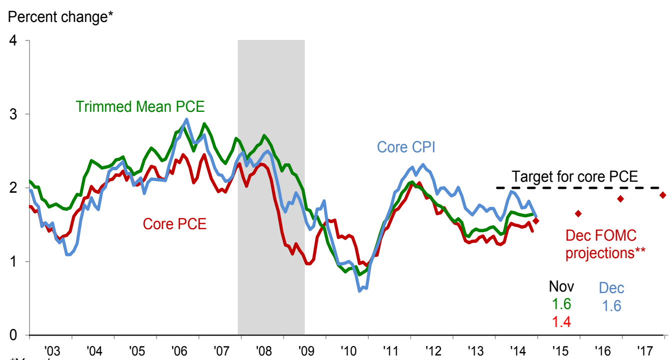
*Year/year, seasonally adjusted annualized rate.
** Seasonally adjusted annualized rate.
NOTE: Shaded area indicates recession.
SOURCES: Bureau of Economic Analysis; National Bureau of Economic Research.

Chart 4
Headline Unemployment Approaches the Natural Rate



*Midpoint of the central tendency of the economic projections from the December 2014 Federal Open Market Committee (FOMC) meeting.
NOTES: Shaded area indicates recession. NAIRU is the estimated nonaccelerating inflation rate of unemployment, or the unemployment level at which inflation is in check.
SOURCES: Bureau of Labor Statistics; Congressional Budget Office; Federal Reserve Board; National Bureau of Economic Research.

Chart 5
Softening Core Inflation Suggests Slack in Labor Market



*Year/year.
**Midpoint of the central tendency of the economic projections from the December 2014 Federal Open Market Committee (FOMC) meeting.
NOTES: Shaded area indicates recession. CPI stands of Consumer Price Index, a measure of consumer price inflation.
SOURCES: Bureau of Economic Analysis; Federal Reserve Board; National Bureau of Economic Research.

tional jump in median expected-income growth over the next 12 months, a component of the University of Michigan's survey, reinforces the broad-based improvement in sentiment because median expectations remove the outliers in all income classes (*Chart 2*).

Growing consumer confidence was likely driven by falling energy prices and associated growth in real disposable income. The Personal Income and Outlays survey released by the Bureau of Economic Analysis shows increases in real disposable personal income on a year-over-year basis in October and November 2014, alongside declines in the personal savings rate (*Chart 3*). This development in income and savings suggests further growth in private consumption in the fourth quarter and into the new year.

Headline Unemployment Reaches New Low

The December establishment survey from the Bureau of Labor Statistics indicates a healthy addition of 252,000 nonfarm jobs, bringing 2014 average monthly job growth up to 246,000—which surpasses average monthly gains of 194,000 in 2013. According to the household survey, the headline unemployment rate decreased 0.2 percentage points from November to 5.6 percent in December 2014 (*Chart 4*).

The current headline unemployment rate suggests that the labor market is outperforming projections from the Federal Open Market Committee's March 2014 Summary of Economic Projections of 6.1 to 6.3 percent as the central tendency for unemployment in fourth quarter 2014. The unemployment rate decline coincided with a drop in the labor force participation rate from 62.9 to 62.7 percent. While this decline in the size of the labor force could explain lower unemployment, it's notable that the employment-population ratio of those age 26 to 54 (the prime working ages) increased 0.1 percentage points in December and 0.9 percentage points for the year. Taken together, these movements suggest that labor force participation rates are returning to trends in line with demographic shifts.

Trimmed Mean Inflation Static Despite Low Unemployment

The steep drop in oil prices has dragged headline inflation measures down. However, the Dallas Fed's Trimmed Mean PCE inflation rate has been in a tight range of 1.6 to 1.7 percent going back to April 2014 (*Chart 5*)[1]. Fourth-quarter headline unemployment is within the range of the Congressional Budget Office's estimate for a nonaccelerating inflation rate of unemployment (NAIRU) of 5.8 percent in the short term and 5.5 in the long term. In theory, an unemployment rate under NAIRU implies that labor is effectively utilized and inflation should accelerate. Yet, trimmed mean inflation has remained static.

There are several possible reasons for the static reading. The decline in oil prices has ripple effects to other core components in PCE because oil is an input cost in many products. For example, the price of physical goods is more susceptible to changes in oil prices than the price of services. The effect is observed in the disparity in price changes in various components of PCE. Core goods prices—goods apart from food and energy items—experienced a historic decline in November that resulted in a 12-month drop of 0.8 percent. Meanwhile, the "big three" core services—rent, owners' equivalent rent and other purchased meals (the price index for dining out)—saw healthy gains of 2.9 percent for the 12 months through November.

Another downside risk to inflation may be the possible underutilization of labor. The headline unemployment rate does not account for discouraged workers and those who are marginally attached. The U-6 unemployment rate—the broadest measure of unemployment, which includes the marginally attached and those employed part-time for economic reasons—declined considerably from 13.1 to 11.2 percent in 2014 but remains elevated compared with the past 20 years.

Given the persistence of core inflation measures and some labor market slack not communicated through the headline unemployment rate, core inflation is likely to remain subdued in 2015 even as the unemployment rate moves below estimates of NAIRU.

—Daniel Lin

Note

[1] "Behind the Numbers: PCE Inflation Update, November 2014," by Jim Dolmas, Federal Reserve Bank of Dallas. http://www.dallasfed.org/research/pce/2014/pce1411.cfm

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About the Author

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