DALLASFED Economic Update

National

Labor Market Improves While Inflation Slumps

March 18, 2015

Economic indicators released since late January suggest that the U.S. will sustain trend growth in the medium term. Upside risks include low oil prices, a tightening job market, rising house prices, rising stock prices and low interest rates. Downside risks include the rising value of the dollar, weak global demand owing to Asia, and geopolitical conflict in Eastern Europe and the Middle East. On balance, the U.S. growth path remains steady.

Short-Term Slowness in Latest GDP Figures

In its second release for fourth quarter 2014 real gross domestic product (GDP), the Bureau of Economic Analysis revised growth down 0.4 percentage points to 2.2 percent (*Chart 1*). This revision primarily reflects a fall in inventory growth, a very volatile component of GDP, although net exports were revised further down as well. Major positive contributions came from personal consumption and business fixed investment.

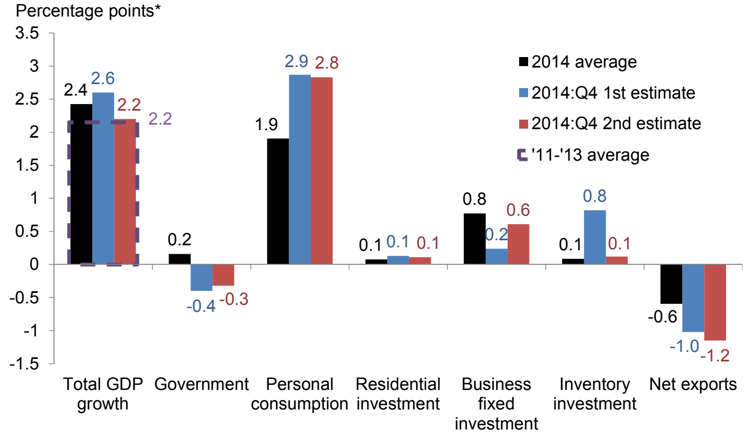
Medium-Term Indicators Remain Solid

Forward-looking economic indicators imply a sustained growth path in the medium term. Chief among the major contributions to GDP will be personal consumption expenditures. Rising consumer expectations (*Chart 2*), along with a declining household debt payments-to-income ratio and rising net worth, will generate upward pressure on demand for final goods and services.

Other tailwinds supporting GDP growth in 2015 include rising home equity and house prices. Despite the disappointing housing recovery to date, indicators such as declining mortgage default rates, loosening credit conditions and a recent spike in household formations could point to a strengthening housing market in coming quarters.

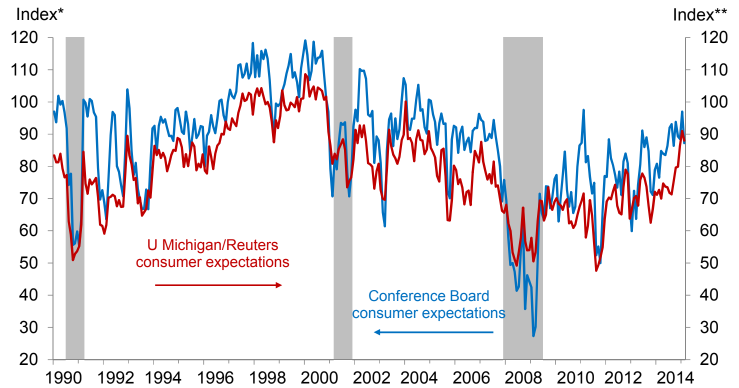
Headwinds to the medium-term outlook could include contractions in the energy sector in response to lower oil prices. However, while energy-related capital expenditures have grown as a share of overall U.S. investment in recent years, they remain only about 1 percent of aggregate U.S. GDP (*Chart 3*). Moreover,

Chart 1
Consumption Expenditures Robust, Net Exports a Drag



*Contribution to total gross domestic product (GDP) growth.
SOURCE: Bureau of Economic Analysis.

Chart 2
Consumers Are Expecting Better Conditions

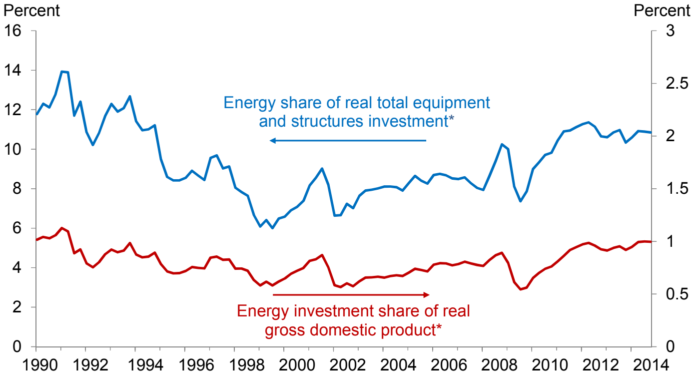


*Seasonally adjusted, 1985 = 100.
**Not seasonally adjusted; 1966:Q1 = 100.
NOTE: Shaded areas indicate recession.
SOURCES: University of Michigan; Conference Board.

small windfalls across numerous industries using petroleum products as an input will likely bolster non-energy-related capital expenditures. On net, the effect of low oil prices on investment, at worst, will be minimal.

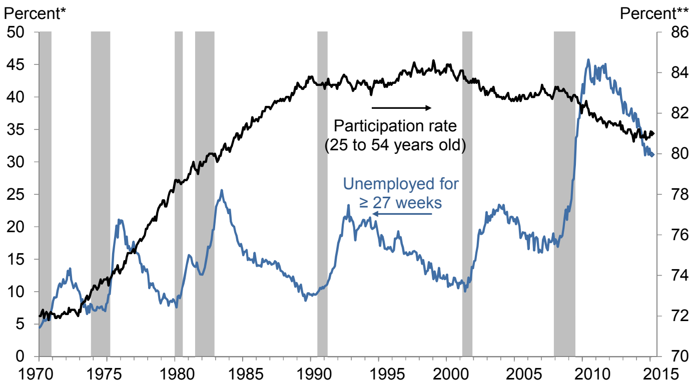
Strengthening U.S. growth relative to major trading partners has led to a rise in the value of the U.S. dollar. This in conjunction with weaker growth prospects in Asia

Chart 3
Energy Sector Share of Investment Is Limited



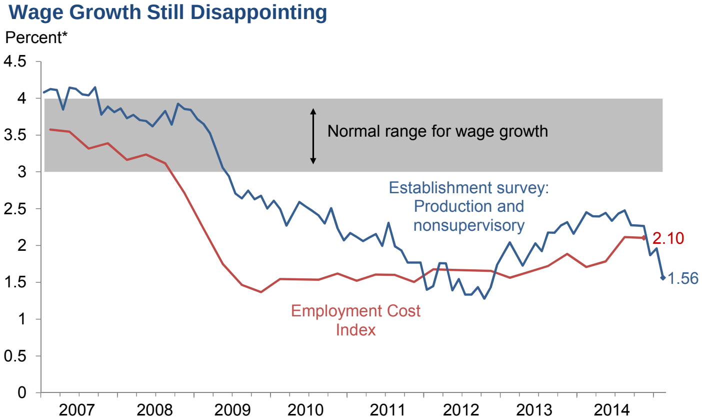
*Real mining and oil equipment and structures investment.
SOURCE: Bureau of Economic Analysis.

Chart 4
Slack Remains in the Labor Market



*Share of total unemployed.
**Seasonally adjusted.
NOTE: Shaded areas indicate recession.
SOURCE: Bureau of Labor Statistics.

Chart 5
Wage Growth Still Disappointing



*Year-over-year growth.
NOTE: The Employment Cost Index controls for compositional shifts.
SOURCE: Bureau of Labor Statistics.

will make net exports a drag on growth in 2015. Additionally, lower import prices will make producer inputs cheaper, softening inflation while spurring domestic consumption.

Job Report Shows Improving Labor Conditions

The February employment report showed signs of a strengthening labor market. Total nonfarm payrolls reached 295,000, with the three-month moving average only slightly lower at 288,000. This is the 12th consecutive month of 200,000-plus payroll gains and a robust signal that labor market conditions are normalizing. Headline unemployment fell to 5.5 percent. Several underlying details of the report, however, indicated that a significant level of slack remains in the labor market. The headline participation rate fell 0.1 percentage points, and the participation rate for prime-age workers declined as well (*Chart 4*). The share of long-term unemployed and workers who are part-time for economic reasons remained at elevated levels.

The slack is responsible for softness in wage growth. The normal range of nominal wage growth—implied by the Federal Open Market Committee's 2 percent inflation target and typical productivity growth estimates of 1 to 2 percent—is 3 to 4 percent. Chart 5 shows that wage growth is well below this range. However, as labor slack diminishes, it is expected that wage growth will accelerate.

Inflation Softens on Strengthening Dollar, Lower Oil Prices

Inflation measures remained subdued in January. The Consumer Price Index (CPI) and Personal Consumption Expenditures (PCE) showed precipitous drops in headline measures. CPI fell to -0.19 percent year-over-year growth, the first reading below zero since the Great Recession, and PCE fell to 0.22. Weak wage growth has been a clear culprit the past few years; however, the recent drop is nearly all attributable to lower oil prices, a volatile component within the headline price computation.

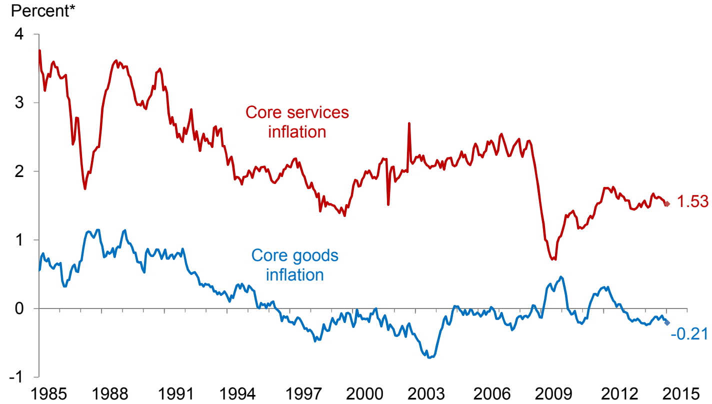
Core price indexes, which strip out the volatile effects of fuel and food costs, also softened in January. The Federal Reserve Bank of Dallas' preferred measure of trend inflation, the Trimmed Mean PCE, dipped slightly to 1.46 percent growth year over year. Core PCE similarly fell, to 1.31. The core PCE inflation component responsible for this softening is primarily in goods rather than services (*Chart 6*). This evidence suggests that downward pressure on import prices, created by a strengthening dollar, have made producer inputs cheaper. As the dollar's strength persists, cheaper inputs via cheaper imports may begin to pass through to final goods, keeping this pressure on consumer prices in the medium term. However, longer-run inflation expectations continue to remain well-anchored.

—Camden Cornwell

About the Author

Cornwell is a research analyst in the Research Department at the Federal Reserve Bank of Dallas

Chart 6
Core Goods a Drag on Inflation



*Year-over-year, seasonally adjusted percentage point contribution to core PCE inflation.
SOURCES: Bureau of Economic Analysis; Federal Reserve Bank of Dallas.