DALLASFED Economic Update
National

Calm amid the Storm: U.S. Economy Sails Through Choppy Data

November 3, 2015

Data released since mid-September suggest that the economy slowed in the third quarter. Evidence of downside risks to U.S. economic growth in the near term include low commodity prices, a strong dollar and increased uncertainty in international markets. However, exposure to these risks is limited, and the underlying growth path for the U.S. economy remains stable.

Strength in Output and Some Labor Market Measures

U.S. gross domestic product (GDP) slowed in the third quarter. The decline was mostly due to a fall in inventories, although contributions from consumption, investment and government also were marginally smaller than in the previous quarter. Final sales to domestic purchasers—GDP less net exports and inventories—remained robust at 2.9 percent. This indicates that the underlying strength of domestic consumption and investment has continued into the third quarter (*Chart 1*).

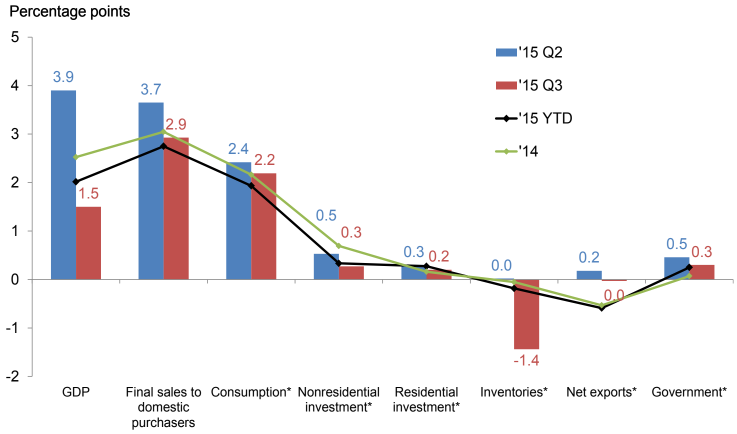
Recent data on households suggest that this momentum will continue. Monthly real personal consumption expenditures (PCE) data for August and September are consistent with robust PCE in the fourth quarter. Monthly real personal income has grown at a similar rate. These reports are supported by October's Conference Board and University of Michigan surveys of consumer confidence, which remain at high levels.

News from the labor market offered some positive signals. Initial claims continued to fall, and the unemployment rate has now reached the Congressional Budget Office's estimate of full employment for the U.S. economy. This evidence of labor market tightening is consistent with signs of wage pressure from the Employment Cost Index. Wages and salaries of civilian workers increased 2.07 percent year over year in the third quarter. A model of wage growth less 10-year inflation expectations predicts that wage growth will accelerate in the following quarters (*Chart 2*).[1]

Weakness in Other Labor Market Indicators and Inflation

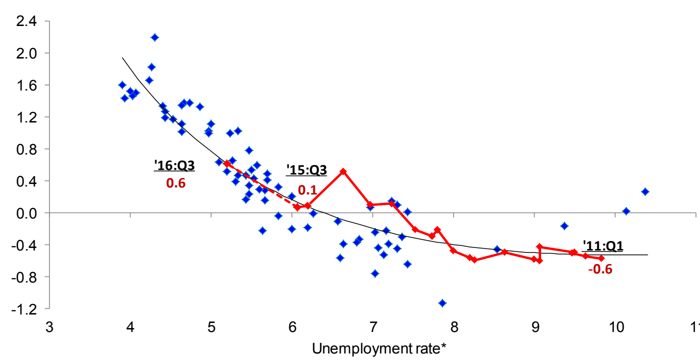
Despite the news of declining unemployment and rising wages, recent reports of slowing job growth warrant caution. Nonfarm payroll job growth for August and September was below expectations and well below the roughly 200,000 monthly pace from 2014.

Chart 1
Inventories Slow Third-Quarter Growth, but Consumption Is Steady



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

Chart 2
Wage Growth Expected to Increase in Following Quarters



*Employment Cost Index wages and salaries growth, less Survey of Professional Forecasters four-quarter-lagged, 10-year personal consumption expenditures inflation expectations, year over year.
**Lagged four quarters.
SOURCES: Bureau of Labor Statistics; Federal Reserve Bank of Philadelphia; author's calculations.

This year, private nonfarm payrolls have averaged 184,000 per month (*Chart 3*). Though this is lower than the 2014 average, it far exceeds the highest estimates for breakeven growth—the number of jobs needed to keep unemployment constant—which is generally 100,000 or lower.[2]

Moreover, slowing job growth is inevitable as the labor pool shrinks. While it is important to note that slack in the economy may remain, headline unemployment suggests that the U.S. is nearing its potential level of output. The Job Openings and Labor Turnover Survey shows that job openings continue to grow relative to the number of employed, implying that the recent weakness in job growth is not entirely due to a lack of labor demand.

If the economy nears a point where labor market slack is exhausted and wages are increasing, inflation should move toward long-term expectations.[3] However, all else has not remained constant. The strong dollar and low commodity prices, including oil prices, have suppressed both headline and core measures of inflation. Headline 12-month PCE Price Index growth remained near zero at 0.16 percent for September. Its cousin, the Consumer Price Index (CPI), was lower still at -0.03 percent.

Core measures of inflation, which attempt to strip out the volatile elements of food and energy, are moving closer to the Fed's 2 percent target for inflation. PCE core, CPI core and the Dallas Fed's 12-month Trimmed Mean PCE inflation measure have all inched upward from lower levels of growth in recent months (*Chart 4*). As effects of a strong dollar and low commodity prices dissipate in the medium term, inflation should move back in line with long-term expectations, which remain anchored around 2.0, according to the Survey of Professional Forecasters.

The strong dollar and low commodity prices will continue to weigh negatively on U.S. manufacturing in the fourth quarter. A strong dollar makes U.S. goods more expensive overseas, driving down demand for manufactured goods. Much of the reduced demand for oil drilling and commodities has affected the growth of new orders for durable goods and, consequently, slowed manufacturing activity. This sluggishness will likely persist throughout the fourth quarter.

Risks Are Mostly External to the U.S.

Uncertainty surrounding international markets continues to spook U.S. financial markets. Indexes of financial stress have increased as equity prices gyrate and bond spreads between risky investments and blue-chip companies widen (*Chart 5*). This stress is well within normal ranges, however, and equity markets appear to have recovered from the precipitous drop in August. Headwinds from slowing growth abroad will continue in the near term, but the U.S. thus far has mostly weathered these effects.

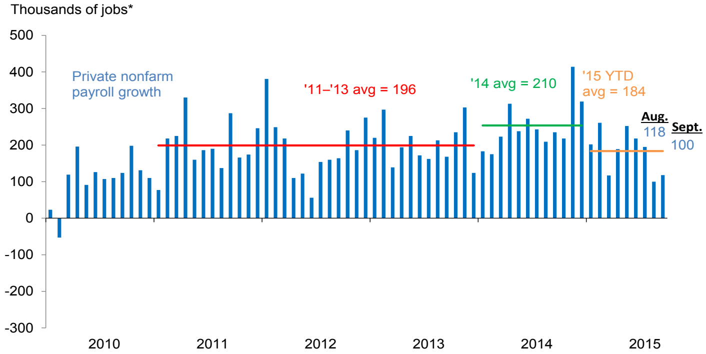
—Camden Cornwell

Notes

1. Specifically, the curve shows results from a regression of four-quarter wage growth (over periods of jobless-rate decreases), detrended using four-quarter lagged 10-year inflation expectations on the four-quarter lagged jobless rate, the inverse of the four-quarter-lagged jobless rate and a constant. In this regression, the coefficient on the inverse jobless rate is large, positive and highly statistically significant, indicating that the relationship between it and wage inflation is strongly nonlinear. For more details, see "Are We There Yet?" by Richard W. Fisher and Evan F. Koenig, Federal Reserve Bank of Dallas *Economic Letter*, vol. 9, no. 13, 2014.

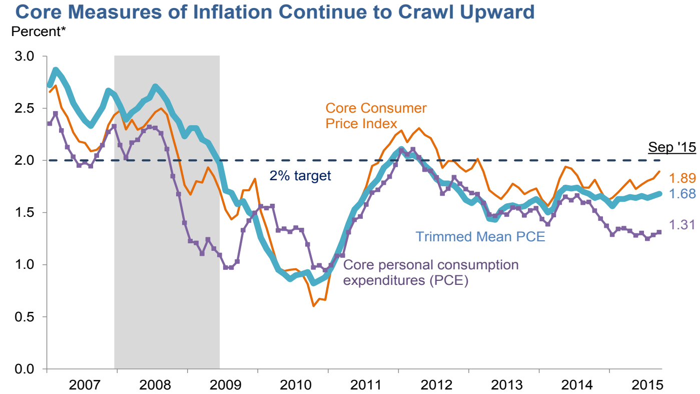
2. "Breakeven Payroll Growth: How Low Is the Bar?" by David Mericle, U.S. Daily Comment, Goldman Sachs, Oct. 19, 2015.

Chart 3
Employment Growth Slows in 2015



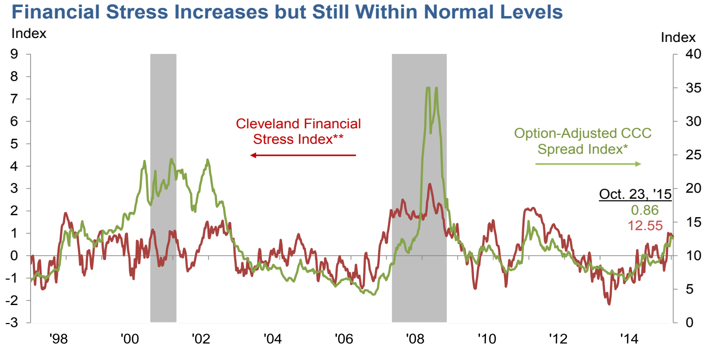
*Month-over-month growth.
SOURCE: Bureau of Labor Statistics.

Chart 4
Core Measures of Inflation Continue to Crawl Upward



*Year-over-year change.
NOTE: Shaded area indicates recession.
SOURCES: Bureau of Labor Statistics; Bureau of Economic Analysis; Federal Reserve Bank of Dallas.

Chart 5
Financial Stress Increases but Still Within Normal Levels



* The index tracks the performance of below-investment-grade-rated corporate debt issued publicly in U.S. domestic markets. Higher values indicate larger spreads against the spot value of the U.S. Treasury curve.
** The index is a coincident indicator of systemic stress in which high values indicate high stress. The index tracks credit, equity, foreign exchange, funding, real estate and securitization markets.
NOTE: Shaded areas indicate U.S. recessions.
SOURCES: Federal Reserve Bank of Cleveland; Bank of America/Merrill Lynch.

3. For a more detailed explanation of the model, see "Inflation, Slack, and Fed Credibility," by Evan F. Koenig and Tyler Atkinson, Federal Reserve Bank of Dallas *Staff Paper*, no. 16, 2012.

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About the Author

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