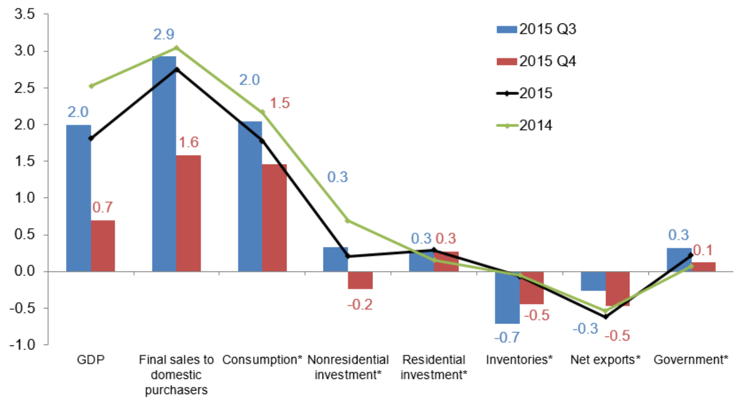
DALLASFED Economic Update
National

Labor Market Strength Supports U.S. Outlook

February 3, 2016

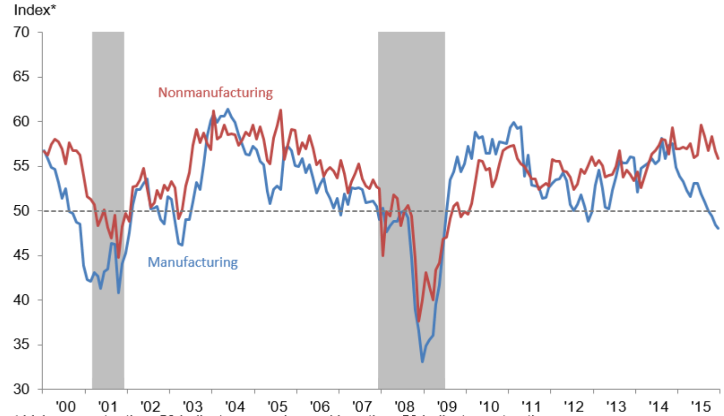
Data released since the December 2015 Federal Open Market Committee meeting supports persistent, yet softer, growth. Service sector businesses continued to expand, while manufacturing activity weakened. The domestic economy has remained largely resilient, however, supported in large part by surprisingly strong labor market indicators and evidence that some core measures of inflation may be normalizing. Downside risks to U.S. growth have increased, particularly due to international factors that have negatively affected U.S. financial markets.

Chart 1
Growth Softer in 2015



*Contribution to total Gross Domestic Product (GDP) growth.
SOURCE: Bureau of Economic Analysis.

Chart 2
Divergence Apparent Between Services and Manufacturing Activity



* Values greater than 50 indicate expansion and less than 50 indicate contraction.
NOTE: Shaded areas indicate U.S. recessions.
SOURCE: Insitute for Supply Management.

Output Growth Weakens in Fourth Quarter 2015

The first release of gross domestic product (GDP) growth for fourth quarter 2015 was lackluster across the board *(Chart 1)*. Part of this weaker growth is attributable to softening manufacturing activity due to lower commodity prices and a rising trade-weighted value of the dollar. Evidence of this effect appears in the nonresidential investment and net exports categories, which cumulatively shaved 0.7 percentage points from overall GDP growth.

Weak consumption growth was largely expected, given data from retail sales and personal income reports received over the course of the fourth quarter. However, softer consumption growth remains puzzling, especially considering strengthening indicators from the household sector. A more detailed breakdown shows that services consumption growth remained robust, yet consumption of goods fell. A decline in commodity prices, all else equal, should support stronger goods consumption, but this effect is not obvious from data collected in 2015. Relative to the current recovery, fourth-quarter consumption growth is normal, suggesting that this is not a worrisome negative signal.

Business Sector Indicators Show Weakness in Manufacturing Sectors

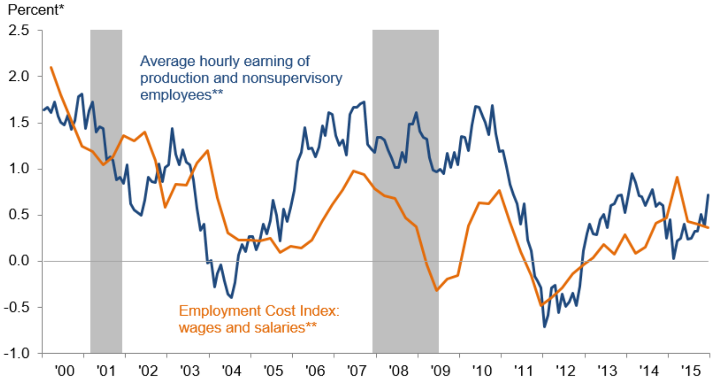
Business sector indicators provide additional evidence of a divergence in manufacturing and service industries. Surveys from the Institute for Supply Management reported a contraction in manufacturing industries, whereas nonmanufacturing purchasing managers indicated continued expansion in December *(Chart 2)*.

Other manufacturing-specific indicators suggested continued softening in December. The Federal Reserve Board's headline industrial production index fell 1.76 percent on a year-over-year basis. Similarly, capacity utilization ticked downward again to 76.5 percent, now 2.5 percentage points below year-ago levels. The Census Bureau's report on capital goods, excluding defense and aircraft, showed a continuing decline in new orders.

Household Sector Continues to Reassure

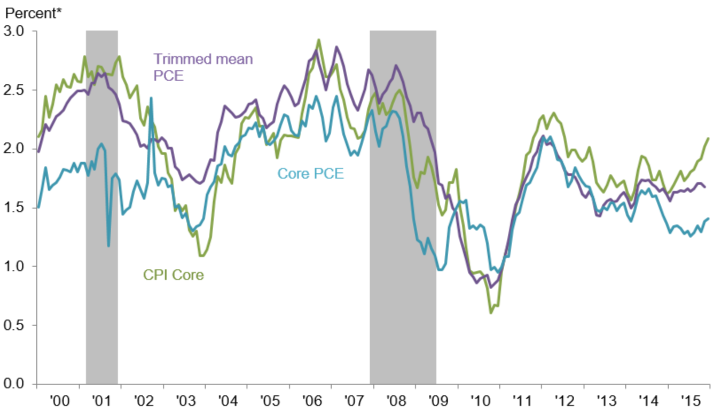
Despite weakness in the manufacturing sector, U.S. households remain on solid footing, supported in large part by a robust labor market. The economy added 292,000 nonfarm jobs in December, well above Bloomberg consensus estimates of 200,000. Measures of unemployment stayed put, with the headline U3 reading of 5.0 percent and the broader U6 unemployment value remaining at 9.9 percent for De-

Chart 3
Real Wages Continue to Climb



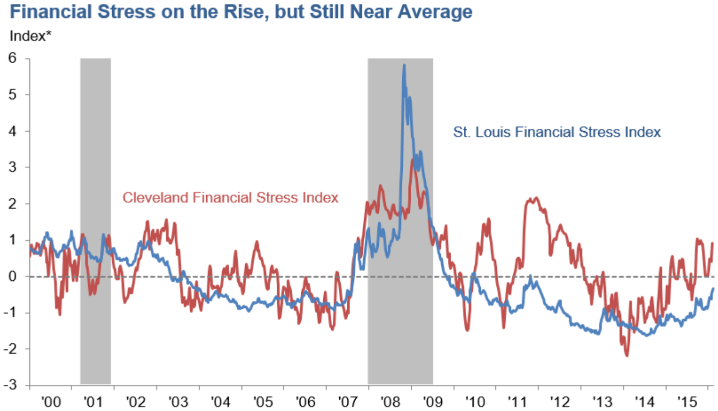
* Year-over-year change.
** Subtracting year-over-year trimmed mean PCE inflation growth.
NOTE: Shaded areas indicate U.S. recessions.
SOURCE: Bureau of Labor Statistics.

Chart 4
CPI Core Inflation Showing Signs of Acceleration, PCE Core Still Soft



* Year-over-year change.
NOTE: Shaded areas indicate U.S. recessions.
SOURCES: Bureau of Economic Analysis; Federal Reserve Bank of Dallas.

Chart 5
Financial Stress on the Rise, but Still Near Average



* Index value of 0 indicates average financial conditions. Values greater than 0 indicate higher-than-average financial stress.
NOTE: Shaded areas indicate U.S. recessions.
SOURCES: Federal Reserve Bank of Cleveland; Federal Reserve Bank of St. Louis.

cember. Moreover, job opening rates from the Job Opening and Labor Turnover Survey remained at all-time highs. These signals have remained resilient, even with declines in oil-and-gas-related employment.

A tightening labor market may be encouraging wage growth. Average hourly earnings of production and nonsupervisory employees ticked upward to 2.4 percent, year over year, in December. A more comprehensive measure of salary and wage growth from the Employment Cost Index remained flat at 2 percent year-over-year growth for fourth quarter 2015. Subtracting trimmed mean PCE inflation from these measures yields a positive real-wage growth that is trending upward *(Chart 3)*.

CPI Inflation Finally Picking Back Up

Inflation showed further signs of acceleration in December *(Chart 4)*. The Consumer Price Index (CPI) growth, excluding food and energy prices, grew 2.1 percent year over year in December. The core personal consumption expenditures price index (PCE) also ticked upward, but remains relatively low at 1.4 percent, year over year. Trimmed mean splits the difference between CPI and PCE at 1.7 percent. It is most likely that headline measures of PCE inflation will tend toward the trimmed mean measure over the coming year.

International Financial Fritz Spills into U.S. Markets

Stock market volatility has increased since the beginning of the year. Following downward revisions to Chinese growth prospects, financial conditions have tightened further and equity prices have dropped *(Chart 5)*.

Financial conditions may have some spillover effects into the real economy. Declines in equity prices tend to decrease household consumption through wealth effects. However, this effect is small and contingent on the persistence of price declines. Moreover, housing wealth continues to rise, offsetting much of the effects from equity markets. On balance, financial stress remains in line with overall averages.

—Camden Cornwell

About the Author

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