DALLASFED Economic Update
National

Certain Indicators Temper Positive Economic Outlook

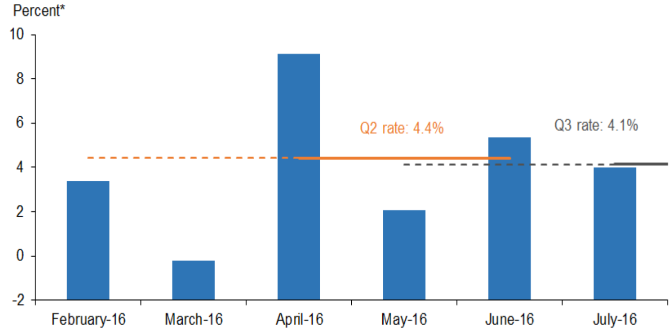
September 26, 2016

Economic indicators released in August and September have been mixed. Consumption spending got off to a strong start in the third quarter, and employment growth slowed but remains solid. However, the more timely purchasing managers' surveys were unusually downbeat. Still, forward-looking indicators and professional forecasts point to stronger growth in the second half of the year. Inflation remains muted and below the Federal Reserve's target rate of 2 percent, with goods and services inflation exhibiting differing trends.

Consumption Gains Trend Downward

Personal income grew at a 3.3 percent annualized rate in July, a slight acceleration from June's 3.1 percent growth. The Conference Board's Consumer Confidence Index rose 4.4 percent in July, reaching its highest level since September 2015. However, retail sales were below expectations in August, dipping 0.3 percent. Real consumption spending continued its solid momentum from the second quarter into July, increasing 4.0 percent annualized *(Chart 1)*. It is on track to grow 4.1 percent annualized in the third quarter, ignoring downside risks from the latest retail sales report. Weak retail sales in August will likely slow down consumption growth during the month, but overall, growth rates will remain above 3 percent—the average monthly rate over the past 12 months.

Chart 1
Consumption Growth Slows in July



*Seasonally adjusted annualized rate.

NOTE: Quarterly growth rates are determined by average of the current and prior two months, represented by the dashed line.

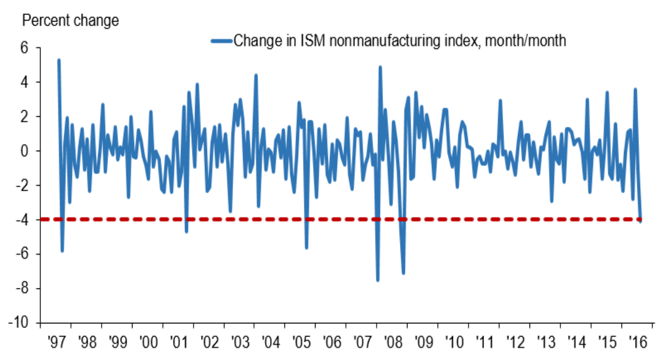
SOURCES: Bureau of Economic Analysis; author's calculations.

Weak Output Indicators Cause for Concern

Real gross domestic product (GDP) growth in the second quarter was revised downward from 1.2 percent to 1.1 percent. Downward revisions in state and local government spending and inventory investment were offset by upward revisions to imports and nonresidential fixed investment. Growth in personal consumption expenditures (PCE) has buoyed overall GDP growth, while negative inventory investment remains the largest drag.

One of the most negative releases in August was the Institute for Supply Management (ISM) Nonmanufacturing Index, which plunged 4.1 percentage points to 51.4—one of the largest monthly drops since the recession *(Chart 2)*. The business activity and new orders indexes were the biggest contributors to this decline. Most of the previous large drops have been associated with major events, such as 9/11, Hurricane Katrina and the financial crisis. The ISM Manufacturing Index also declined to 49.4 in August from 52.6 in July, indicating contraction in the manufacturing sector. These two releases call for caution when projecting economic growth in the near term.

Chart 2
August Drop in ISM Nonmanufacturing Index Among the Largest on Record



SOURCES: Institute for Supply Management; author's calculations.

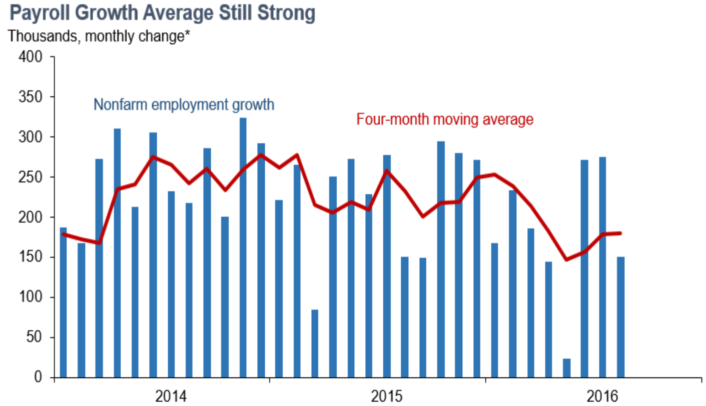
Labor Market Remains Strong

The unemployment rate stood still at 4.9 percent for the third straight month in August. Unemployment is slightly above the Congressional Budget Office's estimated long-term natural rate of 4.7 percent. August's nonfarm payroll employment gains of 151,000 were slow compared with the previous two months of 200,000-plus increases. However, employment gains have averaged 180,000 over the past four months, nearly unchanged from the 183,000 average over the first four months of 2016 *(Chart 3)*. There were no major movements in weekly unemployment insurance claims, with the four-week moving average at 258,500 for the week ending Sept. 17. The jobs openings rate (job openings as a percentage of employment) published in the Job Openings and Labor Turnover Survey ticked up 0.1 percentage points in July, reaching 3.9 percent—the highest rate on record.

Inflation Expectations Unchanged

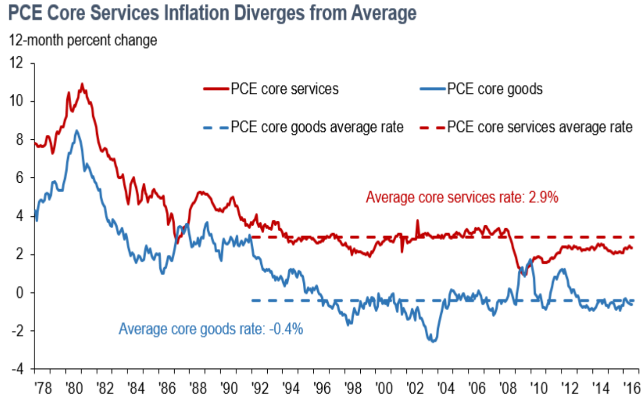
The Consumer Price Index rose faster than expected in August at 0.2 percent, implying that real retail sales were even weaker in August compared with their nominal decline. The 12-month Trimmed Mean Personal Consumption Expenditures (PCE) inflation rate for July was 1.6 percent, in line with the 12-month core PCE inflation rate. The Trimmed Mean PCE inflation rate has now been either 1.6 or 1.7 percent since February 2015. According to the Survey of Professional Forecasters, core PCE inflation will reach 1.6 percent in the third quarter—unchanged from the previous survey—and will only reach 1.8 percent as far as third quarter 2017.

Chart 3
Payroll Growth Average Still Strong



*Seasonally adjusted.
SOURCES: Bureau of Labor Statistics; author's calculations.

Chart 4
PCE Core Services Inflation Diverges from Average



NOTE: Average rates calculated from 1992 to 2007.
SOURCES: Bureau of Economic Analysis; author's calculations.

Divergent trends become apparent when looking at PCE data in depth. Currently, inflation in core goods prices has maintained the level of price stability seen from the early 1990s to the Great Recession, but core services inflation is well below its average rate *(Chart 4)*. Because services make up more than 70 percent of core PCE, this may explain why 12-month core PCE inflation has been below its long-run average rate. One of the largest components of core services—health care prices—has contributed to this slowdown.[1]

Growth Expectations Still Positive

Although GDP forecasts have dipped slightly, they still indicate faster growth in the second half of 2016 compared with earlier in the year. The New York Fed GDP Nowcast stands at 2.3 percent for the third quarter, while the Atlanta Fed GDP Nowcast (as of Sept. 20) stands at 2.9 percent. So while the ISM and retail sales reports were pessimistic, they were not enough to lower growth expectations drastically from late July and would need to be reinforced by additional weak indicators to dampen the outlook over the next few quarters

—Daniel Chapman

Notes
1. More information on this trend is detailed in "Health Care Services Depress Recent PCE Inflation Readings," by Jim Dolmas, Economic Letter, vol. 11, no. 11, 2016.

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About the Author

Chapman is a research assistant in the Research Department at the Federal Reserve Bank of Dallas.