DALLASFED Economic Update

National

Strong Growth and Higher Inflation Mark End of 2016

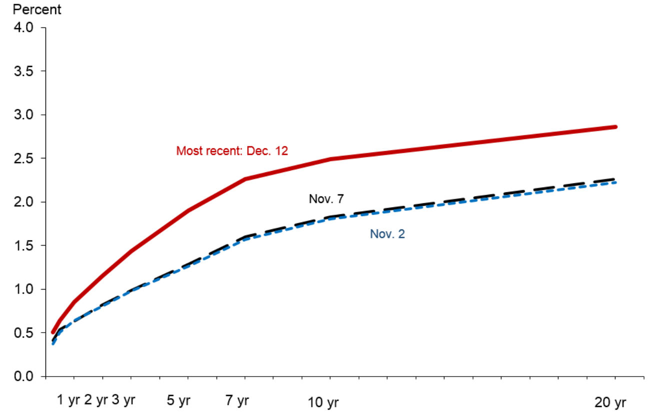
December 16, 2016

U.S. economic indicators released in November and December have been mostly positive. Real gross domestic product (GDP) growth accelerated in the third quarter to its fastest pace in two years, while the unemployment rate fell to its lowest level since 2007. Core measures of personal consumption expenditures (PCE) inflation have edged up toward the Federal Reserve's target rate of 2 percent. Bond yields rose sharply following the presidential election. Professional forecasts point to moderate growth in fourth quarter 2016.

Government Yields Rise After Election

Between the conclusion of the November Federal Open Market Committee meeting (Nov. 2) and the eve of the U.S. presidential election (Nov. 7), there was little change in key interest rates such as the three-month T-bill and 10-year Treasury bond. But since then, there has been a steepening of the yield curve, with the long-term Treasury rate rising more than 50 basis points relative to the three-month T-bill rate as of Dec. 12 *(Chart 1)*. Stock prices have also risen sharply since the election, with the S&P 500 and Dow Jones indexes up 3 to 5 percent. The jump in both bond yields and stocks likely reflects changes in perceptions of future federal government policies, including potential tax cuts, infrastructure spending and deregulation.

Chart 1
Treasury Yield Curve Steepens Since Nov. 8 Election

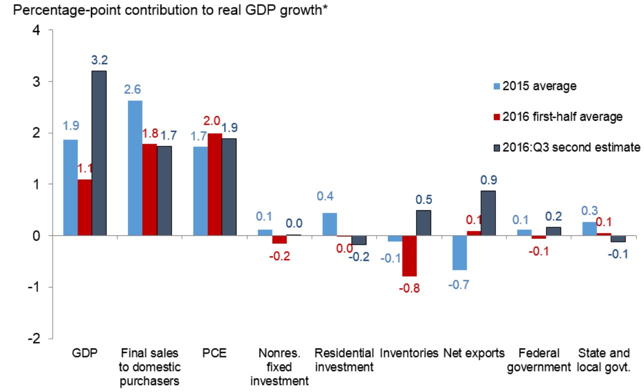


SOURCE: Federal Reserve Board.

Consumption, Output Indicators Trend Upward

Real GDP grew 3.2 percent in the third quarter, an upward revision from the 2.9 percent initial estimate. Net exports made an unusually large contribution due to a sharp rise in soybean exports that was attributable to poor weather in Latin America *(Chart 2)*. The Institute for Supply Management nonmanufacturing and manufacturing indexes have both moved up over the past few months. The nonmanufacturing index rose 2.4 points from October to 57.2 in November, and the manufacturing index climbed 1.3 points to 53.2. These levels are consistent with GDP growth near or above 2 percent when averaged over the third and fourth quarters.

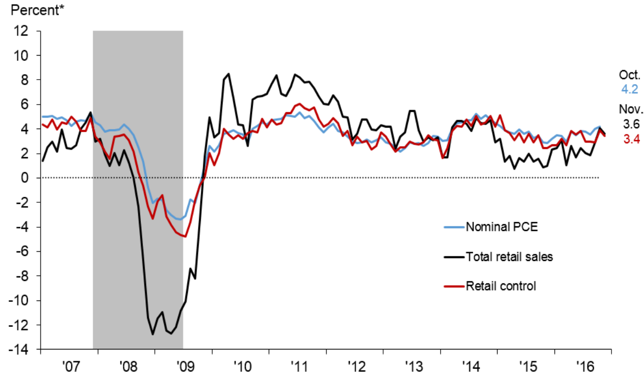
Chart 2
Real GDP Growth for Third Quarter Revised Upward



*Seasonally adjusted, annualized rate.
SOURCE: Bureau of Economic Analysis.

Consumption has also expanded at a solid pace, with nominal PCE growing 4.2 percent year over year as of October *(Chart 3)*. Retail sales in November were slightly disappointing, registering only 0.1 percent growth. However, stronger numbers in October and September suggest that consumer spending levels are still healthy. The University of Michigan's Consumer Sentiment Index reached 93.8 after the election, the highest reading since May and an increase of 6.6 points from October's reading.

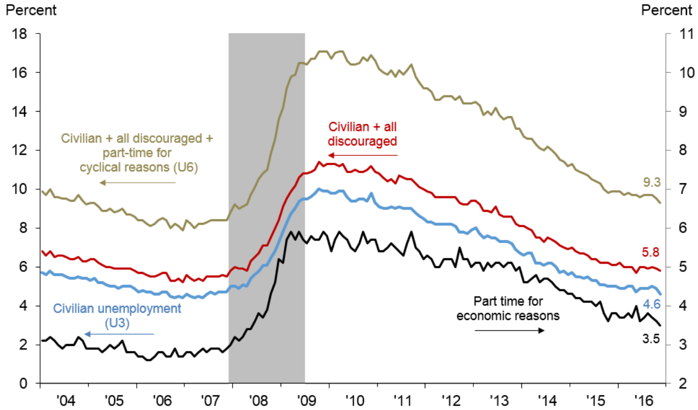
Chart 3
Year-over-Year Growth Solid in Retail Control and PCE Consumer Spending



*12-month percent change.
NOTES: The shaded area indicates recession. Retail control excludes auto, gas station and building material sales, and feeds into the personal consumption expenditures (PCE) calculation.
SOURCES: Bureau of Economic Analysis; Census Bureau; National Bureau of Economic Research.

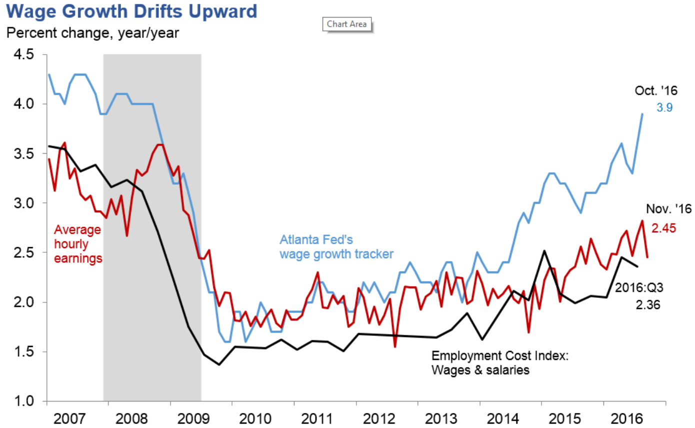
Growth in investment-related indicators was sluggish by comparison. Nonresidential fixed investment contributed zero to real GDP growth. However, a positive sign for the future was a strong increase of 6.6 percent in nominal before-tax corporate profits in the third quarter following a decline of 0.6 percent in the second quarter. Durable-goods orders rose 4.8 percent in October, buoyed by a 12 percent rise in transportation equipment. This stronger-than-expected rise in orders suggests that the slump in business investment may be ending.

Chart 4
Labor Slack Falls in November



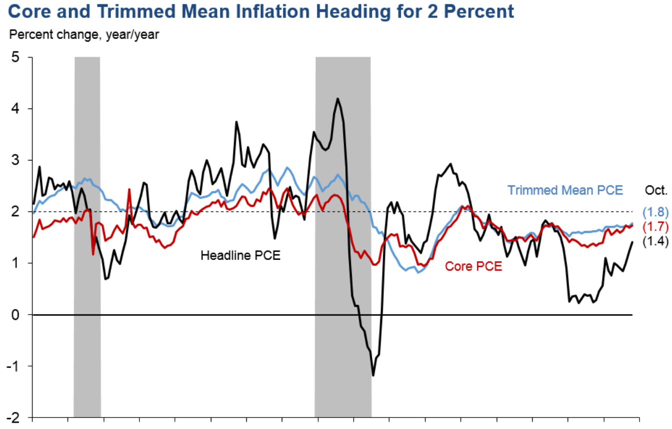
NOTE: The shaded area indicates recession.
SOURCES: Bureau of Labor Statistics; National Bureau of Economic Research.

Chart 5
Wage Growth Drifts Upward



NOTE: The shaded area indicates recession.
SOURCES: Bureau of Labor Statistics; Federal Reserve Bank of Atlanta; National Bureau of Economic Research.

Chart 6
Core and Trimmed Mean Inflation Heading for 2 Percent



NOTES: Shaded areas indicate recessions. The dotted line represents the Federal Reserve's inflation target.
SOURCES: Bureau of Labor Statistics; Bureau of Economic Analysis; Federal Reserve Bank of Dallas.

Labor Market Remains Strong

The headline unemployment rate fell 0.3 percentage points in November to 4.6 percent, accompanied by a 178,000 rise in nonfarm payroll jobs. At a more granular level, the industries with the strongest employment growth included professional services (63,000 jobs), health services (35,000) and leisure and hospitality (29,000). Industries with job losses included manufacturing (4,000) and retail trade (8,000). Oil and gas extraction payrolls rose by 1,100, suggesting that energy activity may have stabilized.

Chart 4 shows the headline plus alternative unemployment rates over time. U6 unemployment—the broadest measure, which includes total unemployed, underemployed and discouraged workers—fell 0.2 percentage points to 9.3 percent in November. U6 unemployment fell slightly less than headline unemployment (U3) because the labor force participation rate dipped 0.1 percentage points to 62.7 percent.

Wage growth has picked up in recent years, with different indicators exhibiting varying degrees of improvement *(Chart 5)*. The Federal Reserve Bank of Atlanta's Wage Growth Tracker exhibited the strongest year-over-year growth of 3.9 percent in October. The reason this measure is much stronger than the Bureau of Labor Statistics (BLS) average hourly earnings growth is that the Atlanta Fed tracks wage growth for those who stay employed (although not necessarily at the same job), while the BLS includes the reemployed and new entrants. The gap between the two suggests that the reemployed and new entrants are receiving lower wages than those of the existing workforce. The BLS' Employment Cost Index aims to measure wage growth while excluding the effect of changes in worker characteristics, controlling for employment shifts between industries and occupations. This explains why its growth has been lower than wage growth for the actual population of workers during the recovery.

Inflation on Track to Reach Fed Target

PCE inflation rates moved toward the Federal Reserve's 2 percent target inflation rate. Core PCE (which excludes food and energy) and Trimmed Mean PCE (the Dallas Fed's alternative measure of core inflation) reached 1.7 percent and 1.8 percent, respectively, on a year-over-year basis in October *(Chart 6)*. Headline PCE rose to 1.4 percent. According to the Survey of Professional Forecasters, core PCE inflation is expected to be 1.6 percent in the fourth quarter—unchanged from the previous survey—and reach 2 percent in 2018.

—Daniel Chapman

About the Author

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