THE ECONOMIC OUTLOOK GROUP

475 WALL STREET
PRINCETON, NEW JERSEY 08540 TEL: 609 - 529 - 1300
WWW.ECONOMICOUTLOOKGROUP.COM

ECONOMIC TALKING POINTS

Bernard Baumohl
Chief Global Economist

October 14, 2009

Consumers Are Emerging From Hibernation

It's one of the few questions that really matter at this point. Can the economy stand on its own without government aid? We have heard many pundits claim the recovery is on "life support." That it is being "held together by tape and glue," meaning the recession would have continued were it not for Washington's aggressive intervention.

But today we got some fresh evidence that the economy is making progress getting back on its own feet. How so when September's retail sales fell 1.5%? Simple. That fall was heavily influenced by the termination of the "cash for clunkers" program in August. Once the program ended, sales plummeted 41% and that sharp decline was the primary cause of last month's fall in retail sales.

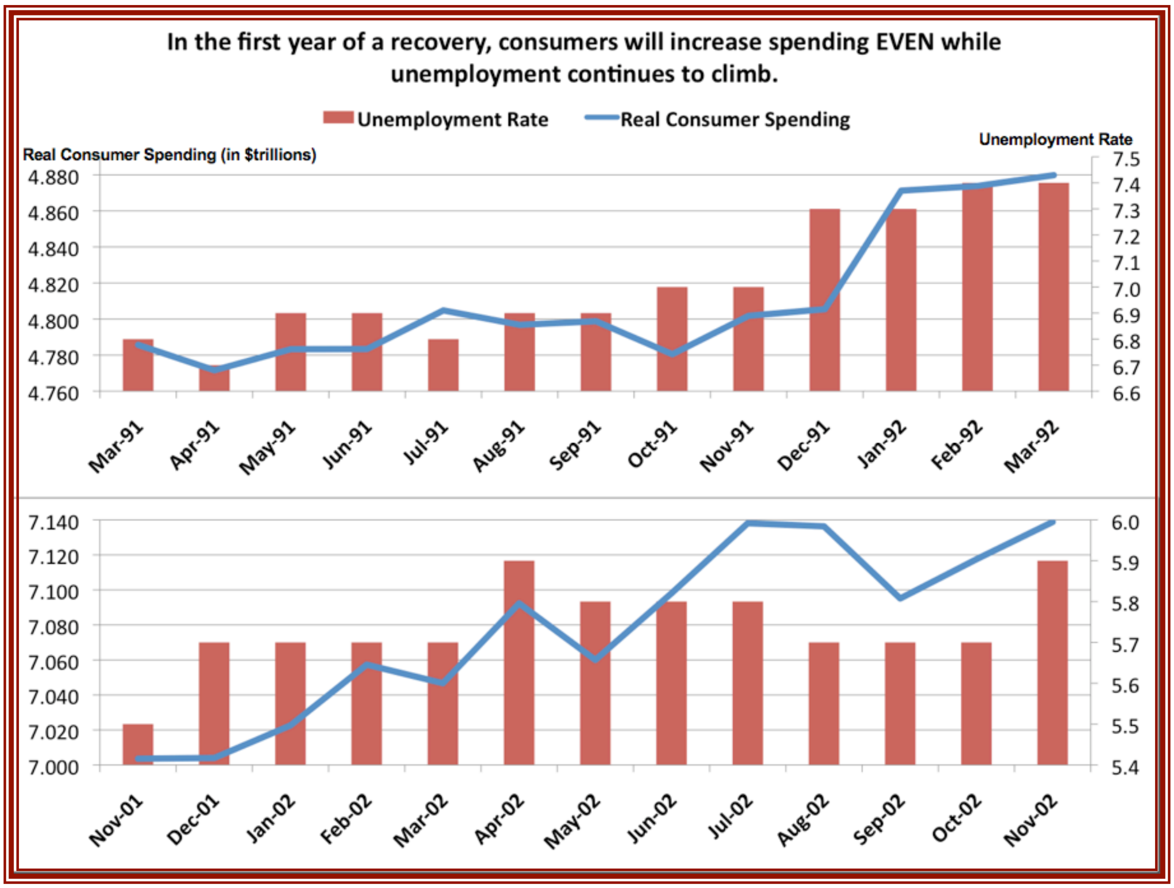
Now for the good news. After stripping out the plunge in motor vehicle purchases, retail sales climbed 0.5% last month, following a 1% jump in August. In fact, retail sales (ex-autos) jumped to $288.5 billion last month, the highest level of the year!!!

Virtually every retail category saw a boost in sales last month: home furnishings (up 1.4%), general merchandise stores (0.9%), clothing stores (up 0.5%), groceries (up 0.9%), sporting good and hobbies (up 0.1%).

But let's go even further. If you remove the three most volatile sectors – autos, gasoline and building material --- retail sales still managed to climb 0.5%, following a 0.7% gain the month before.

All this raises an issue that is often overlooked by analysts. Once a recession ends, does consumer spending pick up **EVEN AS THE UNEMPLOYMENT RATE MOVES HIGHER?** The answer is yes. (See Chart 1.) Past business cycles show that once households become more confident that the economic decline has run its course, they will increase expenditures even in the face of rising joblessness. That may seem counterintuitive at first, but there is a logical explanation for this.

Chart 1.



First, the unemployment rate is a lagging indicator. Why? Those people who were out of work and too discouraged to look for employment will resume their search as economic conditions improve. Statistically that results in a temporary surge in the number of unemployed persons in the labor force--- thereby boosting the unemployment rate. We're projecting that rate to peak at 10.3% in the first half. But the source of that revival in spending does not originate with the unemployed, but from the 90% of those in labor force who ARE STILL working. Thanks to deflation this group has seen their purchasing power increase in each of the last 10 months (based on the BLS' Real Earnings report). This is the group that typically ramps up spending after a recession as confidence grows that their jobs are more secure. That's the pattern that is now emerging.

According to the University of Michigan, consumer sentiment in September soared to the highest level in more than 20 months and this has set the stage for more spending.

Second, we have just concluded the longest recession since the 1930s, which means consumers have shut down spending longer than anytime in recent history. As a result, there is an unprecedented amount of pent-up demand waiting to be unleashed.

Third, the near 60% rebound in stock prices since March plus the stabilization in the housing market have lifted household wealth the last two quarters. True, Americans are still nowhere near recovering the $12 trillion in losses suffered this last recession, but they have seen the recovery process at least begin and that can be reassuring.

Wait...there's more.

In addition to retail sales, the government also released its latest figures on total business inventories. Although this release contains August data on overall sales and inventories, it does provide more evidence on the willingness of households to shop. In fact, inventory levels at retail stores fell 2.3% that month, the biggest one month decline since October 2001! Sure, the August drop in auto inventories played a role. But, again, even if we strip out motor vehicles sales, retail inventories fell 0.3% in August after dropping 0.5% in July.

Bottom line:

We tend to forget just how resilient consumers can be. They have been pummeled by a severe recession, suffered an historic collapse in household wealth, and now face the prospect of a jobless recovery. Those are hardly the prerequisites for a rebound on consumer spending.

And yet Americans appear to be anxious to shop again. I remember a comment once made by Walter Heller, who was a close economic advisor to President Kennedy. At a meeting with journalists, Heller threw up his hands in exasperation because consumers refused to behave in accordance with econometric projections at the time. “Consumers can be very flaky,” he said,” and if you are wrong on their behavior, your forecasts go out the window.” That lesson should not be forgotten. Americans are inherently unpredictable. They will certainly exhibit great restraint during a recession. But once an economy shows signs of recovering, those inhibitions can rapidly fade away.

What everyone ought to be monitoring next is how consumers will finance their shopping so early in the recovery. Do they have the financial resources to sustain any spending?

We think so. Our expectation is that the severe contraction in consumer credit is essentially over. Two indicators now come into the spotlight, both by the Federal Reserve. Watch the monthly consumer credit outstanding numbers to see a turn in the usage of credit. Second, track the weekly releases on bank loans to consumers. Both will tell us a lot whether the consumer is finally back! If they are, the economy could reach a critical mass by late next year where the private sector, not the government, provides the stimulus that keeps this recovery going.

==============================

THE ECONOMIC OUTLOOK GROUP, L.L.C.
475 Wall Street
Princeton, New Jersey 08540

www.EconomicOutlookGroup.com
Tel: (609) 529-1300
