THE ECONOMIC OUTLOOK GROUP

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ECONOMIC TALKING POINTS

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A Decent Start To A Busy Week Of Economic Numbers

Correctly deciphering economic indicators is always important, but it is especially critical at this moment. Analysts are now formulating their 2011 forecasts for the economy and the Federal Reserve will shortly be deliberating on how much new money to inject into the economy when it launches QE -2. Moreover, this week's busy schedule of releases includes early data on October, which lifts the curtain on how the economy is performing this final quarter.

We begin by looking at the latest stats on personal income and spending (PI and PS). While the September's figures are economic remnants of the third quarter, they do represent the most comprehensive figures on consumer spending and thus of great value. There was clear disappointment when the government reported a 0.1% drop in personal income and a tepid 0.2% rise in personal spending. Both came in below expectations and that reinforced the view for many on how fragile this recovery is.

But let's dissect the numbers more closely to see the dynamics playing out here. Clearly, when looking at personal income, we have to focus on its most important contributor, which is wages and salaries (W&S). We know that a vigorous recovery is not possible if Americans fail to receive steady increases in worker pay. In that regard, the 0.1% decline in PI was disquieting.

However, a closer look at the report clarifies what's going on. Wages and salaries in the “private sector” did not fall. The decline in worker pay all came from the public sector as federal, state and local governments slashed their workforce. Remember, government payrolls in September dropped by 159,000 and the elimination of those jobs pulled the overall figures on wages and salaries into negative territory. In contrast, private sector W&S have been rising for three consecutive months.

The point here is that changes in private sector wages and salaries provide a clearer window into the health of the economy than simply blind reliance on the headline W&S.

The increase in private sector pay last month explains why personal spending has held up. To be sure, the O.2% rise in personal consumption expenditures (PCE) was on the weak side. But keep in mind the BEA keeps underestimating in its preliminary releases the month-to-month change in personal spending. For instance, today’s report shows PCE in August was bumped up to 0.5%, from the initial 0.4% increase. The same upward revision occurred in July too. Will we see an upward revision on personal spending for September? We’ll know later this week with release of the October’s employment data. If we see upward revisions on September private payrolls, average hours worked and overtime, it’s virtually certain personal spending for September will be adjusted higher, so stand by.

We were encouraged to see in the personal spending report a strong increase in purchases of consumer durable goods during September. As we said last week in our report on GDP: “Durable good purchases tend to be expensive (e.g., cars, refrigerators, furniture), often require financing and are considered more on the discretionary side of spending. Outlays on durable goods are thus extremely sensitive to how comfortable consumers feel about job and income security.”

It is worth noting that spending on durable goods, which declined every month in the second quarter, has staged a comeback in two of the last three months; it bounced back nicely in July and September, and showed no change for August. Compared with a year ago, durable goods outlays by consumers shot up 9.6% --- four times the growth in nondurable goods and eight times the increase in spending on services.

ISM Manufacturing

Other economic indicators out today help corroborate what we believe is a gradually improving economy. The most timely is the ISM manufacturing index, which showed that activity in October accelerated at the fastest pace in five months! The purchasing manager’s index climbed to 56.9, from 54.4 the prior month. Driving production higher were 11 industries tracked by ISM:

--Apparel, Leather & Allied Products;
--Metals;
--Fabricated Metal Products;

--Electrical Equipment, Appliances & Components;
--Miscellaneous Manufacturing;
--Machinery;
--Transportation Equipment;
--Paper Products;
--Computer & Electronic Products;
--Food, Beverage & Tobacco Products;
--Chemical Products.

Only two have noted lower output:

--Nonmetallic Mineral Products;
--Furniture & Related Products.

There are two other intriguing indexes in the ISM report worth monitoring: New orders and employment.

If new orders increase, it means manufacturers will be busier in the coming months as they ramp up production to satisfy the hike in demand. The new orders index surged in October to 58.9, a five month high. It stood at 51.1 in September.

Hiring in manufacturing accelerated as well last month, with the index climbing to 57.7, compared with 56.5 the month before. Of the 18 different manufacturing sectors tracked, ten reported growth in employment. Four sectors indicated no change in employment, while the other four showed employment declines.

What's driving the jump in manufacturing activity? Foreign demand for US goods has been exceptionally strong, with the export index climbing to 60.5 in October, the highest since last May. Indeed, we have seen numerous international indicators showing the global economic recovery remains on track. China's manufacturing activity in October expanded at its at the fastest pace in six months ---even after the government lifted interest rates and increased bank reserve requirements to restrict bank lending. October represented the 20th straight month of expansion in manufacturing for China. The UK and Germany have also shown strong manufacturing activity lately. Strong overseas demand for US goods is a boon to US manufacturers and will help increase employment at firms with large foreign markets.

Construction Spending

One other noteworthy indicator out today was construction spending, which also took forecasters by surprise after the government reported an increase of 0.5% in September. The consensus expectation was for a decline as much as 1%.

What were the sources of strength in construction? Residential construction spending by private builders jumped 1.8% and public construction outlays climbed 1.3% (with a 2.3% increase in residential building and 1.3% in commercial buildings and structures).

Bottom line:

The next few weeks should bring more clarity on whether the US recovery has, in fact, found new energy. We believe that is the case and expect fourth quarter numbers on employment, consumer spending, exports and even bank lending to eventually demonstrate this.
