

# THE ECONOMIC OUTLOOK GROUP



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## ECONOMIC TALKING POINTS

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### **Strong Retail Sales and Business Investments: Will the Fed Back Away From QE2?**

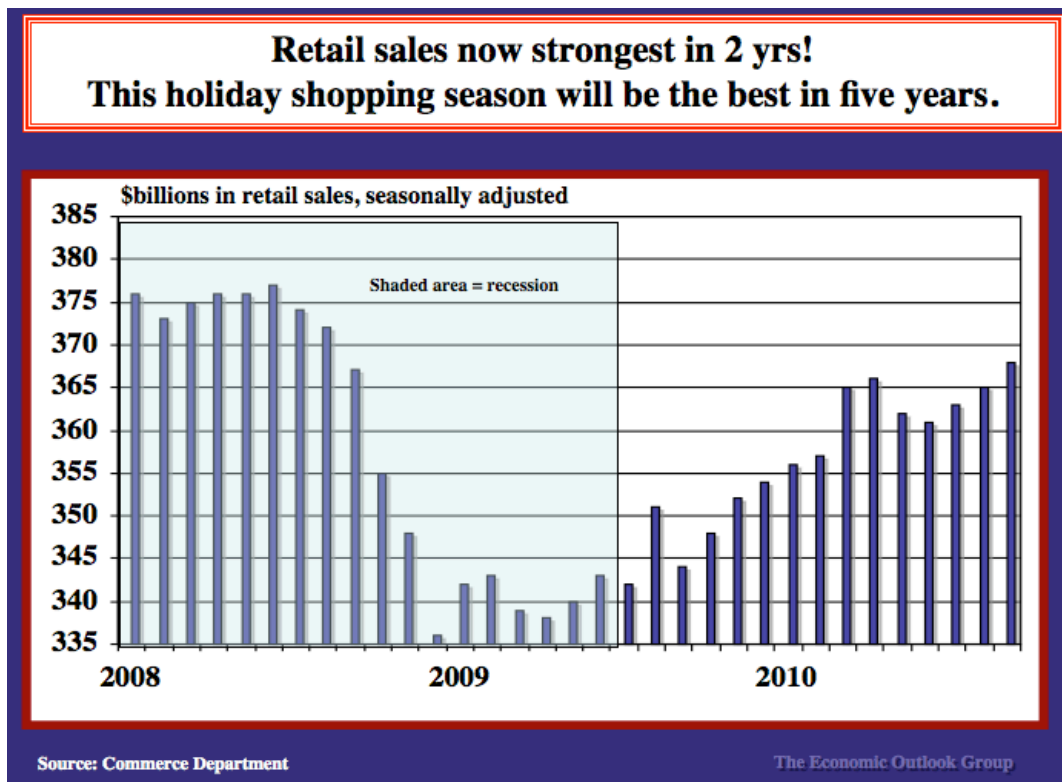
Another important window into the economy came out today and it confirms what we have been saying for months. The fundamentals that drive consumer spending continue to improve. Employers are accelerating hiring, incomes are rising, the pace of layoffs is slowing and the value of stock holdings has increased which adds to household wealth. These positive developments have allowed Americans to become more comfortable about ramping up spending. Indeed, for the first time since the beginning of the year, they have even increased borrowing to finance new purchases.

#### **Retail Sales**

The October retail sales report took many forecasters by surprise not only because October's increase was much stronger than expected, but there was also an upward revision to September. Sales overall jumped 1.2%, the biggest monthly climb in seven months, and September's was changed to show a pick-up of 0.7% (originally 0.6%).

Much of the increase comes from purchases of big-ticket items, products that are typically bought with the aid of credit. For example, auto sales surged 5% last month, to a 12 million unit annual pace, the best in

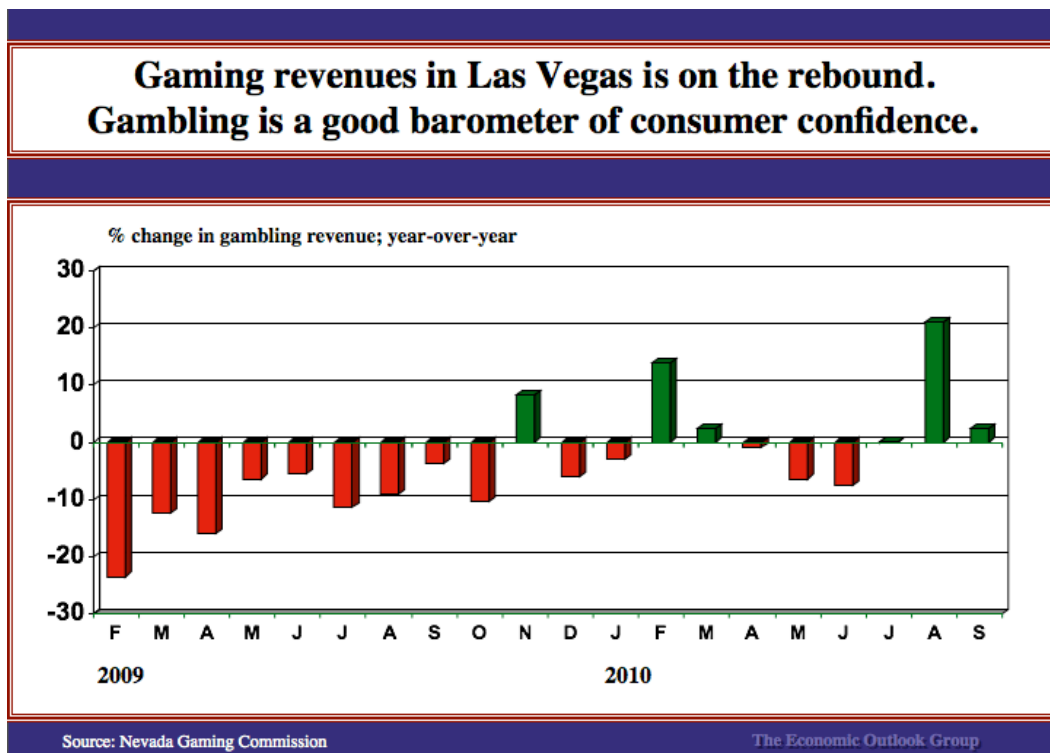
two years (if you exclude the short term burst in purchases from the “cash for clunkers” program in the summer of 2009). As Americans feel more at ease about job security and future income growth, they are also more willing to take on new debt for the first time in a long while. Earlier this month, the Federal Reserve reported that consumers boosted borrowing in September for the first time in eight months! This was only the second increase in the past 20 months. What’s behind the change in sentiment toward debt? For one, households have made significant progress fixing balance sheets, and second, the level of personal savings is now considerably higher than it was the last decade. Both these factors suggest the big declines in the level of debt are coming to an end.



By the way, if you take out the auto component, retail sales climbed 0.4%, to \$306 billion, a record high. But let’s not stop here. Two important components in the retail sales report involve items that are discretionary in nature and thus a fairly good barometer of consumer confidence. One is the amount Americans spend at restaurants and bars. Are consumers willing to eat outside their home more often these days? The answer is yes. Sales at food services and drinking places rose by 0.3% in October, the fifth consecutive monthly increase. Another category representing non-essential spending is sales of “sporting goods, hobby, book & music stores.” That, too, rose 0.7% last month, to its highest level ever. .

Perhaps the ultimate indicator of consumer discretionary spending --- but one *NOT* found in the retail sales report ---is gambling. It stands to

reason that a deteriorating economy with poor job creation tends to dissuade Americans from spending much time at the major casinos. In contrast, an improved economic climate usually increases attendance at the gambling tables. Thus, one of the statistics we track closely comes from the Nevada Gaming Commission, which tallies up gaming revenues. After many months of persistently falling revenues on the Las Vegas Strip, they have now turned around with increases in each of the last two months (August and September). We view this and other discretionary measures of spending as more reliable gauges of consumer confidence than the actual sentiment polling surveys.



All this augurs well for the 2010 holiday shopping season. While the National Retail Federation has forecast a rise of 2.3% in sales this year compared with last year, our analysis suggests the actual increase will turn out to be double that.

### **Business Inventories**

The government also reported that business inventories shot up a hefty 0.9% in September. Some have expressed concerns that this build up in stocks could be unintentional and lead to cutbacks in future production, which of course would cut into GDP growth and employment. But there is just no evidence that a significant slowdown in inventory investing is looming. Business sales rose 0.5% in September to the highest level in nearly two years! All three categories --- wholesale, retail and

manufacturing--- saw big increases in sales. Moreover, the inventory sales ratio remains at 1.27 months, which is just a stone's throw from its all time low of 1.23 months. Inventory levels, while increasing, are still quite lean. In previous expansions, we usually see the ratio above 1.30 months.

The bottom line from this morning's stats is that the American consumer has come alive, and given their importance to both the US and international economy, the outlook for the recovery keeps getting better.

## **What of QE2?**

This inevitably brings us to back to questioning the necessity QE2. As we said in our recent ***Economic Talking Points***, we believe the Federal Reserve should be prepared to pull back from QE2 given the resilience of consumer spending and the rise in both business investments and exports. If they proceed with their agenda and purchase the additional \$600 billion in securities at a time when economic activity is picking up speed, the Fed dramatically increases the risk of unmooring inflation expectations. Precisely when such inflation expectations will spike is anyone's guess. But you cannot indefinitely have an expansionary monetary policy and accelerating economic growth --- and still expect inflation worries to remain subdued. The financial markets, specifically bond investors, will at some point rebel. Once that happens, it could be disastrous for the economy. Instead of lowering rates on medium and long term bonds, which is the Fed's goal, QE2 may inadvertently cause the opposite to happen with bond holders suddenly rushing for the exits to avoid losing money. The result would be a precipitous rise in market rates which will quickly defeat what the Federal Reserve and the White House have been trying to achieve for so long, namely a more robust recovery and faster job growth.

What now? Everyone should closely monitor Bernanke's upcoming speeches and testimonies to see if the central bank is considering backing away from the full implementation of QE2. We expect the Fed will send such a signal before the year is out.