THE ECONOMIC OUTLOOK GROUP

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ECONOMIC TALKING POINTS

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September 14, 2010

They're BACK! The Consumer is Healthier and Gearing Up to Spend Again

We have long said the economy will show fresh signs of life in the final months of the year, with the primary source of this vigor coming from consumers. Today, we got fresh evidence that such a rebound is underway.

Both the August retail sales and the weekly tally on chain store sales by the International Council of Shopping Centers were bullish. These reports, along with some others we'll mention, tell us the US economy is in a much better place than it was a few months ago. Don't be surprised if forecasters start to revise their GDP numbers upwards and closer to our projections. We're looking at GDP growth of 3% in the fourth quarter, and 3.5% on average for all of next year. Most forecasters are for the moment content to project half that pace. But we believe the erasers will soon come out for them.

We begin with retail sales, which increased 0.4% in August, making it the second straight month consumers have increased spending at stores and restaurants. The latest pick-up came despite the fall in autos purchases. Indeed, if you take out the auto component entirely, overall sales jumped an even stronger 0.6%, which turned out to be twice as much as expectations. Of the 13 different categories of spending, just four showed declines. The month before twice as many saw a drop in sales.

All told, Americans spent a $363.7 billion at retailers in August, the most we have seen since April. You may recall that consumers went into caution mode in the intervening months as the economy hit several speed bumps, including fears that a European sovereign debt crisis would

spread to the US and halt the recovery. In addition, there were growing concerns a property crash was imminent in China and this would derail the global economic comeback. However, both issues pose less of a threat now.

The increase in consumer outlays has continued into this month. The International Council of Shopping Centers, which looks at weekly sales of US chain stores, reported that spending rose 0.8% in the week ending September 11th, and is up 2.6% from a year ago.

We expect to see consumers ramp up spending even more. Here are a few reasons why.

1. Household finances continue to improve. Americans have dramatically reduced their debt load and increased savings. For example, household debt service as a percentage of disposable personal income, an important gauge of financial stress, now stands at 12.46%, the lowest in a decade.

2. The personal savings rate has risen to 5.9%, three times the amount it was just prior to the start of the last recession.

3. In its August report on the state of consumer finance in the second quarter, the Federal Reserve Bank of New York found that for the first time since early 2006, household delinquency rates have declined. Moreover, consumer debt continued to shrink that quarter, marking a trend that has been ongoing for six quarters. The result: Household balance sheets are in much better shape and that places consumers in a position to spend again, albeit (hopefully) more prudently.

4. Though the unemployment rate remains stubbornly high, Americans are aware that companies have been hiring workers every month this year. The pace of employment will likely pick up in coming months. One reason for our optimism is based on a little-noticed government release last week. The Labor Department published the JOLTS (Jobs Openings and Labor Turnover Survey) report for July. It showed the private sector is making a lot more jobs available. The number of job openings among firms that month jumped to 2.723 million, the most since December 2008! More job openings lead to greater employment.

5. Consumer confidence levels have also been improving.

Investor's Business Daily and TechnoMetrica Market Intelligence said their IBD/TIPP Economic Optimism Index rose in September. This survey polls more than 900 adults generally in the first week of the month.

The Conference Board acknowledged in its latest series that consumer confidence moved up in August, a conclusion shared by the University of Michigan with its sentiment numbers.

In addition to all these positive developments, the government also reported this morning that business inventories in July jumped by the most in two years, hardly a sign of a recovery on the verge of faltering. The move to rebuild stockrooms and back lots suggests U.S. companies are not backing away. In fact, we could be seeing more such increases in investments, since the inventory sales ratio still stands at a modest 1.26 months, just a hair above its all time low of 1.23 set last April.

All this is not to say there is clear sailing for the economy from this point on. The single biggest obstacle to faster growth remains an arterial blockage in the flow of credit to small and mid-size businesses and that is something the Federal Reserve will have to address more aggressively. One way to speed up the flow of credit to this sector is to create incentives for banks to lend.

How? We have long ago argued that the Fed needs to eliminate the 0.25% interest rate it pays to banks on their excess reserves. Those payments never made much sense in the current economic environment, where the greater worry is deflation, not inflation. Bernanke has, on multiple occasions, publicly chastised banks for not making more loans to small and mid-size firms. Yet, at the same time, the Fed continues to reward lending institutions for keeping all this money idle. Where's the logic?

One of the policy assumptions we built into our forecast is that the Fed will either scale back or end those payments this year on a temporary basis to make more credit available to these companies. Such firms are responsible for 70% of all new hiring in a recovery and the Fed has, in effect, inhibited the flow of credit to this sector by paying lenders to do nothing with all that liquidity. That needs to change.

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