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ECONOMIC TALKING POINTS

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Bleak Retail Sales and Weak Business Spending: A Brief Pause in the Recovery

It's difficult to retrieve any positive factoid in June's retail sales numbers. They dropped another 0.5% last month, after falling 1.1% in May. What is unsettling is that with two consecutive monthly declines in consumer spending, employers may feel even more justified in holding off new hiring until the economic recovery demonstrates more conviction.

Though retail sales did manage to grow seven straight months prior to May, evidence continues to mount that consumers have lately begun to cut back on shopping. Other indicators out recently (e.g., housing, durable goods, ISM) also confirm the economy has downshifted during the second quarter. This afternoon the Federal Reserve released the minutes of the June 22nd-23rd Federal Open Market Committee meeting and it noted that the economy "softened somewhat."

The question is will this economic slowdown be short-lived, that is one limited to the second and third quarter, before returning to a cruising speed of 3.5% to 4% growth later this year and through 2011?

Or are we truly facing a "New Normal" type recovery, with the economy condemned to a growth recession pace of 1% to 2.5% the next several years as it struggles to reboot from the 2008- 2009 global financial crisis (and you can stretch the dates to 2010 if you include Europe's sovereign debt mess)?

Our analysis concludes that the current economic slowdown will not last beyond the third quarter, and that we are far more likely to see consumer spending, employment and growth overall accelerate later this year.

Before we explain why this is our dominant forecast, let's first look at the two main indicators out today.

Retail Sales

Clearly, Americans spent less at retailers in June. Auto sales, home furnishings, building material and garden supplies, food and beverages, sporting goods, and gasoline stations all reported fewer revenues for the month.

However, there is an important distinction to make with this series. Retail sales are presented in nominal dollars and thus do not take into account changes in prices. Since many of these goods have been subject to price deflation (such as on home furnishings, gasoline and food), we'll have to wait until Friday when June consumer prices are released to better understand whether the declines in retail sales were due to falling prices or actual demand, or both. (Case in point: Gasoline purchases were down 2% in June, but the average price at the pump also declined by more than a dime compared with May.)

Secondly, let's also bear in mind that April, May, and June are historically the slowest months of the year for stores. Not only is demand softer those months, but retailers also rush to cut prices in order to generate more sales during such lackluster periods.

Finally, while consumer spending accounts for 70% of all economic activity, the retail sales component represents only one-third of personal expenditures. The rest accounts for spending on services and this typically picks up during the early summer months as people spend more on tourism and other leisure activities. It's one of the reasons why the broader measure of total personal expenditures --- which includes services --- has shown no let up. (For instance, though retail sales fell 1.1% in May, total personal spending was up 0.2% that month.)

Business Inventories

After observing the weakness in consumer spending on goods, companies have taken steps to wind down their purchases of new inventory. Stockpiles rose by just 0.1% in May, the smallest increase so far this year. Every sector --- manufacturers, retailers and wholesalers --- saw fewer sales in May and this will reduce the urgency to replenish inventories in coming months.

A slower build up in inventories will also pare back GDP growth in the second and third quarters and likely curb new employment in manufacturing and retailing. About the only positive news we can see here is that inventory levels are very much in line with sales at this time, with the I/S ratio in May at 1.24 months, just above the record low of 1.23 months during the previous month. Thus any resumption in consumer outlays should

quickly be followed by a jump in business spending to replenish shrinking stockpiles.

The latest weakness in both business inventories and retail sales add to the growing body of evidence that the recovery is now struggling. Our view is that this has been the result of perceived new risks to the economy in recent months.

- (1) Americans have been sidetracked by the eruption of the sovereign debt crises in Europe. Speculation was rife that it would lead to the break-up of the Eurozone, harm European banks and trigger another global financial crisis.
- (2) Another concern was the debate in Congress on financial reforms and whether that bill will ultimately hurt bank lending and hamper the capital markets.
- (3) Last, but certainly not least, many business leaders and investors were increasingly nervous that Chinese policymakers might falter in their plans to prevent a collapse in property prices and inadvertently produce a hard landing for the economy. With the fortunes of emerging countries, commodity prices, and exporters worldwide linked to the performance of China's economy, any sharp pull back of growth in the world's most dynamic economy would have dire consequences globally.

On a macro US level, all three of these threats likely persuaded American employers to shelve hiring plans and pare back business spending until there is greater clarity on where the US and international economies are headed.

We believe that clarity is starting to return.

- (1) The climate of crisis in Europe is abating. Investors are growing more confident that Europe's banks will ride out the sovereign debt mess. Fears of a dissolution of the Eurozone --- an outcome we dismissed early --- has faded, if not disappeared. The euro has bounced back markedly since its June 7th low of \$1.18 level to the dollar, and now stands at \$1.27. This week Greece sold Treasury bills, their first such auction since being bailed out in May, and the investor response was surprisingly strong. Moreover, the cost of credit default swaps to insure against a default by major European banks and insurers has been declining. Later this month, European officials will release the results of the stress test and there is growing confidence it will show that most of the institutions have sufficient capital on hand. The view that the worst is over for Europe has also driven European stock to their highest valuations in two months.
- (2) Work on the financial reform bill is virtually complete and the President is expected to sign it into law this month. With financial regulatory uncertainty now gone and the new rules of the game getting clearer, we expect to see financial institutions ramp up lending. In fact, commercial and industrial loans have just begun to turn up in June, the

first increase since October 2008, according to the Federal Reserve.

(3) As for China, history should serve as a guide to the success of its policymakers in navigating their economy out of trouble. They have an enviable track record of achieving a soft landing when desired. Over the last 20 years, Chinese policymakers adroitly steered the country away from several global economic storms, including the Asian financial crisis and the Russian debt default in the late 1990s, the collapse of the [dot.com](#) bubble in the US, and even escaped the 2008 – 2009 global economic downturn.

Those who worry about a US-style property collapse surfacing in China should know the Chinese real estate market bears little resemblance with that of the US. Homeowners in China are required to put a down payment of 20% to 50% when buying a home (the difference in the percentage depends on whether it is a first, second or third home being purchased). In the US, Americans were able to buy a home with little or nothing down. Nor did China develop a derivatives market with real estate backed securities anywhere close in scale to that of the US.

Will the Chinese economy slow in 2010? Yes, its quarterly pace of 12% growth will not be repeated the rest of the year. Nevertheless, our forecast calls for its economy to expand 9.7% in 2010, versus 9.1% in 2009.

The bottom line:

The anxieties raised by Europe's sovereign debt problem, the uncertainty over the financial regulatory bill in the US, and China's credit tightening policies gave rise to a new round of pessimism about the future. But the global economic backdrop is starting to improve for reasons cited above and this will bring renewed confidence by late summer/early fall that the recovery is gaining fresh traction. Keep your eyes on two key measures from this point on: One is bank lending and the other is employment in the private sector. Both should accelerate much more noticeably by the fourth quarter.