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ECONOMIC TALKING POINTS

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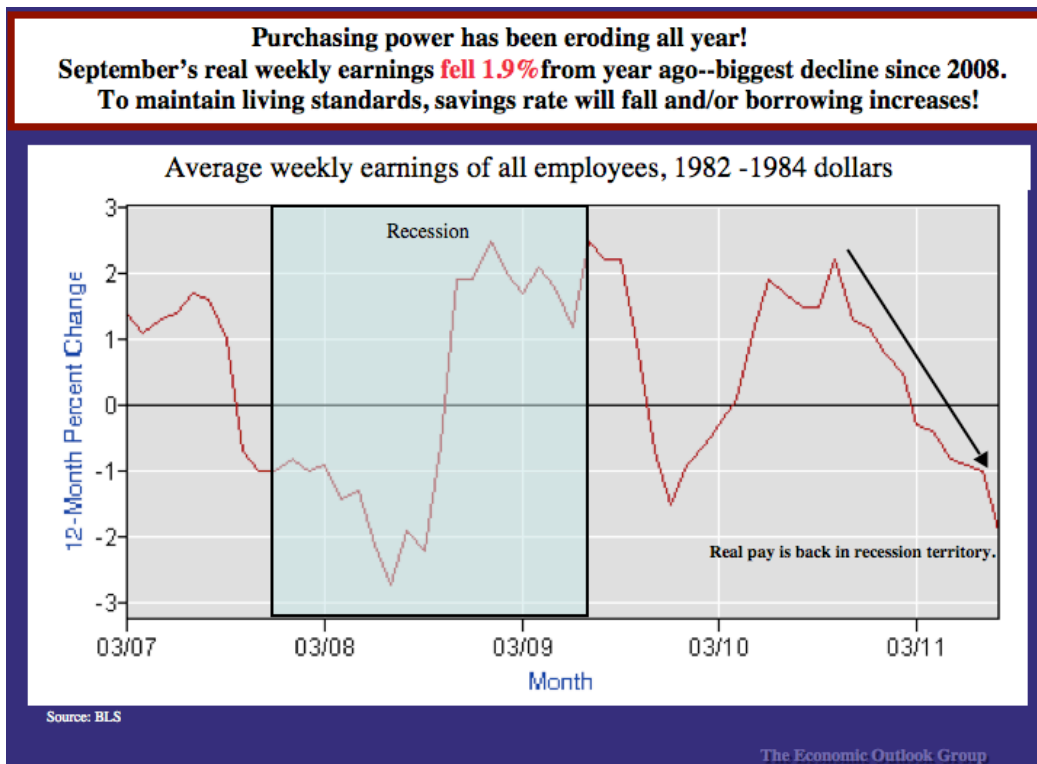
October 14, 2011

Retail Sales Gets Stronger. Are Consumers Really Coming Back?

Here's what is so fascinating about September's fairly strong retail sales report. The 1.1% jump in spending last month (up 0.6% if you take out auto purchases) can certainly be viewed as a non-recessionary number. It's the biggest jump since February. The government even posted a brighter picture for July and August when it revised retail sales higher for both months. At first glance, the latest numbers would suggest that Americans are becoming more comfortable about spending again, prompting retailers to exhale with relief since it may presage a better holiday shopping season. But we fear that exhale is way premature.

Why? Something has to give here. The math is just not there. It is simply not possible for consumers to accelerate spending when they suffer a steady deterioration in purchasing power. Wages have been losing ground to inflation all year and the month of September saw the largest annual decline in real pay since 2008! (See graph 1.)

Figure 1.



The severe erosion in purchasing power, not surprisingly, has pummeled consumer confidence to near record lows. The latest weekly tally on consumer moods from Bloomberg's Consumer Comfort Index showed that pessimism among Americans fell to minus 50.8 in the week ending October 9th. Their survey notes that it was the fourth consecutive week confidence remained below minus 50, a trend that has occurred only three other times in the survey's 26-year history!

Backing up that depressing news was the University of Michigan's Consumer Sentiment Index. Their main confidence measure fell to 57.5 in early October, from 59.4 in September. Most alarming in that report is that consumer expectations of future conditions --- which has a greater influence on household spending --- plunged to its the lowest level in more than 30 years!

What else can you expect? With the September job numbers now in, we see that companies have scaled back hiring every quarter this year (averaging 191,000 a month in the first quarter, 138,000 in the second, and 117,000 in the third).

Given the combined backdrop of poor wage growth, a dismal labor market and falling confidence, we have to ask how Americans can possibly ramp up spending? More specifically, how are shoppers filling the gap between income and consumption? Again, something has to give.

The answer is embedded in a variety of other recent economic reports, and in policies coming out of Washington. First, there is fresh evidence that the deleveraging process among households may be coming to an end.

Every week, the Federal Reserve releases a report on the change in assets and liabilities of commercial banks (also identified as the H.8 series) and one table we have been following closely tracks “outstanding credit cards and other revolving debt.” (See figure 2.) Americans have been paying down such short-term debt continuously since 2009 in an unprecedented effort to deleverage. However, that process appears to have ended. Short-term debt has turned up every month since May and we have to wonder whether household financial stress has now reached a point where more and more Americans *have* to borrow to offset the decline in real pay.

Figure 2.
October 7, 2011
Selected Assets and Liabilities of Commercial Banks in the United States
Percent change at break adjusted, seasonally adjusted, annual rate

	2006	2007	2008	2009	2010	2010 Q1	2010 Q2	2010 Q3	2010 Q4	2011 Q1	2011 Q2	2011 May	2011 Jun	2011 Jul	2011 Aug
Credit cards and other revolving plans	5.3	7.0	4.5	-6.2	-11.0	-15.0	-11.9	-11.1	-8.1	-6.8	-1.3	1.2	7.3	0.2	0.6

Source: Federal Reserve

Others have been forced to dig into their modest savings to finance recent consumption. The personal savings rate has fallen from 5.3% in June to 4.5% in August (latest available). In dollar terms, personal savings in August stood at \$519.3 billion (saar), the lowest since December 2009! Also helping households to shop were the payroll tax cuts and transfer payments this year. (That raises the question of whether a recession next year is more likely if Congress fails to extend the payroll tax cut and unemployment assistance.)

Interestingly, even retailers question whether consumers are really rushing back. Stores have so far acted cautiously to keep their own inventories in check. No retailer wants to get stuck with unsold goods in this economy. Remember, inventories are typically bought on credit and if sales turn soft later this year, it forces retail executives to liquidate those goods through massive discounting and sales, actions that tend to squeeze cash flow and hurt earnings. This morning’s report on business inventories showed the inventory sales ratio for August was unchanged at 1.34 months. But here’s the rub. The effort by retailers to keep their inventories trim is starting to put pressure on manufacturers, who are

getting fewer orders. Take a look at September's ISM new orders index to manufacturers and you see it has been contracting for three consecutive months.

Bottom line:

Many will cheer the improvement in retail sales and see it as evidence that economic activity is building new momentum. Indeed, some private forecasters have raised their GDP forecasts for the rest of this year and 2012. As much as we want to see a genuine improvement in the economy, we worry that the latest pick up in retail sales cannot be sustained because the underlying fundamentals still do not support such a trend.

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