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ECONOMIC TALKING POINTS

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It's All Up To The Consumer At This Point (and the flow of credit)

At this early stage of the recovery, it's not inflation, or the widening budget deficit, or even the unemployment rate that will determine whether the economy can generate healthy growth in coming months. Frankly, those are not the most important indicators to watch right now. The critical statistics at this juncture in the business cycle are those that impact consumer spending. Yes, the federal stimulus program is been a net positive so far. And yes, the recent trend by business to increase spending in order to replenish shrinking inventories has contributed to growth. But for this recovery to accelerate from meager growth to a genuinely palpable expansion, we need to see a revival in consumer spending. They have to play a greater role in the recovery process. We therefore have to shift the spotlight to those factors that strongly affect consumer psychology and influence expenditures:

Are American households sufficiently confident that the job market is starting to turn around?

Are they less anxious about their personal and retirement investments now that the stock market has rebounded 50% since its March lows?

Is there a sense of relief that the value of their largest asset ---their home – has stopped depreciating?

Do the 90% of those in the labor force who are still working feel more secure about their jobs and future income now that employers have slowed the pace of layoffs?

These are the issues that will impact consumer expenditures the rest of the year and through 2010 and determine whether this recovery is durable.

We got some preliminary answers this morning with the release of the retail sales report. August sales at retailers shot up 2.7%, the best showing in three years. Undoubtedly, the cash for clunkers program played a role in beefing up retail purchases last month. More than half of that increase came from the jump in sales of motor vehicles. The government program lifted auto purchases by the most in 8 years.

But that is not the most newsworthy stat in this report. Take out the auto component and retail sales was still up 1.1%, the strongest showing in half a year. Indeed, much of that spending would be considered discretionary: electronic and appliance stores (up 1.1%, more than offsetting the July drop of 1%); Clothing and accessories (up 2.4%, following an increase of 0.2% in July); Sporting goods, hobbies, book and music stores (shot up 2.3%, compared with a decline of 0.6% the previous month); general merchandise stores (up 1.6% last month versus a fall of 0.3% in July). Americans even felt comfortable enough to spend more at restaurants and bars last month (up 0.3% compared with drop of 0.2% the month before).

Of course, we know that purchases of gasoline also contributed to the overall total. But here again, even if we strip out all auto and gasoline purchases, consumer spending held up at a fairly respectable 0.6%. It was only the second increase for this narrower group in six months.

Does this mean consumers are starting to return to shops and restaurants after laying low this past recession? Yes. Don't underestimate the power of pent-up demand. The potential impact that pent-up demand can have once it is released is significant. This recession turned out to be the longest since the Great Depression, which means Americans have pulled back spending much longer than in past downturns. The desire to satisfy some of that pent-up demand should play a large role in the comeback of the American consumer. This is not to say consumers will come back in full force ---- only that we are likely to see some more upward surprises in household spending in the months ahead.

What should we be looking for more closely that would foreshadow a rebound in consumer spending? Among the key measures are (1) household wealth (by the Federal Reserve's Flow of Funds), (2) Real Earnings growth (released tomorrow in a companion report to the CPI), (3) a progressively smaller number in non-farm job losses, (4) more hours worked during the week, (5) stable home prices, (6) higher stock prices, (7) consumer confidence levels, and (8) new and existing home sales.

Plain and simple, it's up to the consumer to prevent the US economy from slipping back to recession.

Two other economic reports were released today: Producer Price inflation and the New York State Empire Manufacturing index.

Producer Prices

August's 1.7% jump in the PPI, while greater than most forecasters expected, is of little concern to us given where we are in the business cycle. First of all, the monthly PPI has been extraordinarily volatile this year. It's been up four months, down three months and flat once, and it tends to mimic the pattern set by energy prices. Core PPI (minus food and energy) has been much more stable which means the underlying rate of inflation remains fairly well behaved. What's more, over the last 12 months headline producer prices fell 4.3%, following a 6.8% decline the previous month.

Now, to be fair, product prices earlier in the production pipeline have started to firm up, as US and foreign economies begin to emerge from recession. Producer prices for intermediate goods have increased an average of 1.2% the past three months, while those for crude have been slightly higher. No doubt the Federal Reserve will be watching the inflation numbers closely in coming months, as they should. But given the enormous slack in the global economy, both in terms of industrial capacity and underemployment, plus the sharp improvements in US productivity, the US economy can grow a robust 4% annually for the next several years without firing up inflation.

NY Fed Empire Manufacturing Index

The New York Fed also released its September manufacturing report for the New York region. The Empire general activity index increased to 18.9 this month from 12.1 in August, the biggest monthly jump in nearly 2 years. This is consistent with an economy in recovery mode and corroborates other data – such as industrial production (tomorrow's release will show the second monthly rise in output) and the ISM series ---- that factory activity has picked up. This should lead to more hours worked, which would generate more household income, encourage additional consumer spending, and eventually lead to greater employment.

But hold off on the Champaign just yet. Even if consumers and manufacturers are making a comeback, there is still one dark cloud hovering overhead, one last obstacle to overcome. The real economy may be itching to grow, but unless banks and other lenders return quickly to help finance consumer and business activity, the paucity of credit will stunt the economic recovery at best --- or totally derail it at worst.

Bottom line: We have probably turned the corner in both consumer spending and in factory output, with activity in both picking up. But the recovery cannot possibly thrive without lenders willing to provide fresh loans to fuel all this economic activity. And for many Americans a tepid recovery that's constrained by scarce credit ---is no recovery at all.

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