

Outlook Improves for Inflation, Bleak for Growth

Overview:

There has been one positive development for the economy since financial markets priced in a global recession: lower energy and commodity prices. Several economic reports this week reflected this positive impact. Declining crude oil prices helped improve the trade deficit in September by cutting imports sharply as exports were also declining. A separate report showed that October import prices posted the third consecutive drop and the largest month-to-month decline on record. Another report showed that retail sales dropped 2.8 percent in October -- the largest monthly decline since January 1987 -- partly because of the biggest drop in sales at gasoline stations since record keeping began in 1992.

Lower gasoline prices are also driving down inflation expectations, according to the University of Michigan's Survey of Consumer Sentiment. The overall consumer sentiment index was little changed in early November, after plummeting in September and October. Incoming data on inflation, including next week's releases on producer and consumer price indices should also show favorable inflation trends.

Other economic news, however, suggested a gloomy outlook for the near term. Although the trade deficit improved in September, trade -- a key support for economic growth in the third quarter -- will probably no longer be a boost for the U.S. economy in the current quarter as overseas economies have slipped into recession. The European Union statistics agency reported on Friday that economic growth in Eurozone -- the 15 nations that use the euro as their currencies -- shrank 0.2 percent in the third quarter, following the same decline in the second quarter.

While the drop in gasoline prices contributed to a decline in October retail sales, consumers also cut spending on other merchandise, with most major categories posting declines for the month. From a year ago, retail sales (not adjusted for inflation) fell 4.1 percent -- a record drop since record keeping began in 1967. Retail sales account for about 40 percent of consumption expenditures with spending on services accounting for the rest. The huge drop in retail sales in October following three consecutive monthly declines suggested that inflation-adjusted consumer spending will likely post another sizable decline in the fourth quarter -- following a 3.1 percent drop (annualized rate) in the third quarter, which was the biggest since 1980.

Finally, this week's initial unemployment claims suggested that November will turn out to be another dismal month for employment. At 516,000 for the week ending November 8, an increase of 32,000 claims, initial claims were at the highest weekly reading since the end of September 2001.

Interest Rates:

Following a surge on Thursday, stock markets declined on Friday in response to a very weak retail sales report. The declining stock markets made Treasuries a safer haven, increasing their demand. The yield on the 10-year Treasury note stayed around 3.74 percent mid-Friday afternoon -- nine basis points lower than the rate on the previous Friday.

Economic Indicators:

The trade deficit narrowed to \$56.5 billion in September from \$59.1 billion in August as a result of weakening exports and imports. Exports of goods and services decreased 6.0 percent while imports of goods and services decreased 5.6 percent. This marks the second consecutive month that both exports and imports dropped. The decline in exports included the impact of the Boeing strike. Net imports of petroleum in September fell 9.8 percent, reflecting a 10.9 percent drop in crude oil prices.

Adjusted for inflation, the real trade deficit widened to \$42.1 billion in September from \$39.1 billion in August. Real goods exports fell the most since the inception of the series in 1994, with the Boeing strike accounting for about one-third of the drop. Real goods imports posted the largest drop since March 2008.

Retail sales dropped 2.8 percent in October. Retail sales excluding sales at auto and parts dealers dropped 2.2 percent. Gasoline station sales fell 12.7 percent, reflecting declining gas prices.

The decline was broad-based. Drug stores and restaurants were the only major segments to post gains. Sales dropped 2.5 percent at furniture stores, 0.4 percent at building material and garden supplies stores, 1.4 percent at clothing stores, 2.3 percent at electronic stores, 1.6 percent at sporting goods, hobby and book stores, 0.4 percent at general merchandise stores, and 1.8 percent at mail order and Internet retailers.

Import prices fell 4.7 percent in October -- the third consecutive decline and the largest month-to-month drop since the inception of the series in December 1988. Over the past year, import prices were up 6.7 percent, decelerating from a 13.6 percent gain in September.

Petroleum import prices fell 16.7 percent -- the biggest drop in more than five years. Price declines were not limited to just energy. Excluding petroleum, import prices fell 0.9 percent -- the second consecutive drop.

The preliminary estimate of the University of Michigan's Consumer Sentiment Index was essentially unchanged in November according to preliminary data, standing at 57.9 compared with 57.6 in October. The current conditions component rose 3.0 points while the expectations component fell 1.3 points. Inflationary expectations fell because of tumbling gasoline prices. The one-year expected inflation rate fell to 2.9 percent from 3.9 percent in October and from above 5.0 percent in May through July. Five-year expectation inflation rate held steady at 2.9 percent, down from a recent high of 3.4 percent.

Next Week:

Monday — October industrial production

Tuesday — October producer price index and the National Association of Home Builders/Wells Fargo Housing Market Index

Wednesday — October consumer price index and October housing starts

Thursday — The Conference Board Index of Leading Indicators for October

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November 14, 2008