Economic Update NATIONAL
Federal Reserve Bank of Dallas

Employment at a Standstill, Inflationary Pressures Linger

September 21, 2011

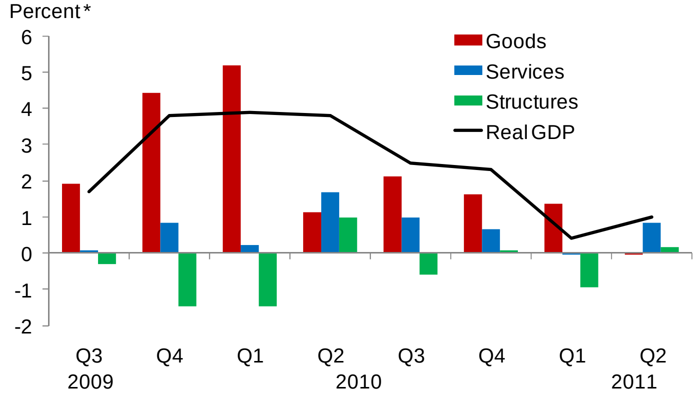
Real economic activity data that have been released in August and early September have been mostly downbeat, with a few exceptions. Financial markets have stabilized, but at a moderate level of stress. Regarding inflation, the latest data show modest, though accelerating consumer price inflation.

Weaknesses

The manufacturing sector appears to be closing in on zero growth. The Institute for Supply Management (ISM) manufacturing index in August declined slightly to 50.6 from July's already-low 50.9 (a reading above 50 is consistent with expansion). This beat the consensus expectation for a below-50 reading (indicating contraction) after a string of disappointing regional Federal Reserve Bank manufacturing surveys. Industrial production increased by 0.2 percent in August and 0.9 percent in July, suggesting that the industrial sector is faring better in the third quarter after almost no growth in the second. Much of the strength in July and August owes to manufacturing, particularly vehicles, as does much of the weakness in the three months prior to July. Once catch-up automobile production levels off, manufacturing should return to a pace consistent with the weaker ISM and Federal Reserve Bank surveys. This is concerning because the recovery thus far has relied heavily on goods production, even though it makes up a substantially smaller share of U.S. output than services (*Chart 1*). If goods production continues to fade, a pick-up in services or structures would be required just to maintain the subpar rate of recovery.

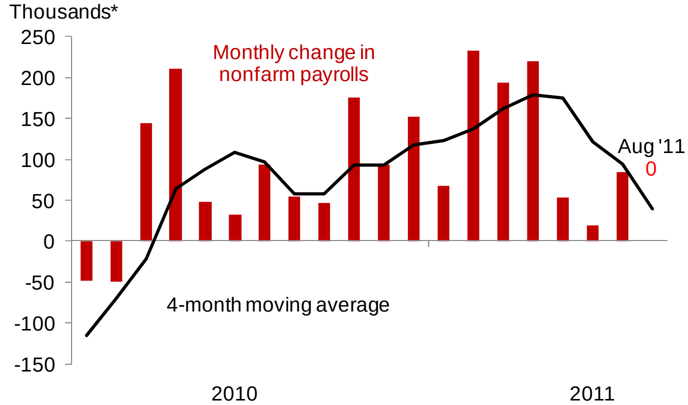
The most discouraging release was the August nonfarm payroll report, which showed a net gain of zero jobs and downwardly revised job growth in June and July by a combined 58,000. The weak reading on the labor market does not appear to be driven by temporary disruptions in August. Payroll growth in August was artificially depressed by the strike of 45,000 Verizon workers, but working in the other direction, public payrolls fell by 17,000 in spite of the return to work of 22,000 state employees in Minnesota. The four-month average has fallen to 40,000 job gains a month, the lowest, excluding temporary census workers, since March 2010 when payrolls first started growing again (*Chart 2*).

Chart 1
Recovery So Far Has Relied on Goods Production



*Seasonally adjusted, annualized rate of contribution to real GDP growth by type of product.
SOURCE: Bureau of Economic Analysis.

Chart 2
May Through August, Payroll Gains Average Just 40,000

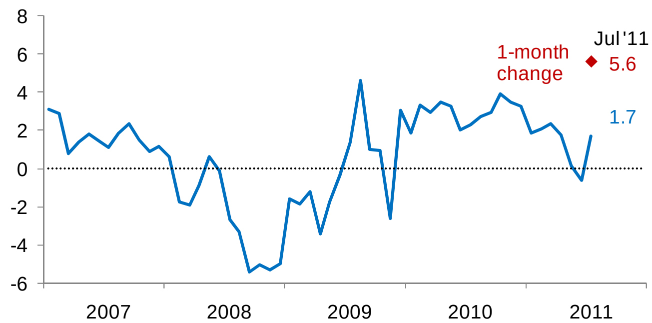


*Excluding temporary census workers, seasonally adjusted.
SOURCE: Bureau of Labor Statistics.

Strengths

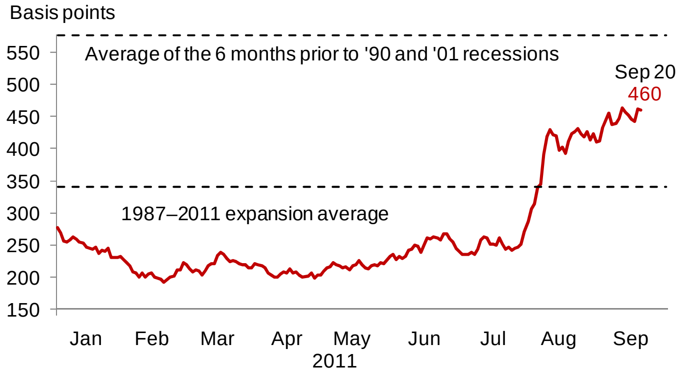
The main exceptions to the generally negative incoming data on real activity were strong real personal consumption expenditures (PCE) growth and a surprising narrowing of the U.S. trade deficit. Real PCE grew sharply in July, posting an increase of 5.6 percent at an annualized rate. This raised the average annualized three-month growth rate of real PCE to 1.7 percent, arresting a generally downward drift in PCE growth. The three-month

Chart 3
Real PCE Rebounded in July



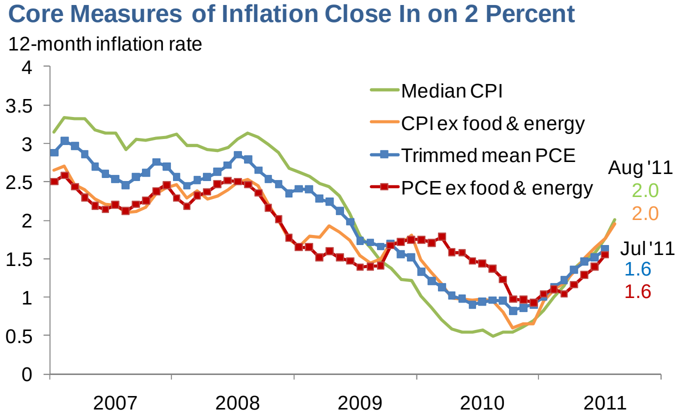
*3-month percent change, annualized, seasonally adjusted.
SOURCE: Bureau of Economic Analysis.

Chart 4
High-Yield/AAA Corporate Spread Stabilized



SOURCES: Federal Reserve Board of Governors; Bank of America/Merrill Lynch.

Chart 5
Core Measures of Inflation Close In on 2 Percent



SOURCES: Federal Reserve Bank of Cleveland; Bureau of Labor Statistics; Federal Reserve Bank of Dallas; Bureau of Economic Analysis.

growth rate had actually dipped negative (−0.6 percent) a month earlier, an infrequent occurrence outside of recession periods (*Chart 3*). As with manufacturing, this can be partially attributed to vehicle sales. With or without vehicles, though, consumption has clearly decelerated over the most recent six months compared with early 2010 through the first quarter of 2011.

The trade deficit narrowed more than expected in July, to $44.8 billion from $51.6 billion. This was driven by a surge in exports and a slight decline in imports. The real trade deficit also narrowed significantly, which raised the expected contribution to real GDP growth in the third quarter. This, along with the strong PCE number, indicates that third quarter output started off on sound footing, although most indicators point to a weaker August.

Financial Markets Stabilize

In the last week of July and the first week of August, financial markets were possibly in their most panicked state since 2009. From July 25 to August 8, the S&P 500 index fell by 16 percent. As dollars poured into Treasuries, yields across the nominal Treasury yield curve fell by significant amounts at longer maturities. The 10-year Treasury yield fell from just over 3.0 percent to 2.4 percent. Since then, financial stresses have been relatively contained, although they have not abated. In particular, corporate bond spreads stopped rising but remain at elevated levels (*Chart 4*). The high-yield/AAA corporate spread, at 460 basis points, is not yet alarmingly high, though. It peaked at over 1,600 basis points in late 2008, and was between 500 and 600 basis points just prior to the 1990–91 and 2001 recessions. From a perspective of gross domestic product forecasting, the change in the high-yield/AAA corporate spread is more informative than the level. While the August rise was sharp, it is only signaling mildly slower growth.

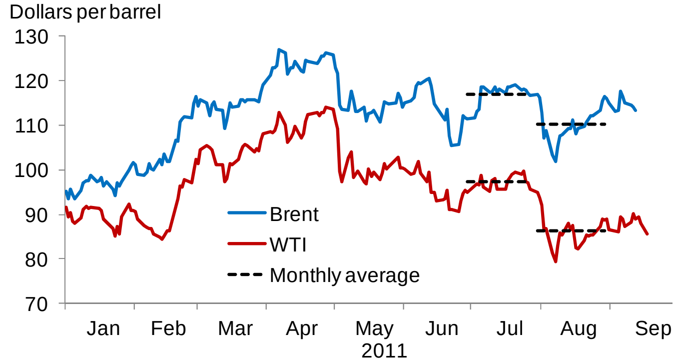
Inflation Modest but Accelerating

The various core measures of inflation, which attempt to strip out near-term volatility, for the Consumer Price Index (CPI) and PCE are at or approaching 2 percent on a 12-month basis (*Chart 5*). Average annualized rates over the six months are somewhat higher—PCE excluding food and energy is at 2.2 percent and CPI excluding food and energy at 2.7 percent. Underlying this are some rather extreme movements in the price of core goods. On a six-month basis, core goods prices in the PCE are up at a 2.1 percent annualized rate. History of these prices would indicate that this should be temporary—since the early 1990s, core goods price inflation, on average, has been close to zero. Alternatively, a period of sustained imported core goods inflation would be consistent with a correction to past excesses, bringing trade balances to a more sustainable level.[1]

Headline inflation rates have run well above core rates recently. Through July, the headline PCE price index is up 2.8 percent, and through August CPI is up 3.8 percent on a 12-month basis. The August one-month 4.6 percent annualized increase in the CPI was a surprise, as the average price of West Texas Intermediate crude oil fell by $10.86 per barrel in August. However, over at least the past five years, month-to-month movements in retail gasoline prices are more highly correlated with month-to-month movements in the price of Brent crude oil, sourced from the North Sea in Europe, which fell only by $6.68 per barrel in August (*Chart 6*). Given no information about the future price of gasoline, which is the dominant factor in the gap between headline and core inflation, the most likely path for headline PCE inflation is that it will fall toward the current 12-month trimmed mean rate, 1.6 percent.

—Tyler Atkinson

Chart 6
Not Much Price Relief for Brent Crude



SOURCES: *Financial Times*; *Wall Street Journal*.

About the Author

Atkinson is a research assistant in the Research Department of the Federal Reserve Bank of Dallas.

Notes

1. "Getting Back on Track," by Evan F. Koenig and Tyler Atkinson, Federal Reserve Bank of Dallas National Economic Update, June 23, 2011, www.dallasfed.org/research/update-us/2011/1104.cfm.