Economic Week In Review: Flirting With Deflation?

Vanguard 10/15 - If you’re old enough to remember the 1970s, you may think inflation is a dirty word. Lately, though, some economists (joined, this week, by the chairman of the Federal Reserve) have dared to utter an even dirtier one: deflation. For the week ended October 15, the S&P 500 Index rose 0.9% to 1,176 (for a year-to-date total return—including price change plus dividends—of about 7.1%). The yield of the 10-year U.S. Treasury note rose 16 basis points to 2.57% (for a year-to-date decrease of 128 basis points).

Inflation Under Control—But At What Price?

Vanguard 10/15 - In a speech on Friday, Fed Chairman Ben Bernanke all but declared victory in the long war against inflation. But in almost the next breath, he sounded a note of concern about an equally dreaded enemy. "For the first time in many decades, [we] had to take seriously the possibility that inflation can be too low as well as too high," Bernanke said. "The risk of deflation is higher than desirable."

Most economists believe that deflation—a toxic combination of stagnant consumer demand and falling prices and wages—isn’t an immediate threat. But data released earlier in the week suggested that inflation remains remarkably tame by historical standards, with the Consumer Price Index posting an unexpectedly modest rise of 0.1% in September.

However, while consumer prices held relatively steady, rising food and energy costs translated into slightly higher wholesale costs in September. Prices for finished goods rose by a greater-than-expected 0.4%, though the increase was just 0.1% with volatile food and energy prices factored out. (Key culprits in the rising cost of food: a 5.2% increase in meat prices, a 9% jump for wheat, and a 26.1% surge in the price of a bushel of corn.)

Still, Bernanke’s deflation warning was underscored by minutes from the latest meeting of the Federal Open Market Committee, in which the nation’s central bankers seemed to be taking a serious look at measures aimed at pumping money into the economy. An announcement could come after the Fed’s next meeting, scheduled for early November.

PPI – September

Barclays 10/14 (excerpts) - The PPI rose 0.4% in September, well above our and the consensus forecast (both 0.1%). The core PPI rose 0.1%, as widely expected. The upside surprise in the headline, relative to our forecast, partly reflected a smaller decline in gasoline prices (-1.8%) than we had expected but was largely driven by a 1.2% jump in food prices. This was particularly focused within meat components, dairy and vegetables. Further gains in food prices at the producer level are likely in the coming months, given recent gains in some commodity prices, although the pass-through to the consumer level is not clear cut - for example, the run up in PPI food prices earlier in the year did not translate into much of a run up within the CPI.

CPI – September

Barclays 10/14 (excerpts) - In our judgment, the chances of outright deflation in the core CPI remains small, but today’s report will add weight to the argument for further monetary policy accommodation, given further signs of disinflation across several components of the CPI.

Retail Sales – September: Consumers Open Their Wallets; Businesses Stock Up

Vanguard 10/15 - In a counterpoint to the anxiety over deflation, retail sales rose 0.6% in September (their third consecutive monthly increase), and August’s figure was revised sharply upward, from 0.4% to 0.7%. Sales were 7.3% higher than in September 2009, buoyed by demand for autos and appliances. On a related note, business inventories were up 0.6% in August, beating consensus estimates.

“Even though the retail sector may be expecting an uptick in consumer demand, given the amount of slack in the economy, a couple months’ worth of strong retail sales numbers cannot overturn the downward trend in inflation,” said Vanguard economist Roger Aliaga-Díaz.

Solid US Retail Sales In September Suggest Healthy Q3 Consumption
Market Comment  Economic Highlights for the week ended October 15, 2010

Barclays 10/15 - Retail sales gained a healthy 0.6% in September following an upwardly revised 0.7% in August (previous: 0.4%). This was above our (0.5%) and consensus (0.4%) estimates. Total retail sales got a boost from motor vehicle sales (1.6%), building supplies (0.6%) and gasoline stations (0.4%), while core retail sales, which strip out these components and serve as a steadier gauge of the underlying trend, rose 0.4%.

Inventories rose 0.7% in today's report, but this was mostly driven by an increase from motor vehicles and parts, while other retailers reduced stock. As such, the inventories to sales ratio increased for the fourth consecutive month to 1.38 from 1.37 previously.

The September retail sales report was very encouraging as the gain in the headline was not merely driven by the volatile components but rather suggested strong sales in September throughout most of the core categories. This report, along with the upward revision for August, are consistent with Q3 real personal consumption expenditures growth between 2.5% and 3.0% q/q saar in Q3 as a whole, above our 2.0% forecast. GDP growth is now tracking close to our 2.5% forecast, having been lower following yesterday's trade report.

Trade Deficit Widens

Vanguard 10/15 - Against the backdrop of a growing debate over the impact of currency valuation on international trade, Americans spent more on foreign-made goods as summer drew to a close. The monthly trade deficit grew $3.7 billion in August to $46.3 billion, a bit higher than consensus expectations. A drop in overseas demand for U.S.-made civilian aircraft took some of the blame, as did a slight increase in Americans’ spending on foreign oil and oil-related products. The trade deficit with China—where policymakers continue to reject U.S. complaints about currency manipulation—jumped 8.2%, to $28 billion.

FOMC Minutes

Barclays 10/12 - FOMC minutes: Accommodation may be appropriate before too long

The September minutes indicated the FOMC elevated the inflation mandate in the statement "to make it clear that underlying inflation had been running below levels...consistent with its mandate for maximum employment and price stability." The committee did this, in part, to help anchor inflation expectations and then followed by saying it was willing to provide additional accommodation to support the recovery and return (increase) inflation to a level consistent with its mandate. Perhaps most tellingly, the minutes also added that members felt "that such accommodation may be needed before long," though the decision would ultimately be data dependent. We think that incoming data, including the employment report released last Friday, have not shown significant improvement to sway FOMC members from thinking that further stimulus is appropriate. We continue to expect the Fed to initiate a new round of incremental purchases at the November meeting.

In discussing their views on the outlook, many participants expressed concern that output growth and progress in reducing the level of unemployment were likely to be "slow for some time." As has been the case in previous minutes, participants noted low levels of confidence, heightened risk aversion and uncertainty, and the weak balance sheets of businesses and households as constraints on the recovery. The moderate pace of recovery combined with the high level of economic slack left most participants thinking that "underlying inflation was at levels somewhat below those that they judged to be consistent with the Committee's dual mandate" and noted that TIPS-based measures of inflation expectations had declined in recent quarters. A number of participants commented on the important role of inflation expectations and worried that declining inflation expectations could lead to higher real interest rates that dampened aggregate demand. The minutes then indicate that the committee discussed a wide variety of possible strategies to anchor inflation expectations, including a formal inflation target, a path for the price level as opposed to the inflation rate, and "targeting a path for nominal GDP."

That these alternatives were discussed robustly enough to warrant inclusion in the minutes suggest that policymakers are indeed concerned about meeting their inflation mandate and are struggling with how best to implement policy and communicate the policy stance to markets. On top of this, following the list of extraordinary policy options with the statement that “the minutes of FOMC meetings were seen as an important channel for communicating participants’ views about monetary policy” certainly provides a strong hint that further stimulus is in store.

Regarding policy implementation, the FOMC focused almost exclusively on providing further stimulus through purchases of long-term Treasury securities. Most participants on the committee see asset purchases as being effective in improving financial conditions, affecting inflation expectations, and gradually reducing the unemployment rate. On the latter front, "many" participants saw unemployment as being higher than structural...
factors alone can explain, suggesting that they see monetary policy as being able to make progress in reducing the level of unemployment.


Press Release 10/14 (excerpts) - In the week ending Oct. 9, the advance figure for seasonally adjusted initial claims was 462,000, an increase of 13,000 from the previous week's revised figure of 449,000. The 4-week moving average was 459,000, an increase of 2,250 from the previous week's revised average of 456,750.

The advance seasonally adjusted insured unemployment rate was 3.5 percent for the week ending Oct. 2, a decrease of 0.1 percentage point from the prior week's revised rate of 3.6 percent.

The advance number for seasonally adjusted insured unemployment during the week ending Oct. 2 was 4,399,000, a decrease of 112,000 from the preceding week's revised level of 4,511,000. The 4-week moving average was 4,488,500, a decrease of 34,500 from the preceding week's revised average of 4,523,000.

Vanguard 10/15 - Hopes for a third straight week of improvement in the job market were dashed, with some 462,000 Americans filing first-time claims for unemployment benefits during the week ended October 9—up 13,000 from the previous week. Pennsylvania and New Jersey reported the biggest increases in first-time claims; California and Florida reported notable declines. Cold comfort for those who lost their jobs: The number of first-time unemployment claims was almost 10% lower than during the same week in 2009.

Barclays 10/14 - Smoothing through the recent movements, claims are continuing to move sideways and suggest that healing in the labor market is proceeding at a sluggish pace. Still, initial claims are substantially below their level a year ago, when they stood at 521k.

The Economic Week Ahead: October 18 – Oct. 22

Vanguard 10/15 - The Federal Reserve’s Beige Book will be released on Wednesday, offering a bird's-eye view of nationwide economic activity during September. Also on tap are reports on industrial production (Monday), new residential construction (Tuesday), and leading economic indicators (Thursday).

This Week’s U.S. Economic Calendar

<table>
<thead>
<tr>
<th>Date</th>
<th>ET</th>
<th>Release</th>
<th>For</th>
<th>Actual</th>
<th>Briefing.com</th>
<th>Consensus</th>
<th>Prior</th>
<th>Revised From</th>
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<td>Oct 18</td>
<td>09:15</td>
<td>Industrial Production</td>
<td>Sept</td>
<td>-0.2%</td>
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<td>Oct 18</td>
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<td>Capacity Utilization</td>
<td>Sept</td>
<td>74.7%</td>
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<td>Housing Starts</td>
<td>Sept</td>
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<td>579K</td>
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<td>Oct 19</td>
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<td>Building Permits</td>
<td>Sept</td>
<td>550K</td>
<td>565K</td>
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<td>Oct 20</td>
<td>14:00</td>
<td>Fed's Beige Book</td>
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<td>Oct 21</td>
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<td>Initial Claims</td>
<td>10/16</td>
<td>450K</td>
<td>455K</td>
<td>462K</td>
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<td>10/09</td>
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<td>Leading Indicators</td>
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<td>Oct</td>
<td>1.5</td>
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