Latest US Data Unlikely to Deter the Fed

We started last week on a downbeat note with Fed Chairman Alan Greenspan dousing hopes of a near term recovery in the US economy. He acknowledged that there are tentative signs of a recovery and feels that there are reasons for concluding that the long-term picture remains bright. However, in the short-term, the economy still faces significant risks. With the unemployment rate continuing to rise, Greenspan remains worried about developments in the household sector. Although stock markets have retraced some of their losses, the effect of the net decline in equity values may not yet be fully played out.

It was interesting that Greenspan comments came just before the release of a number of key US reports, most of which surprised on the upside. The Kansas City Fed manufacturing survey for December indicated that conditions remain very poor. However, this report was blown out of the water by the more closely watched Philly Fed survey which moved back into positive territory for the first time in over a year. November's business inventories release confirmed the trends of the previous month, falling by a slightly stronger than forecast 1.0%. Combined with October's record drop, inventories will be a major drag on Q4 GDP growth. However, the inventory-to-sales ratio remained at 1.39, suggesting that sales and inventory trends are now realigning, which should have positive implications for recovery. Retail sales for December fell 0.1%, which in itself doesn't look very positive but when compared to forecasts of a 1.1% drop, the number takes on a new significance. On a y-on-y basis sales were up 3.4%. The better than expected consumption growth is unlikely to be strong enough to offset the drag from inventory liquidation on Q4's y-on-y GDP figure but will certainly help to soften the blow.

The latest Beige Book reported weakens across the board but there were scattered reports of improvement, something that had been absent from most of 2001's reports. Industrial production experienced another fall in December and has now declined in fourteen of the past fifteen months and is down nearly 6% from its year previous level. There were however, some encouraging signs in the report. Seven of the twenty industries that make up manufacturing reported an increase in production in December and indications are that new orders are beginning to show signs of improvement. Initial weekly jobless claims were expected to rise back above the 400,00 market but instead fell to their lowest level for nearly six months. Finally, according to the Michigan sentiment survey, consumer confidence continues to improve.

So, according to the latest set of data, the US consumer is alive and well and spending, the necessary inventory liquidation is proceeding, industrial production is increasing at an slower rate and the rate of job losses is less severe than it was. All of this indicates that the economy is forming a bottom but the foundations of a rebound in growth is not yet firmly in place. As well as reporting an increase in activity the Philly Fed index also reported that the demand for labour continues to be weak. Although the economy may begin to expand in the months ahead, the unemployment rate may continue to rise for sometime, which combined with a heavy household debt burden, is not good news for consumer spending. The Fed's focus will be on a sustained recovery. Expectations of slow growth for the immediate future, accompanied by rising unemployment, is driving our view that the Fed will reduce interest rates again to 1.50% at the end of the month. Looking at last week's CPI data, the FOMC will certainly feel that an extra 0.25% easing will not risk pushing inflation higher.

Geraldine Concagh
18 January 2002
