

# THE ECONOMIC OUTLOOK GROUP



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## ECONOMIC TALKING POINTS

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### **Don't Count Out Another Rate Cut This Year**

We are now entering the darkest part of the recession tunnel.

- The \$78 billion in tax rebates have been spent. Don't expect another check this year.
- More Americans are now jobless than at anytime in the last five years.
- Home values continue to plummet with no end in sight.
- Employee pay is now trailing inflation by the widest margin in 17 years.

Put it all together and it should come as no surprise that consumers, the largest part of the economy, are cutting back on spending. Retail sales dropped by 0.3% in August, as Americans spent less on electronics, appliances, home improvement and clothing. The August drop was the second consecutive monthly decline. While drivers benefited from falling gasoline prices last month, paying 2.5% less to fill up their cars and trucks, if you exclude gasoline purchases, overall retail sales was still flat. (In July, consumer spending on retail goods, ex-gasoline, fell by 0.6%)

You know things are getting tough when even nonstore retailers are taking a beating. Typically, shoppers who don't want to waste gasoline or deal with traffic and crowds will shop on the Internet or from catalogues. But the poor economy is affecting even this sector as well. Sales dropped by 2.3% at nonstore retailers last month, after a showing a gain of less than 1% the previous month.

Since retail sales can be bumpy month to month, let's step back and get a broader sense of the economy's underlying strength --- or lack thereof. Total retail sales over the

last 12 months was up a sluggish 1.6%. Since retail prices have been rising about 5% in that time frame, the actual quantity of goods bought by Americans has fallen by more than 3% in the past year.

### Consumer Sentiment

Frankly, we're counting the consumer out the rest of the year. True, the latest report on consumer moods by the University of Michigan shows Americans felt better early this month than they did in August. The consumer sentiment index jumped to 73.1 from 63. Since economic conditions and the labor market have deteriorated in recent weeks, the only explanation for the increase in confidence has to be how pleased households were to see the retail price of gasoline fall by 13 cents the past four weeks. We doubt consumer confidence will rise much beyond these levels in the months ahead.

### Producer Prices

Economic weakness here and abroad has softened demand for commodities and manufactured goods. As a result, producer prices fell by 0.9% in August, its first decline of 2008 and the largest drop since October 2006. There is now growing evidence that the inflation bubble has been pricked. It peaked in the first half of the summer and is now set to wind down the rest of the year. One reason to expect lower inflation is that producer prices at earlier stages of the production process are showing signs of deflating. Prices at the intermediate stage, which consists of goods that have gone through partial processing (such as flour, leather, and fabric) fell 1% in August, its first drop in a year and the most since late 2006. The price of crude goods, which represents raw material (timber, coal, oil, cattle, wheat) plunged 11.9% in last month, the biggest decline since April 2003.

Though the Federal Reserve does not focus excessively on producer price inflation when it decides on monetary policy, the latest figures do suggest that the long-awaited moderation of inflation appears to have begun. PPI for finished goods for the year has risen 9.6%, an admittedly small but we think meaningful tilt away from the peak of 9.8% in July. Intermediate goods prices during the past 12 months appear to have stabilized in August at 16.7%, while crude goods has increased by 38.1%, the smallest year over year gain since April.

### Business Inventories

One other economic indicator caught our eye today. The government reported that business inventories increased by 1.1% in July, the most four years. While such a jump can add to GDP growth this quarter, the looming question is "who is going to buy the goods accumulating on stockroom shelves?" Consumers aren't in a shopping mood. Businesses are just as cautious about spending. Take a look at the latest GDP report and you see domestic consumption has utterly collapsed this year. Nor can you rely on foreigners since virtually every industrial country is feeling economic pain and the major emerging countries (China, India, Brazil) are slowing as well.

Much of this inventory could therefore end up languishing on backroom shelves. If so, it will hurt GDP in the coming quarter as retailers, wholesalers and factories cancel new orders until they can get rid of their existing stock.

Clearly, between the economic downturn and the crises in the financial sector, there will be a lot for the Federal Reserve to chew on next week. But it all comes down to this. The US economy is devoid of any forward momentum. Indeed, we believe it has been in recession since late last year. Foreign economies are hurting as well. All this sets the stage for inflation to moderate the rest of the year and well into 2009. This gives the Fed an opportunity to lower rates again before the year is out. We do not expect to see any change in monetary policy next week. But if the economy turns decidedly worse --- by which we mean a further sharp up tick in joblessness and a contraction in personal consumption expenditures --- then the odds of a rate cut in October or December rises to 80%.

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