EconomicUpdate

NATIONAL
Federal Reserve Bank of Dallas

Economy Still Fragile

December 15, 2010

Economic indicators released early in November suggested that the U.S. economic outlook was brightening. Since then, releases have been mixed. Real activity appears to be gaining momentum, yet not rapidly enough to provide consistently strong job gains.

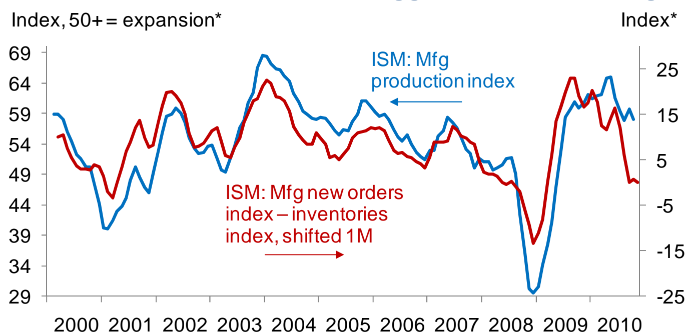
GDP Revised Upward

Growth of real gross domestic product (GDP) was revised up to 2.5 from 2.0 percent annualized in third quarter 2010. Contributions from consumption, net exports and government were larger than initially reported, while inventory investment was revised downward, increasing final demand growth to 1.2 percent annualized from the original 0.6. This is encouraging because the possibility of slow growth after the temporary impetus from the inventory cycle fades remains a predominant concern for the recovery.

Manufacturing Strengthens

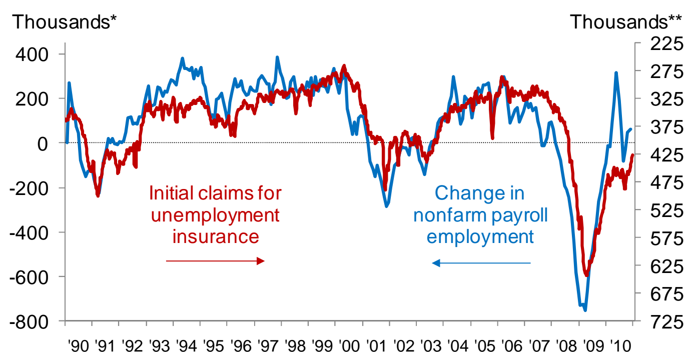
Expansion in the manufacturing sector continued, for the time being at least. Industrial production was up 0.4 percent in November after declining by 0.2 percent in October; however, this is largely due to swings in the utilities component. Manufacturing, which excludes mining and utilities, grew a 0.3 percent in both November and October, up from the more sluggish 0.1 percent growth in September and August. This puts manufacturing closer in line with the Institute for Supply Management (ISM) index that has pointed toward solid manufacturing growth. The November release of the ISM manufacturing survey showed continued expansion, but with some cracks beneath the surface. The new orders component slipped while the inventories component increased. The gap between these two components is a useful indicator of future production because overall gains should be preceded by new orders, while growth in inventories leaves production vulnerable to a correction in the future (*Chart 1*).

Chart 1
New Orders Less Inventories Suggests Future Slowing



*Three-month moving average, seasonally adjusted.
SOURCE: Institute for Supply Managment.

Chart 2
Initial Claims Consistent with Slow Job Growth



*Three-month moving average, seasonally adjusted.
**Four-week moving average, seasonally adjusted.
SOURCES: Bureau of Labor Statistics; Department of Labor.

Labor Market Has Yet to Find its Footing

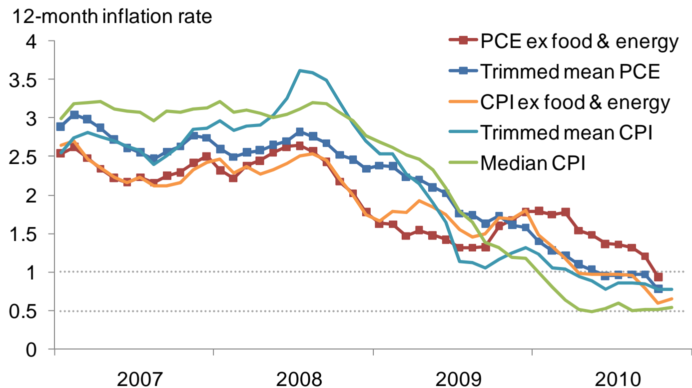
Initial claims for unemployment insurance were choppy in the month of November; there have not been two consecutive increases or decreases in claims since the week of Oct. 9. The four-week moving average is trending downward, currently at 427,500—the lowest since August 2008 when claims were on the rise. However, this is still above the 400,000 threshold that is historically associated with sustained payroll growth (*Chart 2*).

Assuming the old norm is still relevant, November's disappointing employment report should not have been a surprise. Nonfarm payrolls increased by only 39,000 in November, substantially down from the initial estimate for October—151,000—that garnered so much optimism. The October number was revised up to 172,000, good news to be sure, but also highlighted the stop-and-go nature of employment growth. The unemployment rate, which is derived from a different survey, increased to 9.8 percent after seeming stuck around 9.6 percent for much of the year.

Inflation Slips

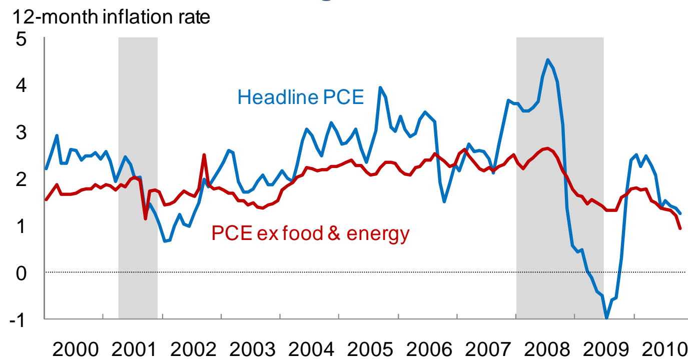
Apart from yet another sharp increase in the price of gasoline, inflationary pressures in October were absent. The consumer price index (CPI) excluding food and energy, the personal consumer expenditures (PCE) price index, and the trimmed mean PCE index all were essentially unchanged in October. These negligible one-month inflation rates pulled 12-month core rates down. In previous months, core rates appeared to be on a steady path at or around 1 percent yearly

Chart 3
Core Measures of Inflation Uniformly Fall Below 1 Percent



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

Chart 4
Inflation Tends to Converge to Core Rates



NOTE: Shaded areas indicate recession.
SOURCE: Bureau of Economic Analysis.

growth, suggesting that the underlying rate of inflation was near that value. October's values fell in between 0.5 and 1 percent, presumably the lowest rates since the 1950s, although core measures do not date that far back. The November release of CPI was more encouraging. CPI excluding food and energy increased 1.2 percent annualized rate in November, after three months of little or no change. The year-over-year rate increased, but remains at the subdued level of 0.7 percent (*Chart 3*). Consistent increases in core rates would suggest the deflationary threat may be passing.

Headline inflation remains above core rates. The PCE price index grew 1.3 percent over the last year and the CPI 1.1 percent. Food and energy make up a significant portion of consumers' budgets, so why do economists focus on inflation excluding food and energy? Core measures of inflation attempt to filter out the more volatile price fluctuations to determine the underlining trend. Prices of food and energy are quick to adjust to changes in supply and demand, while other prices cannot be changed as quickly. Because these slower evolving prices are set in intervals, they contain some information regarding inflation expectations and less information about temporary market disruptions. Thus headline inflation tends to converge to core inflation rather than core converging to headline, and core inflation is a better indicator of where inflation will be in the future (*Chart 4*).

The recovery remains fragile. The European debt crisis is still a risk that may impact the U.S. banking sector and economic growth that is still below average. However, economic activity appears to be inching away from its midsummer slump.

—Tyler Atkinson

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