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*by Dr. Al SantaLuca*

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Falling Oil Imports And Rising Prices Bias Releases this Week

In the releases of November 8 - 12, three items differed sufficiently from consensus expectations to make them worth discussing. First of all, the trade deficit for September fell by about \$2 billion from August's \$53.5 billion level; analysts had expected no change from August. Next, the advance report on retail sales for October (excluding motor vehicles and parts) showed greater strength than expected. However, as we will see below, energy prices were at the root of the discrepancy from analysts' projections in the case of both the trade deficit and retail sales.

Finally, business inventories grew much less than expected in September; viewed in the context of related industrial statistics, this has implications for the cyclical recovery in the industrial economy.

Trade and Energy Prices

Observers took the \$2 billion decline in the trade deficit as a sign that the bleeding in the trade account may have been staunched. What we see, however, is an unusual decline in petroleum imports plus unusual fluctuations in the 'Royalties and License Fees' portion of the import account.

The dollar value of imported energy-related petroleum products dropped about 5% in September compared to August (on a seasonally adjusted basis); this accounts for about one-third of the dollar value decline in imports. However, petroleum imports dropped in the month as a consequence of all the hurricane activity, so we can expect a rebound in the October figures. The average price of petroleum imports rose \$1.25 a barrel and will be up again in October. The combination of higher prices and a snap back in imports will have a large negative impact on next month's trade figures.

Another anomaly in September's report occurred in 'Royalties and License Fees'. This value grew by \$800 million from July to August, and then fell by about the same amount from August to September. This unusual event, combined with lower oil imports, accounts for about three-fourths of the trade deficit's decline.

We certainly expect that lower energy prices, whenever they finally drop significantly, will benefit the trade deficit, but the benefit is probably overestimated. If oil prices fell to levels of one or two year ago, the benefit would only be about \$2 to \$3 billion a month. Unless other trade categories improve significantly, this would still leave the trade deficit somewhere between \$45 and \$50 billion per month.

## Retail Sales and Energy Prices

Early estimates for October retail sales showed an increase of 0.9% over September, excluding autos. In spite of substantially exceeding the estimates of 0.6% month-over-month growth, much of this growth simply reflects higher energy prices. Sales at gasoline stations increased 4.3% in the month, accounting for about 40% of reported growth. When we back out sales at gasoline stations, the increase from last month is just over 0.5%. Adjusting for gasoline sales also shows that retail sales growth fell from September to October. Higher energy prices may have finally started to cannibalize sales from other sectors.

## Declining Business Inventories

Business inventories are still growing at manufacturers, retailers, and wholesalers. But more important than the simple month-to-month increase in the value of inventories, the rate of growth has decelerated over the last three months. We take this as a sign that the industrial recovery that began in 2003 is also beginning to decelerate. Confirming evidence comes from the Leading Economic Index which has fallen for the last four months, and from the Institute for Supply Management Manufacturing index which has been slowing since the Spring. We don't think most analysts have factored into their forecasts an approaching peak in the business and industrial recovery.

## Conclusions

This month's improvement in the trade deficit is not a long-term turning point, but the result of several anomalies in the monthly figures. Secular improvement in the trade balance waits on important structural changes in the economy, not one-time effects. Energy prices have also risen enough to distort the monthly retail sales numbers. Whether this continues depends on where oil prices settle over the next few months. And finally, we begin to see the signs of a peak in the strong industrial recovery which started in 2003.