*econ today*SM *economics - without the hype*

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#2004_13 *july 20, 2004*

June Manufacturing and Retail Sales Soft

This week's surprises showed first, that the industrial side of the economy has started to falter and, second, that retail sales for June dropped even more than expected.

For the first time in a long while, the industrial sector surprised analysts on the downside. The most important indicators of industrial activity (Capacity Utilization, measuring the percent of capacity used; and Industrial Production, measuring the month-to-month change in amount produced) both slipped more than expected.

Then, the consumer's willingness to spend seem to be flagging as retail sales put in their worst performance of the year. June results slipped more than forecast, even though analysts already knew that spending had eased in the last half of June.

Industrial Anemia

Over the last year, expanding industrial activity and resilient consumer spending combined to create the strongest GDP growth since the official end of the recession in late 2001. But further progress in the recovery depends on job growth like we saw in the Spring, which itself requires continued strength in both of these areas. However, June's anemic industrial statistics provides the first tangible evidence that the manufacturing recovery is maturing and its growth rate peaking. In fact, the manufacturing sector lost jobs in June for the first time since January; further job losses would confirm that the industrial expansion had reached a plateau.

None of this means that the industrial sector is heading for a recession, only that the driving forces behind the high growth phase of this cycle are decelerating. The momentum behind the industrial recovery came from two sources. First, a slow rebuilding of industrial inventories started late in 2003; this followed the largest inventory liquidation cycle of the last 20 or 30 years. Even now, businesses are still replenishing their stocks following this liquidation cycle. Secondly, expanding economic activity outside the U.S., particularly in China, propelled export growth in industrial products.

However, softening economic activity domestically and overseas will soon put pressure on these trends. Inventory growth should slow in response to the sluggish domestic economic activity of the last several months. And while exports continue strong (the latest trade figures are for May), Chinese officials announced earlier this year that they would act to dampen the very rapid growth in their economy. Since Chinese imports of commodities and capital goods has supported global expansion, their change in strategy will also moderate the export growth of their trading partners. So, while another industrial recession seems unlikely, conditions have weakened enough to argue that a growth peak has already occurred.

Retail Sales Not Good

The weekly retail sales figures began to weaken in the last half of June, but the final numbers (down 1.1% from May) still surprised most analysts. The decline in auto sales accounted for most of the shortfall; yet even allowing for this, retail sales exclusive of autos dropped well below forecast. The slide in retail sales numbers isn't an isolated instance of consumer weakness. It fits a larger pattern which includes deteriorating job creation and income growth in June, big declines in home refinancing, and higher energy prices.

Preliminary weekly reports show that July retail sales have increased from June. We should expect some bounce since the last several months have displayed an alternating up-and-down pattern: sales increased in March, fell in April, increased in May, and then fell again in June. A feeble rebound in July, compared to the strong 1.4% rebound of May, would increase the probability that a cyclical decline in retail sales had begun. Even with the monthly statistics available to us now, sales growth appears to have crested: sales actually declined during the April - June quarter in contrast to solid growth in the first quarter.

Conclusion

This week's surprises focused attention on something new: simultaneous weakness on the demand side of the economy (the consumer) and on the supply side (the industrial sector). This convergence creates the greatest threat to the economic recovery since it began. Most analysts seem to underestimate the threat from persistently high oil prices, slack job growth, waning consumer wage growth, a big drop in refinancing activity, and Fed increases in short term rates. The economic recovery is vulnerable; the biggest surprise may be waiting for those expecting the rebound to continue.