

THE U.S. ECONOMIC MONITOR

OCTOBER 4, 2013
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No payroll report today, but the claims numbers suggest labor market fundamentals are improving.

If fiscal catastrophe is averted, Q4 consumption should be boosted by falling energy spending.

The drop in the ISM non-manufacturing survey reflects impact of rising summer gas prices.

As Energy Spending Drops, Real Consumption Should Pick Up

On the face of it, the sharp drop in gasoline prices over the past month might be considered one of the few positive recent developments in the economy. The numbers are quite startling, with retail prices down by 18 cents per gallon, or 5.1%, in just four weeks, with further declines in the pipeline. If wholesale gas prices remain at their current level, the national average retail price will level off at about \$3.30 per gallon, compared to the peak of \$3.68 in mid-July.

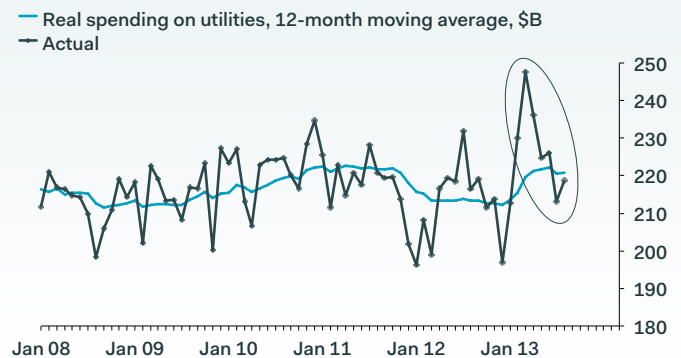
Unfortunately, when these numbers are set in the context of normal late summer/early fall movements in gas prices, as the driving season ends, they look rather less impressive. We reckon seasonally adjusted gas prices in the CPI will be unchanged in September,

down about 2% in October and up by about 2% in November. The three-month annualized rate of change, which stood at 32% in August, will therefore drop to about zero by November. We are happy to see seasonally adjusted prices stabilizing, but we can't expect any serious boost to spending as a result.

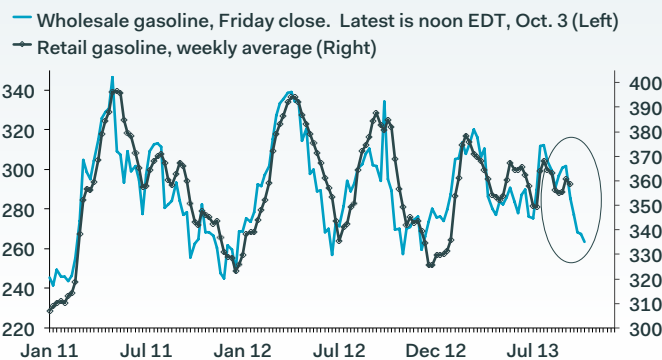
Looking at the broader question of overall energy spending, however, the picture is brighter, thanks to the steep drop in spending on natural gas and electric utility supply since late spring.

This has nothing to do with prices, which have risen over the past year. Instead, the drop in spending has been triggered by the weather. After soaring utility spending in January and February, triggered by colder-than-normal weather, more normal conditions have allowed spending to drop back to trend.

LOWER UTILITY SPENDING IS FREEING-UP CASH

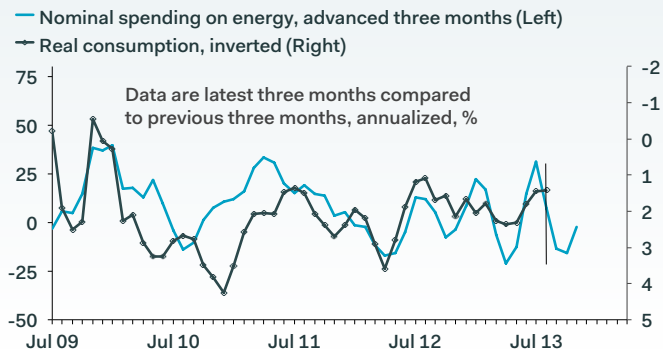


FURTHER TO FALL, BUT MOST OF THE DROP IS SEASONAL



Gasoline and home heating oil are responsible for two thirds of all consumers' spending on energy goods and services, with utilities accounting for about one-third. Still, that's a big enough proportion to matter, and it means we need to look at overall energy spending when we are thinking about the impact on real consumption spending. Our next chart, on page two, shows clearly that turning points in the rate of change of spending on energy affect real consumption

FALLING ENERGY SPENDING SHOULD LIFT Q4 CONSUMPTION



with a lag of three months or so. Over the past year or so, the spending numbers have not fully reflected *all* the volatility in energy prices, but the relationship has been clear enough. The good news now is that the impact of the early summer rise in gas prices was more than offset by the drop in spending on utilities, which should mean that consumption growth picks up again in the fourth quarter.

We doubt, however, that the rate of growth of spending will reach the pace implied by the chart. The uncertainty caused by the government shutdown and the looming debt ceiling fight seems likely to induce a degree of caution. And if Congress fails to reach agreement over the debt ceiling and the country defaults, we would expect spending to collapse regardless of what happens to spending on energy, but that is not our base case. Yet.

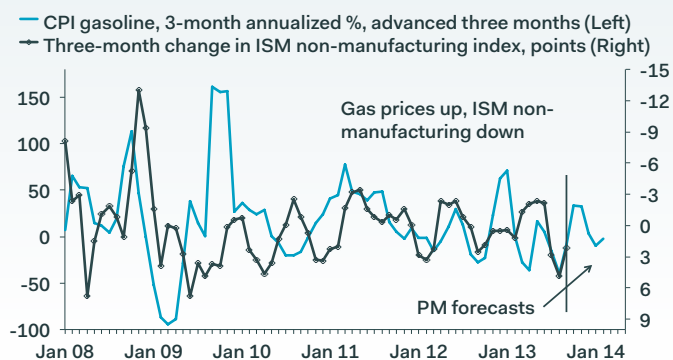
ISM Dip is a correction, not a crash

We were never completely convinced by the strength of the August employment reading from the ISM non-manufacturing survey, so we cannot be too disappointed at the abrupt drop in the September survey, released yesterday. The 57.0 August reading was consistent, if sustained, with payroll growth of 300K per month, but the September number, 52.7, signals gains of 200K. It is reasonable, we think, to look for 300K gains at *some* point next year, when the small business sector finally joins in properly with the recovery, but it is not going to happen immediately.

Looking more broadly at the survey, the drop in the headline index to 54.4 in September from 58.6 is nothing to be alarmed about. In the medium-term, the ISM non-manufacturing survey is little more than a lagging indicator of movements in core retail sales, which is why we tend not to place much emphasis on it as an indicator of the state of the broad economy.

In the short-term, however, the index is susceptible to swings in gasoline prices, as our next chart shows. *Both the strength of the survey in July and August and the sudden drop in September can be traced to prior swings in gas prices.* If this pattern continues, the headline index will be little changed over the next few months, but that assumes a resolution to the budget and debt ceilings crises without some sort of catastrophe in the markets.

ISM NON-MANUFACTURING RESPONDS TO GAS PRICES



On a more upbeat note, it does now seem that a good part of the recent drop in jobless claims—about which we have been quite skeptical—is real. Initial claims nudged up trivially last week and now stand at just 308K, more than 20K lower than in August, before computer upgrades in California and Nevada distorted the numbers. Continuing claims spiked following delayed reporting from California but this is of no economic significance. ***What matters is that fewer people are being laid off, and that can only be good news for future payroll numbers.***

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THIS WEEK IN BRIEF

Note: "D" prefix denotes Datanotes for these releases. **All official releases are subject to cancellation as a result of the shutdown of non-essential government services.**

Monday, September 30• **D: Chicago PMI (9)/9:45 EDT**

The headline index rose to a robust **55.7** from 53.9, closing the gap with the national ISM index. Orders and production both rose, but the employment index dipped a touch.

Tuesday, October 1• **Redbook Chain Store Sales (9/28)/8.55 EDT**

Sales growth rose to **3.8%** from 3.4%, reinforcing the clear upward trend which began to emerge in the spring.

• **D: ISM Manufacturing (9)/10:00 EDT**

The headline index rose to **56.2** from 55.7, the best since April 2011. Most of the gain was in orders and inventories; the new orders index slipped a bit.

• **D: Construction Spending (8)/10:00 EDT: Cancelled**

We hope for a **0.5%** increase, with a pick-up in private non-residential spending offsetting the stalling in private new housing construction. **Consensus: Incomes 0.4%**.

Wednesday, October 2• **MBA Mortgage Applications (9/27)/7:00 EDT**

The purchase index dropped by 5.6% to **189.4**, reversing most of last week's unexpected 6.6% jump. The underlying trend has been broadly flat in recent weeks.

• **D: ADP Employment Report (9)/8:15 EDT**

ADP reported private payrolls rose by only **166K**, rather weaker than we expected in light of significant improvements in a host of advance indicators of employment.

Thursday, October 3• **D: Initial Jobless Claims (9/27)/8:30 EDT**

Claims rose just 1K to **308K**. Despite our skepticism, it does now seem that the trend in claims has dropped sharply over the past month or so, though the good news is yet to be reflected in the payroll numbers. Continuing claims spiked as a result of California distortions; ignore them.

• **D: ISM Non-Manufacturing (9)/10:00 EDT**

The index dropped to **54.4** from 58.6, but we see this as a correction triggered by the lagged effect of higher gas prices in the summer. Employment dropped too but remains strong.

• **D: Factory Orders (8)/10:00 EDT: Cancelled**

Total orders should be **unchanged**, following the 0.1% increase in durable goods orders reported last week. **Consensus: 0.3%**.

Friday, October 4• **D: Employment (9)/8:30 EDT: Cancelled**

We expect payrolls to rise about **225K**. Most short-term labor market indicators have improved over the past month. The unemployment rate should dip a tenth to **7.2%**, and we expect hourly earnings to rise **0.2%**. **Consensus: Payrolls 180K, unemployment 7.3%, hourly earnings 0.2%**.

THIS WEEK'S FUNDING

Monday 30 Auction: \$25B 3-month, \$25B 6-month bills
Announcement: 4-week bills (Oct. 1)

Tuesday 1 Auction: 4-week bills

Wednesday 2 Nothing

Thursday 3 Announcement: 3-month, 6-month bills (Oct. 7)
Announcement: 3-year notes (Oct. 8)
Announcement: 10-year notes (Oct. 9)
Announcement: 30-year bonds (Oct. 10)

Friday 4 Nothing

PANTHEON'S FINANCIAL FORECASTS

	End-month:				
	4:00pm Thu.	Dec	Mar	Jun	Sep
Fed funds actual	0.09	0.20	0.20	0.20	.20
2-yr	0.31	0.40	0.50	0.60	.70
10-yr	2.61	2.75	3.00	3.25	3.50
30-yr	3.70	3.70	4.00	4.25	4.50
Curve 10-2	230	235	250	265	280
Curve 30-2	339	330	350	365	380
Dow Jones IA	14,996	15,500	15,500	15,750	16,000
Dollar/Yen	97.3	101	105	107	109
Dollar/Euro	1.36	1.32	1.28	1.26	1.24
Dollar/Sterling	1.62	1.55	1.50	1.48	1.46

PANTHEON'S ECONOMIC FORECASTS

GDP	Q4 third	0.1%	2011 year:	1.8%
	Q1 third	1.1%	2012 year:	2.8%
	Q2 third	2.5%	2013 year:	1½%
	Q3 forecast	1-to-2%	2014 year:	3.0%
	Q4 forecast	1-to-2%		
	Q1 forecast	>2%		

CPI Aug: 0.1% (1.5% y/y); core 0.1% (1.8% y/y)

December 2013 forecast: 1.9% y/y; core 1.8% y/y

June 2014 forecast: 2.0% y/y; core 1.8% y/y

Unemployment: December 2013, 7.2%; June 2014, 7.0%

Federal budget: FY 14 forecast: -\$500B (2.9% of GDP)