

U.S. Economics Weekly: Market and Policy Comments

Shifting Focus to Rebounding Growth

- Although the economy stalled temporarily in the first quarter due to weather, there were clear signs that demand was rebounding (especially consumer spending) by the end of the quarter. Consumer discretionary spending soared in March, providing an elevated starting point for second quarter growth. Also, continued improvement in the labor market reinforced our view that economic growth has begun to pick up.
- As expected, the Fed statement was little changed from March. The Fed tapered its asset purchases by another \$10 billion and we think the bar is now extremely high for changing that pace of tapering. The Committee upgraded its assessment of the current environment and emphasized that consumer spending has accelerated. In doing so, policymakers are beginning to focus on the improving economy.
- The sharp drop in the unemployment rate of 0.4 percentage point is not likely to be reversed, and at 6.3% it is now close to the Fed's central tendency forecast for yearend. The continued decline in the jobless rate is an indication that the labor market is strengthening. At this point wage increases are modest, but we anticipate pressures will emerge gradually later in the year.

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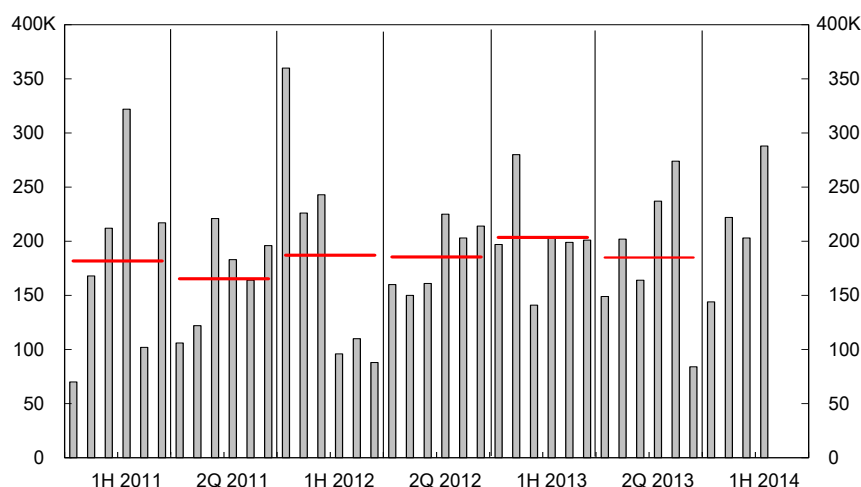
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Change in Nonfarm Payrolls and Half-Year Averages, 2011-April 2014



Source: Bureau of Labor Statistics.

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Shifting Focus to Rebounding Growth

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The robust economic outlook is progressing along the lines that we and the Fed had anticipated.

The stall in GDP is old news.

Consumer spending was influenced by special factors.

Solid consumer spending in March points to a more robust pace of growth.

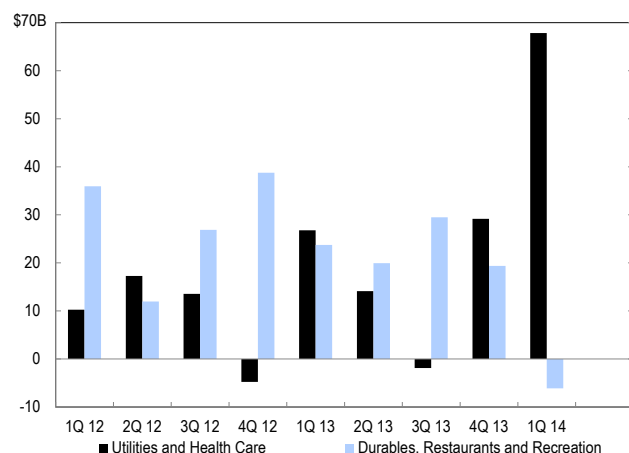
The robust outlook for the economy is progressing along the lines that we and the Fed had anticipated despite the low growth reported in this week's first quarter GDP release. Moreover, today's employment report reinforced our view that the economy appears to have finally shed the restraints from harsh winter weather. Recent indications of demand, particularly consumer spending, have rebounded smartly and are consistent with growth in the 3½% range in the next two quarters. This brisk pace of recovery would keep the Fed on track to end asset purchases this fall and begin to tighten its policy stance in the summer of 2015.

BEA's first estimate for first quarter GDP was even weaker than our below consensus estimate, edging up just 0.1% in the first quarter. We view this report as extremely old news because the pullback in growth largely reflected distortions from inhospitable weather. We would not be surprised if the GDP gets revised up as new information is likely to reflect improving activity in March as the weather began to improve.

We were surprised by a 3.0% rise in first quarter consumer spending, led by a 4.4% jump in expenditures on services. We suspect much of this surge may be in response to the introduction of the Affordable Care Act and forced spending on energy (especially heating fuels) (Figure 1). These gains were partially offset by a weather-related sharp decline in discretionary spending on durable goods, restaurants and recreation services. The net effect of all these special factors was to increase consumer spending by \$24 billion. Consumer spending apart from special factors rose by just 2.1%.

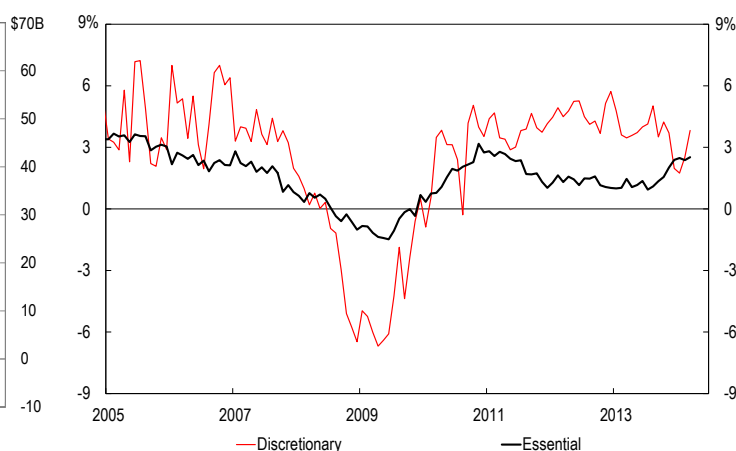
Importantly, monthly consumer spending data point to an accelerating and much more robust pace of growth at the end of the quarter as weather normalized. Discretionary spending, which includes durable goods, and restaurant and recreation services, rebounded sharply in March (Figure 2). These data confirm that underlying fundamentals supporting consumer spending remains intact. The consumer is likely to be a key force behind the acceleration in GDP. The March level of consumer spending (in real terms) already was 2.3% above the first quarter average, setting the stage for a major jump in the current quarter.

Figure 1. Distortions to First Quarter Real Consumer Spending



Note: Figures are quarter-to-quarter level changes.
Source: Bureau of Economic Analysis.

Figure 2. Real Discretionary and Essential Personal Consumption (Year-to-Year Percent Change), 2005-March 2014



Note: Discretionary spending includes consumer durables and some services like air travel, restaurants and lodging. All else is called "essential."
Sources: Bureau of Economic Analysis and Citi Research.

We made no changes to the Fed call.

The FOMC changed the text of the statement concerning its assessment of the current economic environment (the first paragraph). It now emphasizes that growth “has picked up recently” and that “household spending appears to be rising more quickly.” These changes recognize improvements in the economy that already have materialized in the data. This shift moves past weather distortions and instead focuses on the rebound in activity, especially the faster pace of consumer spending. Such optimism is a first step toward formulating an exit strategy.

The Fed statement was little changed from March and was fully anticipated by markets.

Against this backdrop, the Fed statement was little changed from March and was fully anticipated by markets. As expected, the Fed tapered its asset purchases by \$10B and LSAPs now total \$45B per month. We think the bar has become extremely high for changing the pace of tapering.

The Fed needs to address its exit principles soon.

The minutes of the April 30 FOMC meeting (to be released in three weeks) may be more interesting than this week’s statement, especially in light of the fact that the Fed Board met separately to address where monetary policy is headed in the medium term. We have been noting for some time that the Fed will have to address its exit principles soon. That process may have started with discussions about how to implement policy tightening at this meeting and the special Board meeting.

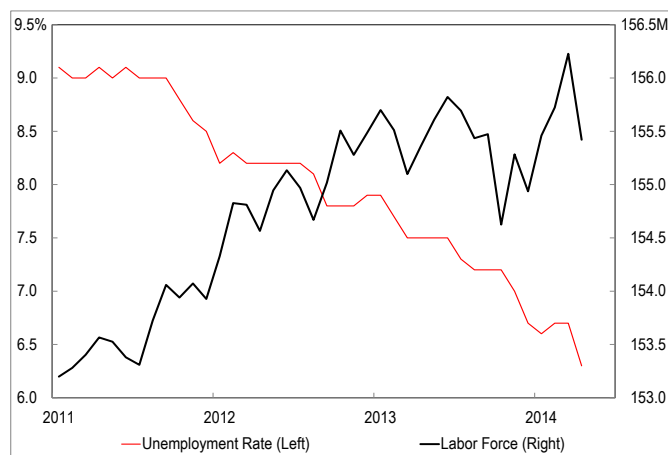
The size of today’s sharp decline in the unemployment rate was rare.

The minutes also may give clues about members’ views of the degree of slack in the economy. The size of the decline in the unemployment rate (0.4 percentage points) was rare — this was only the fourth occurrence in the past 30 years. Typically such declines are not reversed in subsequent months. The current level of the unemployment rate (6.3%) is near the middle of the Fed’s central tendency projections for the end of 2014 (eight months from now). The April decline will probably prompt policymakers once again to ratchet down their yearend forecasts for the unemployment rate.

Employment in the payroll and household surveys went in opposite directions.

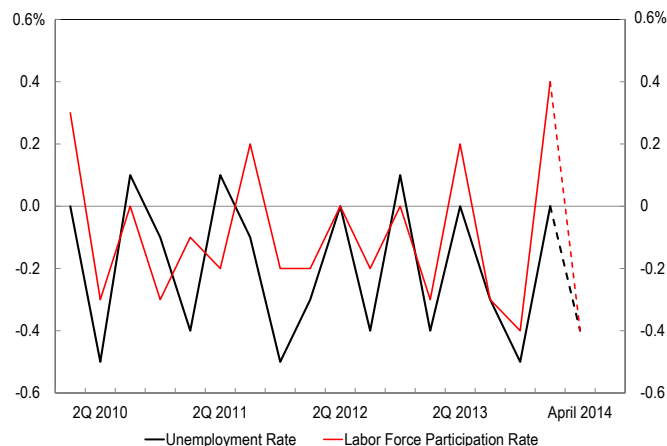
There were several points of confusion in the employment report. For example, even though payroll employment rose by 288 thousand, the household survey showed a 73 thousand drop. Also, the decline in the jobless rate was accompanied by a plunge in the labor force and a 0.4 percentage point decline in the participation rate. Unfortunately labor force data are notoriously volatile and such big changes need to be put in perspective. During the first three months of the year, the labor

Figure 3. Unemployment Rate and Labor Force, 2011-April 2014



Source: Bureau of Labor Statistics.

Figure 4. Unemployment Rate and Labor Force Participation Rate (Quarter End Changes), 2010-April 2014



Note: Dashed lines depict April figures.
Source: Bureau of Labor Statistics.

force increased by 1.3 million and the unemployment rate was unchanged at 6.7% (Figure 3). The April declines in the labor force and unemployment rate may actually be a move back to their longer run trends.

The unemployment rate continues to trend down.

The unemployment rate has been falling for the past three years at a pace averaging 0.2 percentage point per quarter. However, the decline has come in fits and starts. Most recently, there was no change at all in the unemployment rate in the first quarter. Typically, quarters with little change in the rate are followed by large declines, so the latest drop may not be out of line. Also, these changes in the unemployment rate tend to coincide with changes in the participation rate (Figure 4). If anything, the rise in the participation rate in the first quarter seems odd.¹

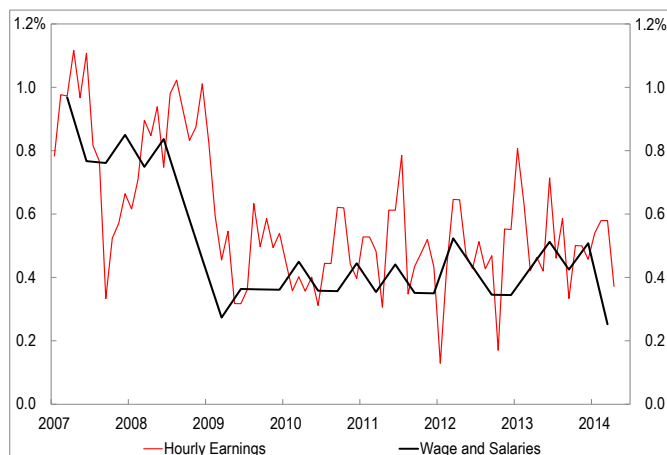
Weak wage data seem out of step with labor market developments.

Although the Fed looks at an array of labor-market indicators, Fed Chair Yellen has emphasized that the unemployment rate still is the best measure of labor force health. Such a fast-paced decline suggests that the degree of slack may be diminishing. Nevertheless, the most recent data did not show evidence of incipient wage pressures. Average hourly earnings were little changed in the past two months and the employment cost index posted a low print. So far there has been no material change in wage trends (Figure 5). We continue to believe that the labor market is tightening and anticipate gradually rising wage pressures later in the year.

This week's outside payroll gains likely reflect weather.

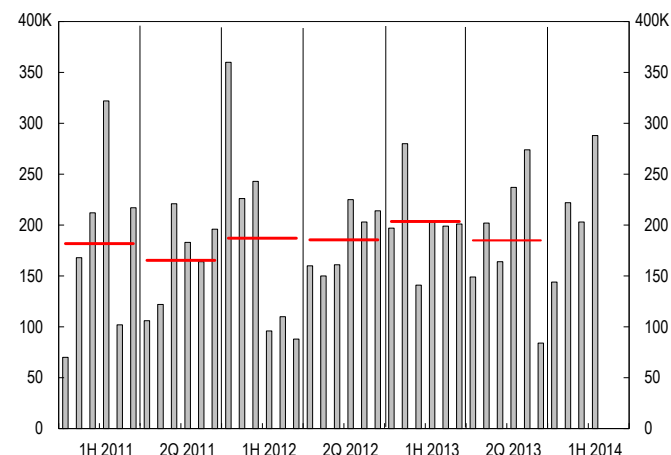
Although we believe the labor market is strengthening, this week's payroll gains may have been the least interesting aspect of today's report. Employment soared in April, rising by 288K and there were upward revisions totaling 36K. But much of this jump may have been a rebound from weather depressed levels. Although initial claims jumped again at the end of April, that rise followed two very low prints at the start of the month. These gyrations probably represent nothing more than volatility in the series. The four week moving average was 320K, exactly the same as it was in March. Initial claims have been gradually trending down, and this improvement is broadly consistent with a slight pickup in the payroll trend toward 200K (Figure 6).

Figure 5. Average Hourly Earnings (Three-Month Percent Change) and Wage and Salary Employment Costs (Quarterly Percent Change)



Source: Bureau of Labor Statistics.

Figure 6. Change in Nonfarm Payrolls and Half-Year Averages, 2011-April 2014



Source: Bureau of Labor Statistics.

¹ We will be featuring an in-depth analysis of labor force and participation rate issues next week,

(E) Indicates Citigroup estimates. (A) Advance. (P) Preliminary. (F) Final. (UNCH) Unchanged. (R) Revised. Contributors: Martha Berasain and Cathy Gaeta.

Notes

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Appendix A-1

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