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October Surprise: Sharpest Drop in Inflation in Decade

A record-tying drop in producer prices and slowing retail spending prompt Action Economics to lower its GDP and consumer-inflation forecasts

by [Michael Englund](#)

Two U.S. data reports released on Nov. 14 point toward a slower pace in both economic growth and inflation. A larger-than-expected drop in retail sales for October—and a sizable downward revision to the September figures—have taken a chunk out of the U.S. gross domestic product forecasts for both the third and fourth quarters. The recent weakness has reduced upside risk for GDP growth over the near term, and should keep the "hard landing" scenario alive in the financial markets.

Meanwhile, the producer price index, a gauge of inflation at the wholesale level, matched its largest monthly decrease on record. This lower-than-expected reading has prompted us to downsize our forecasts for key consumer price measures. Here is [Action Economics'](#) rundown on the reports:

RETAIL SALES

Retail sales fell 0.2% in October, with the number, excluding auto sales, down 0.4%. Those follow September's 0.8% overall decline (revised from -0.4%) and 1.2% drop ex-auto (revised from -0.5%). On a year-over-year basis, retail sales are up 4.3%, compared to 5.1% in September. The ex-auto rate is up 2.9%, vs. 5.3% previously. Excluding autos and gas, retail sales were up 0.3% in October. Gas station sales fell 6.0% after an 11.1% plunge in September.

Housing-related spending in September was revised lower, with weakness evident in the building material, furniture, and appliance components. This adds to the notion of at least some "passthrough" of housing weakness to household spending, which has been surprisingly absent up until now.

We still see much of the September and October spending restraint as reflective of slow digestion by households of big energy price adjustments that are depressing spending over the short term, but which make cash available for purchases as we enter the November-December holiday shopping season. The risks have increased for a bigger savings rate rise as we enter 2007 than we had previously assumed, which means a bit less spending relative to the income growth path.

DOWNWARD REVISIONS TO COME

The report implies sizable downward revisions to the near-term consumer outlook, as September's significantly lower revised figures will prompt downward third-quarter adjustments in the next GDP report, and will take a chunk out of fourth-quarter spending growth as we are now entering the new quarter with a lower growth trajectory.

We now expect a \$9 billion downward adjustment to third-quarter real (i.e., adjusted for inflation) consumption, which will lower "real" consumption growth from 3.1% to the 2.5% area. We have also lowered our fourth-quarter "real"

consumption forecast to 3.5%.

For GDP, we now expect no net third-quarter revision from 1.6% growth, and we have lowered our fourth-quarter forecast to 2.6%. There may still be some lingering upside real GDP risk from an upward revision to state and local government spending, and some downside risk to the last round of chain price data.

We continue to believe that ongoing strength in virtually all measures of consumer confidence, steady growth in household net worth, and strength in household income in recent months all indicate that we are not seeing a "sea change" in household savings behavior. Yet the savings rate should rise sharply to the positive 0.5% area in October.

The October retail sales data do make the early holiday sales reports following the Thanksgiving Day holiday even more important than usual, as those arguing for a "hard landing" will assume that October nominal sales weakness will extend through yearend, with consumers quickly raising their savings rate in response to housing-market and economic uncertainty.

PRODUCER PRICES

The headline producer price index fell 1.6% in October, while the core rate, which excludes food and energy prices, was down 0.9%, following a headline decline of 1.3% in September and a 0.6% jump in the core. On a year-over-year basis, headline PPI fell to a -1.6% pace from 0.9% in September; the core rate slowed to 0.6%, vs. 1.2% previously.

The big factor in the overall decline: energy prices. Gas prices were down 7.9% (on top of a 22.2% plunge in September), dragging the overall energy price measure down 5.0%.

The report revealed a hefty October core price drop—the biggest since 1993—with the surprise almost entirely reflecting the seasonal impact of new vehicle pricing, with car prices falling 2.3% and trucks down by a jumbo 9.7%. Though this vehicle price impact is likely temporary, and may well not translate to the other inflation measures, the sheer magnitude of the drop, alongside the weakness in the major October trade price components, suggests downside risk to the other inflation measures.

We have knocked down our consumer price index estimates for October to a 0.3% headline drop with a restrained 0.1% core gain, and we have lowered our forecasts for the personal consumption expenditure (PCE) chain price indexes to a 0.2% headline drop with a 0.1% core gain.

Englund is chief economist for [Action Economics](#).

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