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ECONOMIC REPORT

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MIXED NEWS ON RECOVERY: BIG JUMP IN SEPTEMBER RETAIL SALES, BUT INDUSTRIAL PRODUCTION DOWN

SUMMARY

- Retail sales rose 1.9 percent in September, far exceeding expectations.
- Retail sales are above their pre-pandemic level, and consumer spending is driving the nascent economic recovery.
- Consumer spending growth will slow going forward, and a lack of additional stimulus is a downside risk.
- Industrial production fell in September, against expectations for a small increase. The recovery in the industrial sector is lagging the overall rebound.
- The consumer price index increased modestly in September, and inflation remains lower than the Federal Reserve would like.
- With weak demand and lots of excess capacity in the U.S. economy, inflation will remain low in the near term.

Retail sales increased 1.9 percent in September from August, much better than the 0.7 percent consensus expectation. Sales were up 1.5 percent excluding motor vehicles and parts, and 1.9 percent excluding gasoline. Excluding autos and gasoline sales were up 1.5 percent. Control sales—excluding food service, autos and parts, gasoline, and home improvement stores, and which go into nominal consumer spending in GDP—rose 1.5 percent in September from the previous month. Control sales were up 9.1 percent year-over-year in September.

Total retail sales, as well as most of the major aggregates, are actually above their pre-pandemic level now, despite enormous job losses in the U.S. economy from early 2020 (see Chart 1). Although employment has soared over the past few months, it is still almost 11 million jobs below its pre-pandemic peak in February. One-time stimulus payments distributed to many households earlier this year and expanded access to unemployment insurance benefits have allowed consumers to increase their purchases. With consumer spending making up about two-thirds of U.S. GDP, this has jumpstarted a nascent economic recovery.

A gradual return to more-normal spending patterns, rising employment, the boost to household incomes from stimulus payments earlier in the year, very high savings, strong home sales, and very low interest rates are all positives for retail sales growth through the rest of 2020 and into 2021. Online sales will continue to increase much more rapidly than brick-and-mortar sales. Although sales growth is strong, it will slow through the rest of this year and into next year. The slowing will be even more pronounced if Congress does not pass another stimulus bill. Unemployment remains pervasive throughout the U.S. economy, and households with unemployed workers will need to cut back on their spending due to the fading impact of the one-time stimulus checks and the recent expiration of extra unemployment insurance benefits. A lack of additional household stimulus would be a significant drag on the recovery in the months ahead.

Retail sales growth was strong across most segments in September compared to August. Sales at auto dealers were up 4 percent over the month, as stimulus payments and low interest rates spurred sales. Sales at clothing stores jumped 11 percent, and sales at specialty stores were up almost 6 percent. Sales at general merchandise stores rose 2 percent, including a 10 percent jump for department stores, with households gradually returning to in-person shopping. Food service (primarily restaurant) sales rose more than 2 percent over the month, although they remained down 14 percent in September on a year-ago basis as many households are still reluctant to venture out. Building materials sales were up a little less than 1 percent in September from August, but were up 14 percent from one year earlier; people are repairing and

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sprucing up their homes now that they are spending a lot more time there. Food and beverage sales (primarily grocery stores) were flat on the month, but were up a little more than 10 percent year-over-year as people continue to eat at home more because of the pandemic.

Industrial production fell 0.6 percent in September from August, the first decline since output plunged in March and April due to the pandemic. September's drop was a surprise; the consensus expectation was for an increase of 0.5 percent. Manufacturing output fell 0.3 percent over the month, with big declines in production of motor vehicles and parts (down 4.0 percent) and computer and electronic products (down 2.6 percent). Utilities output was down 5.6 percent for the month, while mining output rose 1.7 percent.

The recovery in industrial production from the pandemic has been weaker compared to other measures of economic activity. There was an initial large improvement in June and July as factories reopened, but the pace has softened since then. Overall industrial production remained down 7 percent in September from February, making up a little more than one-half of its 16 percent cumulative decline in March and April (see Chart 2). The decline in industrial production in September does not necessarily mean that the industrial sector is in trouble, but does indicate that its recovery will be a long slog.

The overall capacity utilization rate fell to 71.5 percent in September from 72.0 percent in August. The rate was 76.9 percent in February, and then it plunged to 64.2 percent in April as the pandemic hit. It has rebounded since then, but remains far below its pre-pandemic level. The manufacturing capacity utilization rate was 70.5 percent in September, down from 70.7 percent in August. The manufacturing capacity utilization rate is up from its trough of 60.1 percent in April, but down from 75.2 percent in February. Large swathes of excess capacity throughout the U.S. economy will make it difficult for businesses to raise prices, keeping inflation low in the near term.

The consumer price index rose 0.2 percent in September, down from a 0.4 percent increase in August and 0.6 percent increases in June and July. The core index, excluding food and energy prices, was also up 0.2 percent in September; it rose 0.4 percent in August and 0.6 percent in July.

On a year-ago basis, overall inflation was 1.4 percent in September, up from 1.3 percent in August and 0.1 percent

Chart 1: Thanks to Stimulus, Retail Sales Above Pre-Pandemic Level

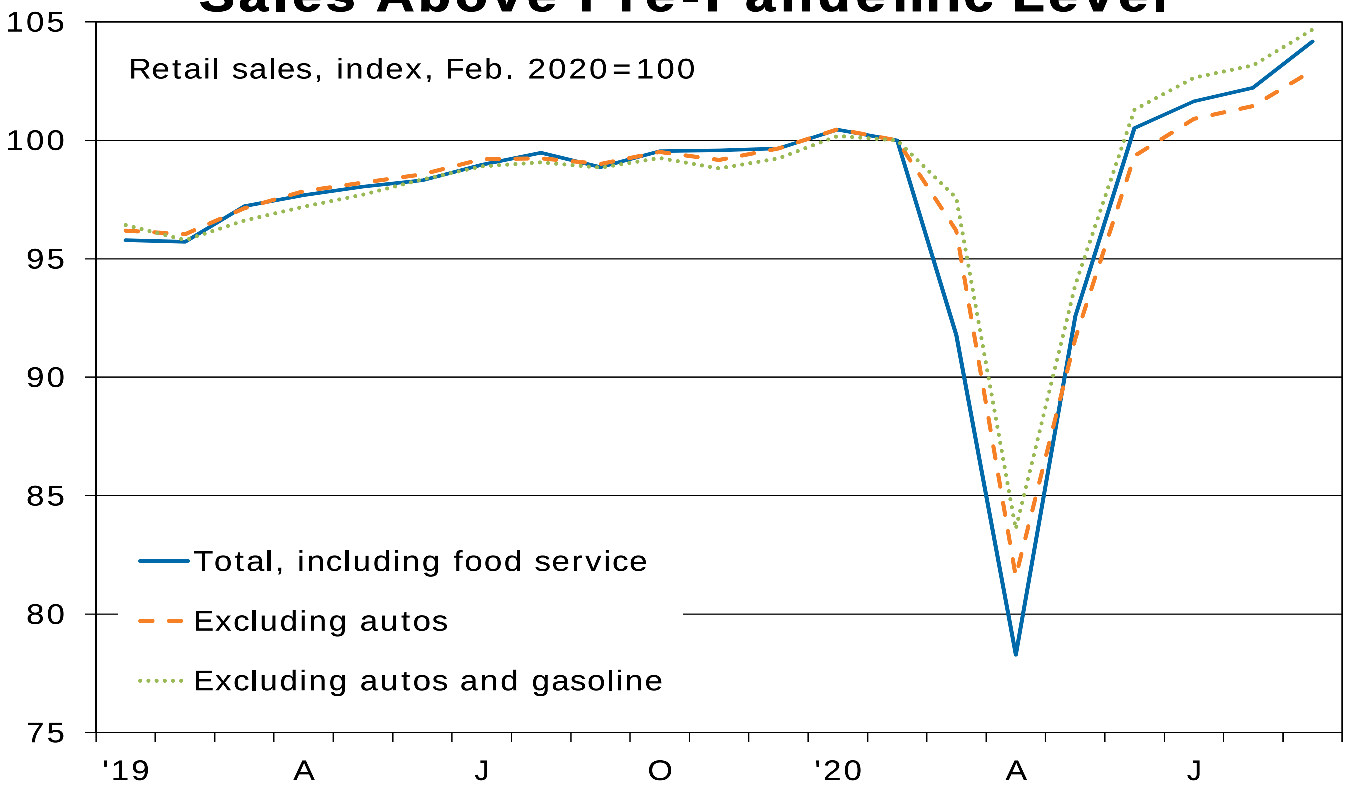

Chart source: Census Bureau

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in May. Core inflation was 1.7 percent year-over-year in September, unchanged from August and up from 1.2 percent in May and June.

Inflation has been on a roller coaster ride lately, but now things are settling down. Prices actually declined in aggregate in the late winter and early spring as demand plunged for many good and services, especially energy, air transportation, and used cars and trucks. Prices then rose as the recovery from the Viral Recession got underway in mid-year. Now price gains are modest as supply chain disruptions have eased and weak demand and excess capacity in many parts of the economy have limited firms' pricing power. According to respondents to PNC's recent semiannual survey of small and mid-sized businesses, inflationary pressures have declined from the spring, both for the inputs these firms use and the prices they charge their customers.

After slowing in mid-year because of the Viral Recession, both core and overall inflation have picked up somewhat on a year-ago basis. The Federal Open Market Committee would like inflation to average 2 percent over the medium term, as measured by the personal consumption expenditures price index, which tends to run a bit more slowly than the CPI. Both overall and core CPI inflation are well below that objective, and have been below it for most of the past decade. Thus the central bank would like to see inflation move somewhat above 2 percent, at least for a couple of years. As long as inflation remains below 2 percent the FOMC will keep its short-term policy rate, the fed funds rate, in its current range of 0.00 to 0.25 percent, providing stimulus to the economy. PNC expects the FOMC to keep the fed funds rate in this near-zero range at least into 2024. The FOMC may also try to push long-term interest rates even lower, to spur a stronger economic recovery and inflation of above 2 percent.

Chart 2: Industrial Output Still Well Below Pre-Pandemic Level, Flat Since July

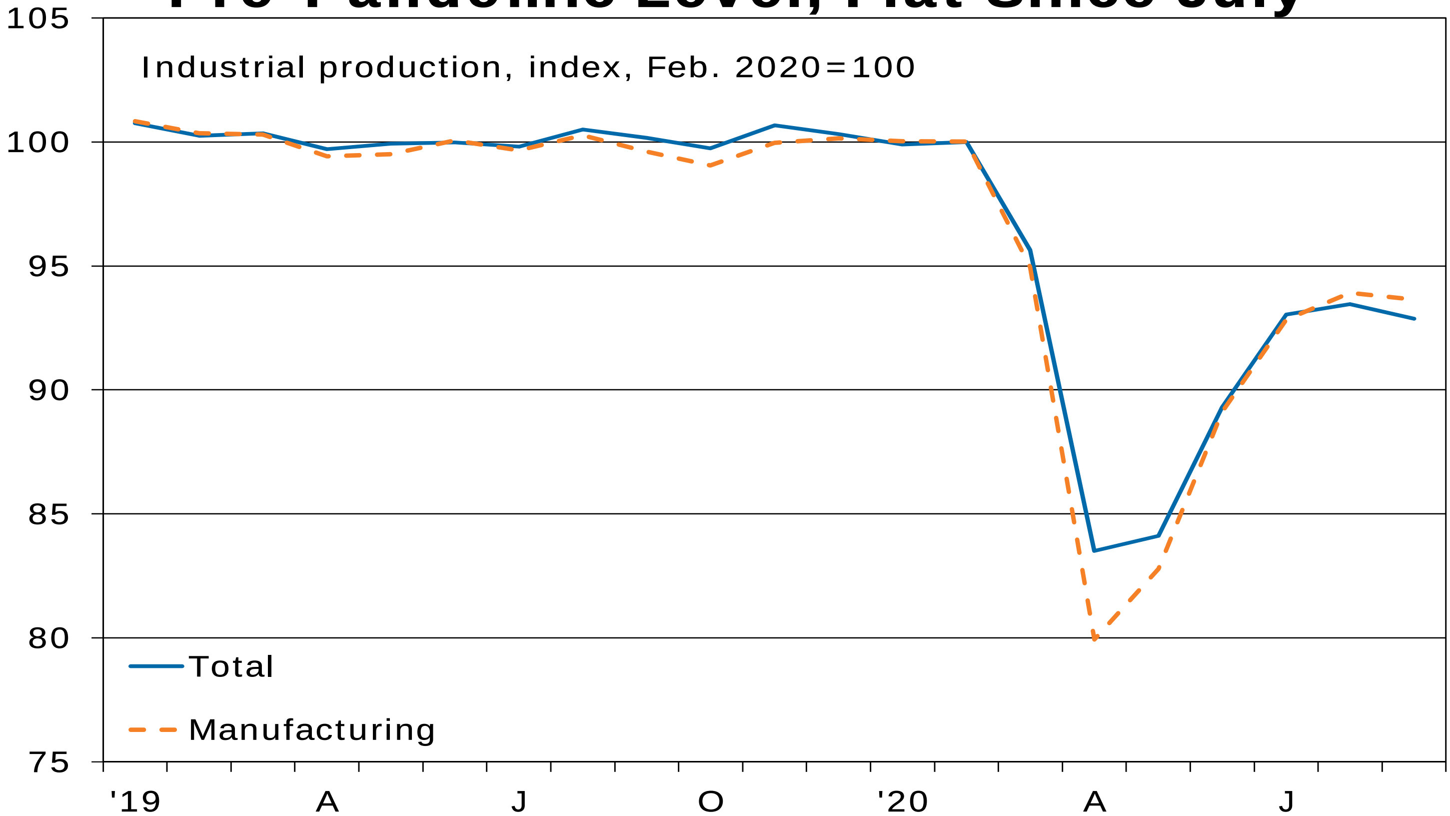

Chart source: Federal Reserve Board

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