The consumer is king

### Much stronger than expected retail sales
Retail sales surged 0.8% in July, above expectations of a 0.3% gain. After netting out autos, gasoline and building material sales, “core control” sales climbed 0.9%. This is significantly above our forecast and adds 0.4pp to Q3 GDP growth, bringing our tracking for Q3 GDP to 1.7%. Our tracking for Q2 GDP was unchanged at 1.8%. While this is certainly far from healthy growth, it is also clearly not at recession levels either. Combined with the solid payroll report for June, today’s retail sales data further reduces the likelihood of QE3 in September but does not take it off the table, in our view. All eyes are on durable goods next week and July payrolls in early September. Today’s data may have bought the Fed some time.

- **The volatile components**: Auto sales edged up 0.8%, gasoline station sales increased 0.5% and building material sales jumped 1.0%. Gasoline sales have tumbled over the prior three months, reflecting lower prices. On a seasonally adjusted basis, gasoline prices stabilized in July. Building material sales have also been very noisy – falling sharply over the prior few months after very strong gains in the winter. We think this was largely due to abnormal weather patterns and July is likely a “clean” read.

- **General merchandise**: Consumers increased spending on general merchandise with department store sales up 0.6% and non-store retailers posting a solid 1.5% gain. Sporting good sales also up 1.6%, clothing up 0.8% and electronics gained 0.9%. The gain in non-store retailers, which capture internet shopping, has been impressive over the past several years, up over 15% this year.

- **Consumer fundamentals**: The strong gain in July sales comes on the back of several months of sluggish growth. Overall, consumer fundamentals are still weak with only slow job growth and hence sluggish income gains. That said, in part because of the drop in commodity prices, real disposable income has been on an up trend, running at a three-month annualized pace of 3.8%. The saving rate was able to tick up to 4.4% in June. This recent improvement may have supported consumer spending.

- **GDP implications**: Even after assuming a modest payback in core retail sales over the next two months of the quarter, today’s report adds 0.4pp to Q3 GDP growth. We are therefore now tracking 1.7% for Q3 GDP growth. The revisions were minor, hence leaving Q2 GDP sill tracking 1.8%.
The bigger picture: Despite today’s stronger retail sales report, we remain comfortable with our outlook for the second half of the year. We continue to believe that the uncertainty shock from the fiscal cliff will start to show up in the hard data in short order. Corporations will likely slow investment, initially in equipment and software, but ultimately also in labor. We believe this will spill over to the consumer, translating to a slowdown in spending and lower confidence. We still have confidence in our forecast for 1% GDP growth in Q4.

FOMC implications: While we believe the Fed will engage in QE3 before year-end, today’s retail sales report is another piece of data (along with June payrolls) that makes it less urgent. We look for the Fed to extend its forward guidance for the first rate hike at the September 13th meeting from late-2014 to late-2015. But, we believe it has become less likely that the Fed will go ahead with a one-two punch and announce QE3 at the next meeting as well. We believe it has become increasingly possible that the Fed waits until December for confirmation of the slowing economy and completion of operation twist. That said, it is clearly data dependent – durable goods next week will be an indication of corporate behavior, ISM on September 4 will provide an update on the slowing manufacturing sector and, of course, the all-important jobs report on September 7.

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