US: Robust retail sales argue for a more cautious Fed

US households are in the mood to spend, buoyed by rising real incomes and asset prices. With inflation broadly in line with the central bank's target and unemployment close to 50-year lows, we don’t see the case for anything more than a couple of precautionary Federal Reserve rate cuts

Source: iStockphoto

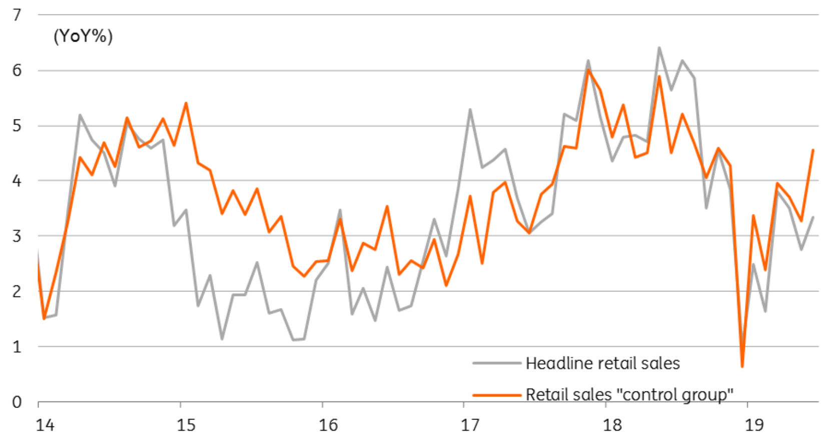
Sales surge

US June retail sales look very strong with the “core” retail sales control group rising 0.7% month-on-month (consensus 0.3%) with upward revisions to the history. Headline sales rose a more modest 0.4% (consensus 0.2%), but even this is a firm figure that suggests the market is too aggressive in terms of pricing for interest rate cuts.

The headline rate was always going to be somewhat depressed given it is a nominal (value) figure and faced having to deal with a near 5% fall in the retail price of gasoline (3.6% on a seasonally adjusted basis, according to the CPI report). Gasoline station sales consequently fell 2.8% MoM. We also knew that the auto component wasn’t going to contribute meaningfully given unit sales were unchanged on the month. Nonetheless the nominal value of motor vehicle and parts sales rose 0.7% MoM in today's report, suggesting some margin improvement.

It is the core control group that really interests us though. It excludes the volatile food, auto, building materials and gas station sales and better reflects the spending patterns seen in the personal consumer expenditure data, which in turn contributes to GDP. There was broad strength with furniture, clothing and health rising 0.5% while non-store retailers saw sales rise 1.7% MoM for the second month in a row. The year over year growth of this key indicator continues to strengthen and currently stands at 4.6%.

Retail sales surge back



Source: Bloomberg

Today's retail sales report suggests that personal consumer spending rose robustly in 2Q, probably close to 4% annualised, which in turn will help to keep GDP growth above 2%. Despite this financial markets continue to price in four 25 basis point interest rate cuts from the Federal Reserve over the next 18 months.

Yet, in an environment where growth is solid, core inflation is close to target, unemployment is near 50-year lows and stock markets are at all-time highs, there seems little justification for anything more than precautionary rate cuts. We expect 25bp moves in both July and September as an insurance policy to try and mitigate any negative effects from lingering trade tensions. For us to put more cuts into our forecast, we would need to see a dramatic escalation in the US-China trade conflict that would lead to clear evidence of weaker hiring and investment. At this stage, there is little evidence of this happening.

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