U.S. Economic Flash

Bernanke Emphasizes Risks, June's Inflation and Production Data Unlikely to Influence Immediate Fed Policy

- ### Fed Chairman Addresses Cautions on Economic Outlook

Ben Bernanke spoke today in his semiannual monetary policy report to Congress, reiterating most details that were highlighted in the latest FOMC meeting minutes. The Fed Chairman touched on the recent slowing in economic activity as well as the downside risks to growth, yet no new anecdotal information was revealed. In regards to the labor market, he noted that the slowing in employment growth throughout 2Q12 can only partially be attributed to seasonal adjustment issues and the unusually warm winter weather. The full extent to which these factors have contributed to the loss of labor market momentum will likely be clearer when July's data are released. Despite the recent declines in gas prices that have boosted consumer spending power, uncertain employment and income expectations have kept household confidence low. Bernanke mentioned that this is also translating into hesitation among "would-be home buyers", limiting potential growth in housing activity. While the usual headwinds to the recovery remain, Bernanke emphasized the significance of the European fiscal and banking crisis and the U.S. fiscal cliff as the two main sources of risk moving forward. European authorities have taken "constructive steps" to improving the fiscal situation in the region, and the U.S. has been working to improve its financial system so as to avoid severe shocks. Still, Bernanke stressed that "European developments that resulted in a significant disruption in global financial markets would inevitably pose significant challenges for our financial system and our economy." Domestically, the impending fiscal cliff remains a significant risk to growth. As in previous statements, Bernanke once again underlined the importance of cooperation in Congress to address these fiscal challenges so as to avoid further deterioration in economic activity. Finally, the Chairman reiterated the Fed's commitment to take further action as appropriate, though he revealed no additional insight on the probability of QE3.

- ### Upward Pressure on Core Inflation Continues

The consumer price index was unchanged in June following a 0.3% decline in May. Energy prices continued to decline for the third consecutive month, down 1.4% due in large part to a 2.0% drop in the gasoline index. Food prices helped to offset some of the energy price declines, gaining 0.2% after remaining unchanged in the previous month. Headline inflation remained steady at 1.7% on a YoY basis, in line with our models which suggest an annual rate near 2.0% for 2012. However, components other than food and energy continue to exert pressure on core inflation, which increased 0.2% for the fourth consecutive month. On the services side, medical care prices accelerated to 0.7% growth in June while shelter prices increased a modest 0.1%. Leading the commodities were apparel and new vehicles, which increased 0.5% and 0.2%, respectively. In general, inflation data for June are unlikely to have much influence in the next FOMC meeting. Views on the risk of higher inflation will remain divided given the disparity between headline and core figures.

- ### Industrial Production Rebounds in June

In other news, industrial production recovered from previous weakness, increasing 0.4% in June after falling 0.2% in May, with the index reaching its highest level of the recovery. Total output was lead by the manufacturing sector, which gained 0.7% to offset the 0.7% decline in the previous month. Given the latest deterioration in other indicators on the sector, growth in manufacturing output is a positive surprise that should ease some worries on slowing activity. Mining output also increased 0.7% in June, while utilities declined 1.9%. While the growth in manufacturing and total output is certainly good news, the data are not necessarily enough to convince FOMC members that we are out of the woods just yet. As Bernanke mentioned in his speech to Congress, "forward-looking indicators of investment demand suggest further weakness ahead."

Kim Fraser
kim.fraser@bbvacompass.com
+1 713 831 7345