

# Monthly Economic Update

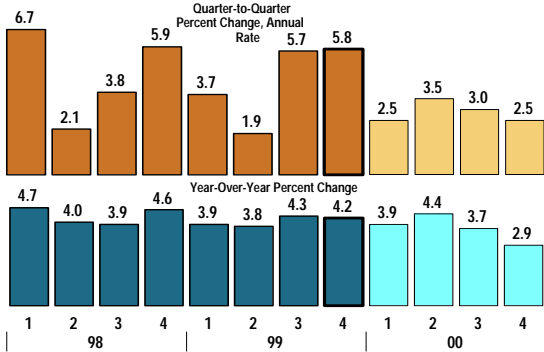
## Main Themes

Planning & Research

February 4, 2000

### Real GDP Growth Surges Higher Interest Rates Will Slow Growth in 2000

#### Real Gross National Product



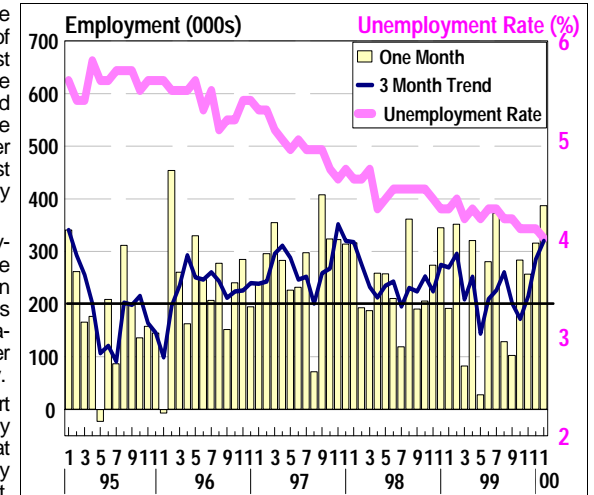
- For the second quarter in a row real gross domestic product (GDP) grew at over a 5% annual rate, led by inventories and federal government spending.
- For 1999 real GDP grew 4.0%, the third year of 4% or more growth.
- Real consumption also remained strong, growing at a 5.3% annual rate, led by spending for furniture and consumer electronics. Real spending on clothing and shoes, however, declined during the quarter.
- Year-over-year real GDP remained in the over 4% range that is above what the Federal Reserve feels is consistent with acceptable inflation.
- Reflecting the continued strength in the economy, overall GDP prices increased at a 2.0% annual rate, the largest increase since the first quarter of 1997.
- Growth will need to slow to reign in the upward inflation trend that appears to have started in the fourth quarter.

### Growth Continues Too High Interest Rates Rise to Slow Growth

- As the economy moved into the longest economic expansion in history, economic growth continued to exceed the rate that the Federal Reserve considers consistent with a low stable inflation rate.
- Responding to the excessive growth rate, the Fed raised interest rates for the fourth time since July 1999.
- At least two more rate increases are likely this year, including one in March.
- The impact of higher rates will take time to work its way throughout the economy and overall growth will remain relatively strong in 2000.
- Rising interest rates will ultimately slow economic growth by weakening the stock market, slowing export growth, and moderating consumer demand, particularly for housing and big ticket consumer durables.
- Sales growth at general merchandise and apparel specialty stores (GMA) and drug stores, while expected to slow from the very high rates of 1999, will remain relatively strong with GMA up about 5% and drug store sales up 8%.

### Surging Employment Growth Confirms Excessive Economic Momentum Unemployment Rate Lowest Since January 1970

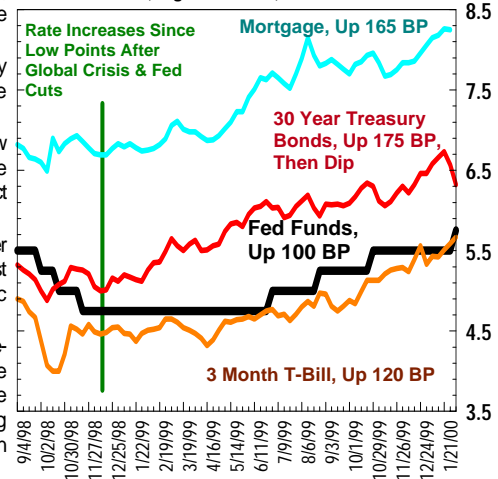
- The January increase in employment of 387,000 was the largest monthly increase since September 1997, and brought the three month average over 300,000 for the first time since January 1998.
- Some of the employment gain can be traced to a surge in construction payrolls related to the unseasonably warm weather during most of January.
- However, this report confirms the many other indicators that point to an economy that is growing too fast, giving support to the expectations that the Fed will raise interest rates further.
- The unemployment rate declined to a 30-year low of 4.0%. Without slowing of employment growth, it is likely that the unemployment rate will decline again, putting increasing pressure on wages.



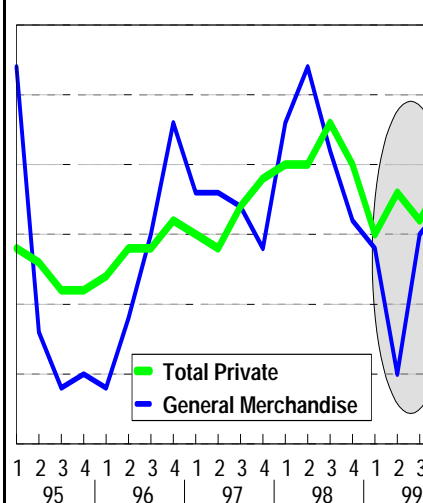
### The Federal Reserve Raises Short Term Interest Rates Again However, the Treasury Uses the Surplus to Buy Back Long Term Bonds, Driving Long Rates Down

- Responding to continued strong economic growth, tight labor markets, higher inflation, and wage acceleration the Federal Reserve raised the federal funds rate by 25 basis points (bp).
- They also stated that the risks for the economy were "weighted mainly toward conditions that may generate heightened inflation pressures in the foreseeable future."
- The increase in interest rates that the Fed started in July of last year now stands at 100 bp. However, the federal funds rate is only 25 bp above the level in September 1998, before the Fed lowered rates to offset the impact of the world financial crisis.
- With the S&P500 40% above the September 1998 level and consumer confidence at a record level it will probably take further increases in interest rates to slow consumer spending enough to prevent strong economic growth from leading to higher inflation.
- Rates on long-term Treasury bonds, particularly the 30 year, dipped recently, not because of diminished inflationary expectations, but because the Treasury Department announced it would only auction 30-year bonds once a year, not twice, and use some of the budget surplus to buy back existing long-term bonds. Lower long-term rates may offset some of the impact on spending of the Fed's increase in short rates.

Economic Growth, Higher Inflation, Fed Increases Drive Market I



### Compensation Increases Accelerate Is This the Beginning of Wage-Price Spiral?



- The employment cost index for total compensation increased by 3.4% in the fourth quarter over the previous year.
- This is the largest increase since the fourth quarter of 1998, and looks like it may be the beginning of the increase in wage inflation that we have been expecting for some time.
- Compensation in the general merchandise industry increased by 3.2%, reflecting a sharp step-up from a 2% gain in the second quarter.
- This upward trend in wage inflation combined with strong economic growth and tight labor markets reflect an increase in price pressures that will probably require a number of interest rate increases to dampen.
- Should the Fed be overly cautious in fighting this increase in price pressure now they may need to be overly aggressive in the future and risk a more negative outcome.

	1999	1999	1999	1998
GENERAL ECONOMY	OCT	NOV	DEC	DEC
Payroll Emp. Change (000's)	284	257	316	2,719
Unemployment Rate (%)	4.1	4.1	4.1	4.4
Industrial Prod. (%CH)	1.0	0.4	0.4	5.0
Housing Starts (millions)	1.642	1.598	1.712	1.750
3 Month T-Bills (%)	4.86	5.07	5.20	4.39
30 Year T-Bond Yield (%)	6.26	6.15	6.35	5.06
S&P 500 (Index)	1300.0	1391.0	1428.7	1190.1
Percent Change from Prior Month				
PRICES	OCT	NOV	DEC	DEC
PPI	-0.1	0.2	0.3	3.0
CPI	0.2	0.1	0.2	2.7
GVA Price Index	0.3	-0.4	-0.1	-1.0
Drug Store Price Index	0.1	0.2	0.1	3.0
Percent Change from Prior Month Seasonally Adjusted				
CONSUMER RELATED	OCT	NOV	DEC	DEC
Consumer Confidence Index	130.5	137.0	141.7	126.7
Consumer Sentiment Index	103.2	107.2	105.4	100.5
Disposable Personal Income	1.3	0.4	0.2	5.8
Wage & Salary Income	0.6	0.3	0.7	6.6
Consumer Spending	0.6	0.7	0.8	7.7
Consumer Credit - Total	0.4	1.1	NA	NA
Consumer Credit - Revolving	0.0	0.8	NA	NA
Retail Sales	0.3	1.1	1.2	9.7
GVA	0.0	0.1	0.6	7.0
Percent Change from Prior Year Not Seasonally Adjusted				
RETAIL SALES	OCT	NOV	DEC	YTD*
Total	6.8	10.7	10.3	9.2
GVA	6.2	5.5	7.8	7.7
GAF	6.2	6.0	7.8	7.8
Department Stores+	6.1	4.8	7.9	7.4
Apparel Specialty	3.8	4.4	5.5	6.4
Furniture & Appliance	6.0	8.0	7.8	7.9
Mall Dept. & Apparel Spec. (MDA)	2.5	2.0	3.6	4.1
Drug Store Sales (DSS)	9.4	11.4	12.0	11.6
Percent Change from Prior Year				
JCPENNEY SALES	OCT	NOV	DEC	YTD*
Total Company**	2.8	0.7	7.0	6.1
Store Merchandise**	-7.4	-8.7	0.2	-3.9
JCP Drug Store Sales**	21.3	19.7	25.2	20.9
JCP SHARE	OCT	NOV	DEC	YTD*
Store Share of GVA -1999	2.42	3.55	2.85	2.71
Store Share of GVA -1998	2.77	4.10	3.07	3.02
Rolling 12 Mo. Store Share - 99	2.75	2.70	2.67	NA
Rolling 12 Mo. Store Share - 98	3.07	3.06	2.98	NA
JCP Drug Str Share of DSS - 99	9.54	12.49	9.38	10.45
JCP Drug Str Share of DSS - 98	8.60	11.63	8.39	9.65

\* Fiscal Year                      \*\* Internal Reporting    NA Not Available

+ Includes national chains, conventional, & discount department stores

## GENERAL ECONOMY

- US economic growth continued robust at 5.8% in the fourth quarter according to preliminary figures. The biggest sources of fourth quarter strength were inventory accumulation, government spending and consumer spending on goods. On an annual basis compared to 1998, the economy grew at 4.0%, still strong though down somewhat from 4.3% and 4.5% in 1998 and 1997. The last time the economy expanded 4% or better for three consecutive years was 1976-8. Consumer spending grew at a strong 5.3% from 1998, the biggest gain in 15 years. While relatively small, there do appear to be Y2K related effects in inventory accumulation and consumer spending which will likely reverse in the first quarter, slowing growth somewhat.
- On February 4, the Labor Department reported that **payroll employment grew 387,000 in January**, after increasing 316,000 in December. The growth was inflated by a surge in construction employment due to warm weather early in the month. Employment growth has averaged 320,000 per month over the past three months, significantly faster than the Federal Reserve Board would like to see, making additional rate hikes likely.
- The same government report showed that in January, the unemployment rate dropped to a new 30-year low of 4.0%** - the lowest since January 1970. This, combined with claims for unemployment insurance that are at historic lows as a share of the labor force, confirm that labor markets remain extremely tight.
- Industrial production increased 0.4% in December. It was up a strong 5% from 1998, the biggest year-over-year gain since May 1998.
- Housing starts jumped in December despite higher interest rates. Starts for all of 1999 reached 1.66 million units, the highest since the real estate boom in 1986.
- In January, the interest rate on the 3-Month T-Bill averaged 5.32%, with the average yield on the 30-Year T-Bond at 6.63%. Since then, the Federal Reserve Board (Fed) has raised the federal funds rate 25 basis points and the Treasury Department has announced refinancing plans that include a substantial reduction in the issuance of long term bonds due to the budget surplus. These developments have driven the 3-month rate up to 5.45% on February 3 and the 30 year rate down to 6.14%. In fact, the yield curve is partially inverted with the highest rates in the two to five year maturities. This inversion is a result of supply issues and not a harbinger of a recession.
- The S&P 500 averaged about 1425 in January, little changed from December. It closed at 1425 on February 3.

## PRICES

- The Producer Price Index (PPI) rose 0.3% in December from November. Year-over-year, the PPI was up 3.0% in December.
- Consumer inflation, as measured by the Consumer Price Index (CPI) increased 0.2% in December. Year-over-year gains ticked up to 2.7%, the biggest year-over-year gain since May 1997.
- The GMA price index dropped 0.1% in December. It is now down 1.0% from last year.
- The drug store price index increased 0.1% in December, with the year-over-year gain slipping back to 3.0%.

## CONSUMER RELATED

- The Conference Board's Consumer Confidence Index, **jumped to 144.7 in January** according to preliminary figures—the **highest figure in the 32 year history of the series**. The consumer assessment of present conditions also jumped to its highest level ever, while the gauge of expectations for the next six months hit a 16 year high. The University of Michigan's Consumer Sentiment Index, **also achieved a record high, of 111.4 in January**, according to preliminary figures. It was led by its expectations component. **These high confidence levels suggest continued strong spending.**
- Special factors which have boosted income growth the past several months are virtually gone with the result that disposable income grew only 0.2% in December. Disposable income was up 5.8% in December from 1998. For the year, disposable income grew 5.6%, over 1998, the biggest annual growth since 1992.
- Wage and salary income increased 0.7% in December and 6.6% from 1998. For the year it was up 6.8% over 1998.
- Consumer spending increased 0.8% in December and is up a strong 7.7% from 1998. For the year, spending grew 6.9%, the biggest annual gain in a decade.
- Total consumer installment credit outstanding surged 1.1% in November from October, led by auto loans. It increased 6.9% from 1998. With higher mortgage rates having put a damper on consumer refinancing, consumer installment borrowing may be picking up.
- Revolving consumer installment credit increased 0.8% in November. Compared to 1998 it grew 5.7%.
- Seasonally adjusted retail sales surged 1.2% in December, bringing year-over-year growth to a strong 9.7%. Growth was led by a 2% jump in sales at grocery stores, the biggest gain since January 1989 when inflation was much higher. The grocery store gain, and perhaps some other gains, may have been driven by Y2K related stock piling by consumers.
  - Seasonally adjusted GMA increased 0.6% in December from November following two weak months. Sales were up 7.0% from 1998.

## RETAIL SALES

- GMA sales growth improved 7.8% from 1998 in December. Sales are up 7.7% on a year-to-date basis.
  - Unadjusted department store sales growth improved to 7.9% in December, with year-to-date growth of 7.4%.
  - Unadjusted apparel specialty store sales growth was 5.5% in December with year-to-date growth of 6.4%.
- Mall department and specialty apparel store (MDA) sales growth improved to 3.6% in December (estimated). Sales were up 4.1% year-to-date.
- GAF sales rose 7.8% in December from last year. On a year-to-date basis, GAF also increased 7.8%.
- Drug store sales surged 12% year-over-year in December, possibly inflated by Y2K related stockpiling. Year to date, sales are up 11.6%.
- JCPenney store merchandise sales **increased 5% in January** according to preliminary data, the first back to back increase since the spring of 1998. These data also show JCPenney **drug store sales increased 15.0% in January**, as consumers shifted some purchases from January to December due to Y2K concerns. **Total company sales were up 10.6% in January**, compared to 7.0% in December.
- JCPenney store merchandise share of GMA dropped in December, compared to 1998 in a monthly and a year-to-date basis.
- JCPenney drug store share of drug store sales was 9.38% in December, up from 8.39% in 1998. Year-to-date market share has increased slightly—80 basis points—in part reflecting the Genovese acquisition.