

THE ECONOMIC OUTLOOK GROUP



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ECONOMIC TALKING POINTS

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The Smaller Drop in GDP is Deceiving

You can tell confidence in the economy is awful when everyone seems grateful that fourth quarter GDP declined by *just* 3.8%. The consensus survey had economists looking for a drop of more than 5%, so it's understandable why many have expressed relief the deterioration wasn't as bad as initially feared.

But let's be clear here. This is the advance report and some of the data on the economy for the last three months have not yet been collected. When faced with incomplete information, economists at the Bureau of Economic Analysis (BEA) fill in the gaps with guesses. Normally, their estimates tend to be fairly close to the actual numbers. However, when an economy is being pounded by severe shocks (such as the credit crises, a breakdown down in private capital markets, a collapse in housing and a dramatic jump in joblessness), the estimates by government economists could be way off the mark.

In fact, even under calmer conditions, the average revision between the advance report and the one released a month later has been a 0.5 percentage point change in either direction (plus or minus). By the time all revisions are completed, the average change from advance to the last GDP report tends to be 1.2 percentage points. So, yes, there is the temptation to breath a sigh of relief conditions weren't much worse. Just bear in mind that IVQ GDP is likely to be revised upwards, perhaps substantially, as more data becomes available.

Having said that, let's draw some conclusions from this first report. Economic activity slowed sharply in the final three months of 2008, with GDP falling at a 3.8% rate. That followed a 0.5% drop in the third quarter. The fourth quarter dive was the steepest since 1982 and it brought GDP growth for the entire year to a miserly 1.3%, the slowest since the last recession in 2001. The US economy has now been shrinking in size three of the last five quarters.

The greatest drag on the economy is consumer spending, which has completely shut down. Worries over job security, rising debt burdens, and the catastrophic loss of household wealth from plummeting home and stock values have so unnerved consumers that they are in lockdown mode. Personal spending fell at a 3.5% rate in the last quarter, which followed a 3.8% decline the previous period. It is the first time since 1947, when the government first kept tabs on household outlays, that we had two back-to-back quarters where expenditures declined by more than 3%. That negative trend will continue through the first half of this year as conditions in the labor market and household finances worsen.

Another sector pulling the economy down has been business investments. It fell at a 12.3% pace in the final quarter, after showing a slight 0.4% up tick during the summer period. What's startling, however, is that business spending has now fallen in 8 of the last 11 quarters. Within that category, we see a catastrophic collapse in residential investments. It declined at a 23.6% pace in the fourth quarter and has been in free fall *every quarter since the end of 2005.*

Nor can we count on exports to give the economy a lift any longer since every major country in the world is in or near recession. For the first time in this business cycle, exports fell at a 19.7% rate the last quarter. **This is the largest quarterly drop in exports in 34 years!!**

With consumer and business spending shrinking and exports plummeting, is there any sector in the economy where expenditures have picked up. Sure ---the government! Federal spending climbed at a 5.8% rate in the fourth quarter, more than offsetting the 0.5% fall by revenue-strapped state and local municipalities. Needless to say, we expect government outlays to explode in the coming quarters once the \$800 - \$900 billion economic stimulus plan is signed into law.

Final sales to domestic purchasers

The overall drop in economic activity would have been much worse had it not been for the government's practice of counting the change in inventories. Bear in mind, the GDP represents the total price tag in dollars of all goods and services made in the US. Even products that were made but not sold and ended up in stockroom shelves are still counted in GDP. You might see where I'm going with this. There was a significant rise in inventories last quarter as consumers stayed away from stores. That build-up in inventories added 1.32 percentage points to the GDP and thus masked the true weakness

of demand inside the US. Fortunately, the BEA also includes in its GDP report actual sales to US buyers *excluding* the change in inventories. That figure (known formally as “final sales to domestic purchasers”) more accurately represents how weak domestic demand is in this country. This category of final sales imploded in the final quarter, falling by a 4.9% rate, the biggest quarterly decline in 28 years!

Nominal GDP

So far, we’ve looked at GDP in real (inflation-adjusted) terms. When examined in nominal dollars, GDP shrank by 4.1% in the final three months of 2008, the largest fall recorded since 1958. Nominal GDP closely parallels the trends in corporate sales and thus has ominous implications for earnings.

Inflation/Deflation

Another worrisome development is the increasing probability that deflation is around the corner. The headline personal consumption expenditure (PCE) price index plummeted by a record 5.5% in the last quarter. If you strip out food and energy, core PCE rose 0.6%, quite a contrast from the 2.4% rate in the third period. Clearly, the Federal Reserve was right to warn in its FOMC statement earlier this week of the growing danger of deflation, saying “the Committee sees some risk that inflation could persist for a time *below the rates* that best foster economic growth and price stability in the longer term.” The Fed didn’t want to utter the word “deflation” but it is certainly on their radar screen and that blip is getting larger and brighter.

ECI and Consumer Sentiment

Two other key reports were released today. The modest 0.5% rise in the Employment Cost Index last quarter was the smallest in nearly a decade. As we said yesterday, businesses are in survival mode and they are slashing payrolls, benefits and hours worked as much as possible. The wage and salaries component in the private sector inched up 0.6% in the fourth quarter, the same as in the summer period. But benefit costs did ease back to 0.4% rise, from 0.6% the previous quarter. If you look at the trend over the full year, wages and salaries climbed 2.6% in 2008, compared with 3.3% in 2007 and 3.2% in 2007. The cost of benefits increased by just 2%, versus 2.4% the year before and 3.1% in 2007.

One countertrend out today has been the final January number on consumer sentiment by the Reuters/University of Michigan survey. It actually rose to 61.2 from 60.1 in December. Frankly, there isn’t much to extrapolate from this number. Perhaps people were inspired by a young and dynamic new President in the White House. Perhaps it was the decline in gasoline prices (which has since rebounded) or expectations that the

massive economic stimulus bill will help rescue the economy. All these explanations may be a reach since earlier this week, the Conference Board came out with its own January survey on consumer confidence and it dropped to a record low of 37.7. Whichever survey you prefer, what we do know with certainty is that the mood of consumers are greatly depressed and will remain so in the months ahead.

Bottom line: We are facing the greatest economic crises in our lifetime and the latest GDP report underscores. Consumers and businesses are hunkering down and bracing for a prolonged downturn. Although talk the Great Depression sounds like ancient history, I'm afraid we could be staring at this monster once again. The economic stimulus, while significant in size and scope, is unlikely to have a material effect on the economy until late this year --- and even then the benefits will be quite modest initially.

Our expectation is that we will see further declines in GDP the first two quarters of 2009, followed by positive, but very sluggish, growth in the second half with the unemployment rate continuing to rise until early 2010. Despite all of the monetary easing, the upcoming surge in government spending and tax cuts, we believe it's going to take a minimum of 18 to 24 months for this economy and the financial sector, in particular, to recuperate from the follies committed earlier this decade.