THE ECONOMIC OUTLOOK GROUP

475 WALL STREET
PRINCETON, NEW JERSEY 08540 TEL: 609 - 529 - 1300
WWW.ECONOMICOUTLOOKGROUP.COM

ECONOMIC TALKING POINTS

Bernard Baumohl
Chief Global Economist

July 31, 2009

The GDP Report: The Economic Nightmare is Just About Over. But Prepare for a Jagged V-Shaped Recovery.

Before we get caught up in the minutia of the latest GDP benchmark revisions, let's begin with the most urgent questions: What does the GDP report tell us about the current state of the economy? Is this recession over? And, if so, what can we look forward to?

Based on the latest data, the economy continues to transition from contraction to growth. What comes next, however, could be several quarters of a jagged v-shaped, stomach-churning recovery.

Here are some of the highlights from the new GDP release:

(1) In terms of GDP growth, our forecast for the second quarter was just about spot on with our call for a 0.9% decline; the official data printed a 1.0% drop in output, which turned out to be the smallest in a year and suggests the recession has lost its grip in the spring.

What we did not quite expect, however, was the much steeper fall in activity during the first three months, when the economy tumbled at a 6.4% rate, the worst performance in nearly 30 years. We have now had four straight quarters of decline in the GDP, the longest streak in history (or at least when such records began in 1947). We believe that, streak, though, has ended in this quarter.

(2) What are the latest sources of strength and weakness in the economy?

For one, consumer spending continues to pull the economy down. It fell at a 1.2% rate in the second quarter, after an anemic 0.6% increase the first three months of the year. Note that U.S. households have slashed spending in four of the last six quarters. (And in those two periods where outlays did rise, it was still pathetic ---less than 1% each.) One obvious theme that runs through these numbers is that Americans were more traumatized by this recession than any in the past 80 years. They suffered historic losses in personal wealth and watched helplessly as employers were firing workers at a pace not seen since great Depression. The cutback in spending this past quarter was enough to subtract 0.88 percentage points from the GDP numbers.

Nevertheless, we continue to believe the outlook for consumers has turned brighter. We expect households to resume spending in the second half for several reasons. First, the destruction in household wealth has finally run its course. The value of residential real estate, the largest asset Americans own, has stabilized. Indeed, the median price of existing homes is now the highest since October 2008. Second, the stock market has moved higher in recent months as well. The S&P 500 has gained more than 9% and the NASDAQ is up a hefty 25%. In addition, there is a growing sense among individuals that the recession has bottomed out. These factors, plus the rise in household purchasing power (thanks to falling inflation) will improve consumer psychology. Since Americans have essentially stopped shopping since late 2007, there has been a build in pent up demand, which should stimulate spending the rest of this year and through 2010. As a result, we expect consumer expenditures will rise and contribute to GDP growth.

(3) Businesses outlays this past spring dropped for the 7th consecutive quarter. The latest fall, a 20.4% decline, sliced 2.64 percentage points off GDP growth. What is worth noting, however, is the pace of that decline has slowed in every business category. For instance, aggregate spending fell by 20.4% in the second quarter, less than the 50.5% and 24.2% declines seen in the first and fourth quarters, respectively. Moreover, spending in the major business sectors --- equipment, commercial construction, and even homebuilding, dropped less than in earlier quarters too.

(3) Partially offsetting the damage done to the economy by the weakness in consumer and business expenditures has been the improved performance in U.S. trade. The US recession curbed imports, which fell more than 15% in the second quarter. Exports dropped too, but to a lesser extent, just 7%. The combination narrowed the US trade deficit in the second quarter and that contributed 1.38 percentage points to the GDP.

(4) The other sector that prevented the economy from slipping into an even deeper hole is the government. Though the Administration's $787 billion stimulus program has recently begun to dribble out, it was enough to help add 0.82 percentage points to growth in the last quarter. Even state and local government increased spending thanks to aid from Washington, adding another 0.30 percentage points to GDP. Much more of the Obama

stimulus plan will be injected into the economy in the second half of the year and through 2010, and that should add more momentum to growth.

(5) One promising piece of good news was the sharp decline in business inventories. The value of goods carried on store shelves, back lots and warehouses fell at a $141 billion annual pace in the second quarter, the most ever! That drop sets the stage for companies to replenish their stocks now that the economy is on the mend. A sustained jump in orders will ramp up production at factories, lead to new hiring, and increase household income and spending down the road.

A couple of quick points about the latest benchmark revisions.

The government does a comprehensive review of how they measure the country's economic performance every five years. At such times the Bureau of Economic Analysis refines its methodology, modifies some definitions, introduces new concepts and gets rid of old ones ---all to get a better, more accurate understanding of what is going in the world's largest economy. In the latest release, the government has revamped data going back all the way to 1929. What are some of the preliminary themes to emerge?

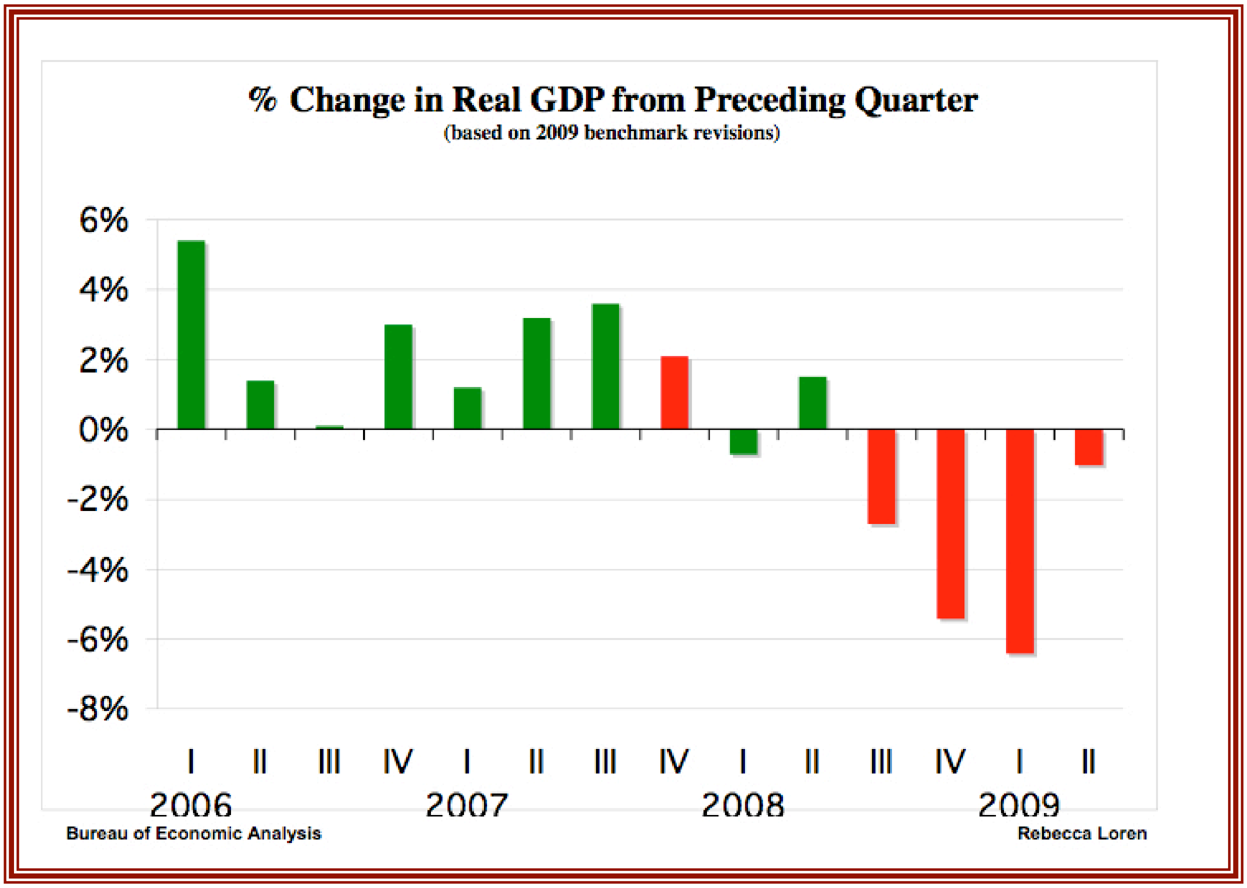
- The 2008 – 2009 recession is now the longest, most destructive since the Great Depression.

- Interestingly, when one looks back over the past decade (1998 thru 2008), the BEA found the economy actually did much better!! than previously thought. It revised growth upwards in seven of the last 11 years, left them unchanged in two, and lowered the performance for just two, 2006 and 2008.

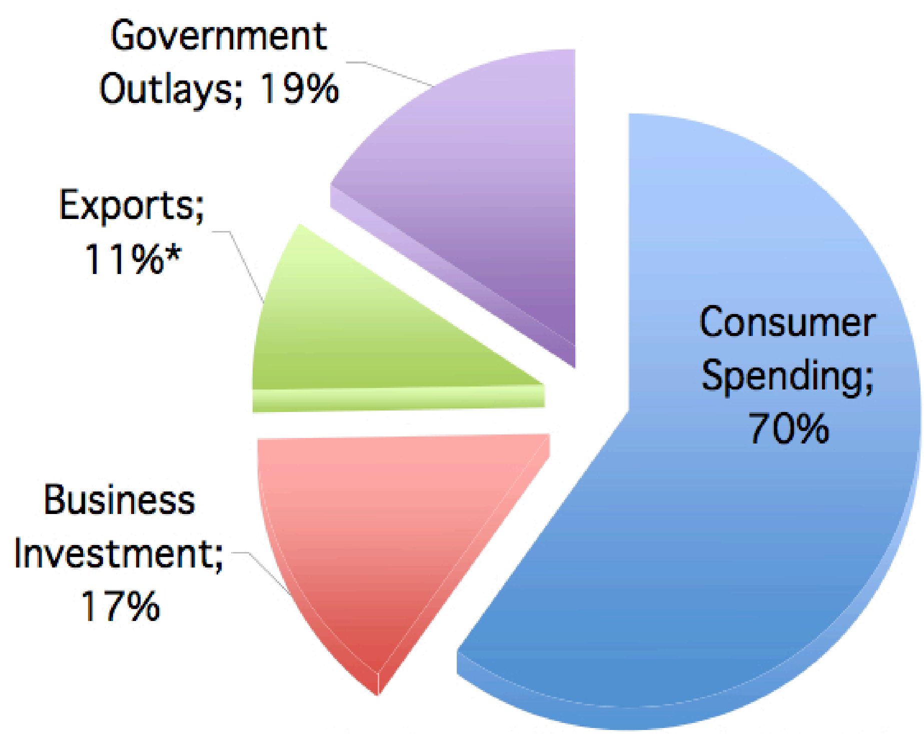
Could this mean the US economy bounces back with more vigor the next 18 months? Don't count on it. Too many structural problems afflict the US. It will take at least a half a decade for the financial sector to fully recover from years of reckless lending. In the meantime, credit will remain in relatively short supply. Both banks and households are also still in the process of deleveraging and this, too, will limit spending and borrowing. Nor should we expect employers to rush out the hiring signs. We have long argued that once this recession ends, we'll probably witness the mother of all jobless recoveries. In other words, the US economy will remain extremely fragile through at least 2011. Any new shock between now and then, economic or geopolitical, could trigger a relapse back into recession.

- Since the beginning of the recession in 2007, the sector that has seen its role shrink the most has been the private business sector. It represented 17% of GDP in 2006, the year before the downturn began, but now makes up just 11%. A major reason for that decline has been the free-fall in capital investments and residential spending.

Not surprisingly, the government's role in the economy has increased, moving up from 18.5% to 19.9% the last two and half years. One unexpected trend was that even with the cutback in household spending, the role of consumers went up from 69.9 in 2006 to 71.2% in the second quarter of this year. However that trend is expected to reverse as Americans save more, borrow less, and spend more cautiously in the years ahead.

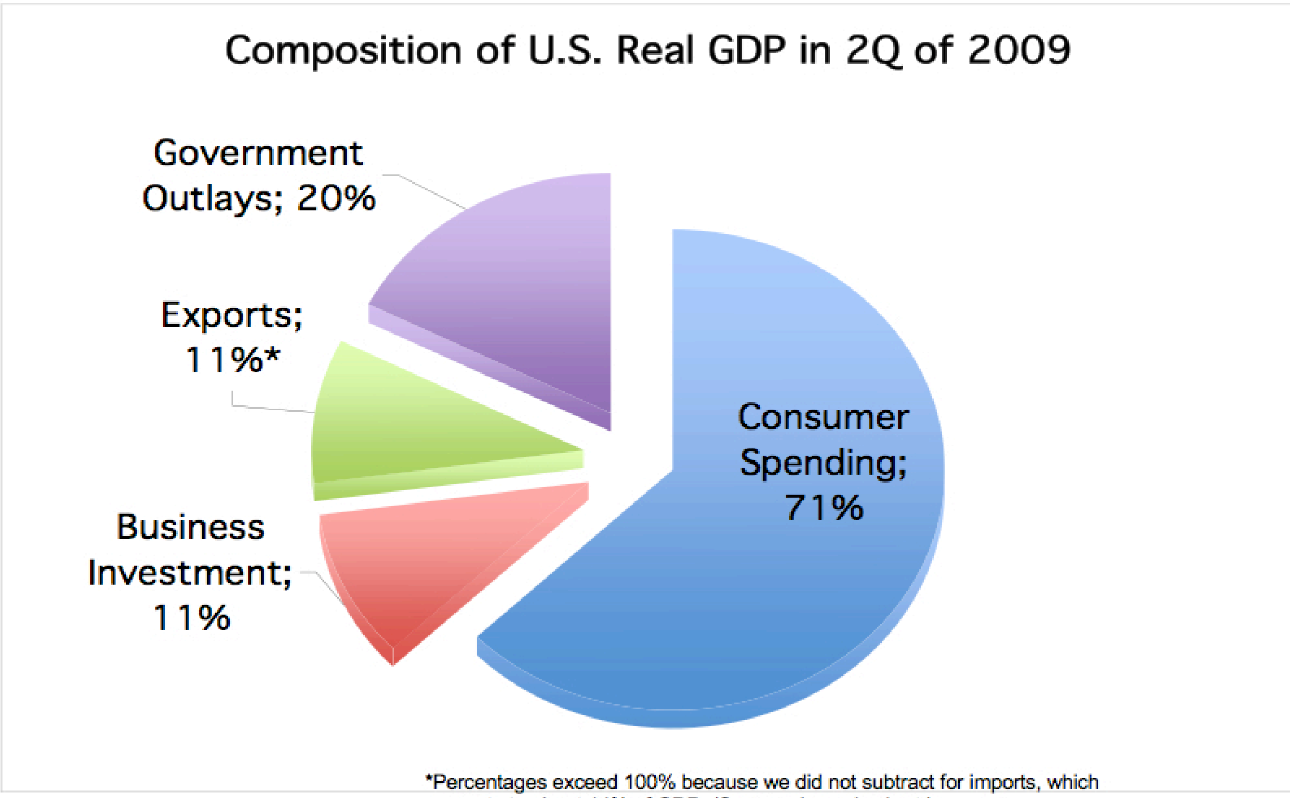


Composition of U.S. Real GDP in 2006



*Percentages exceed 100% because we did not subtract for imports, which amounts to 17% of GDP. The chart was designed to show how much these sectors contributed to the economy in 2006, compared with the second quarter of 2009.

Bureau of Economic Analysis **Rebecca Loren**



*Percentages exceed 100% because we did not subtract for imports, which amounts to about 14% of GDP. (See previous pie chart.)

Commerce Department

Rebecca Loren