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 & Managing Director

October 29, 2009

GDP: The U.S. Economy Is Back! (…with government help)

Sure, go ahead. Toss some of that confetti that's been boxed up for so long. A modest celebration is in order. With the latest 3rd quarter GDP report, we see the economy finally awoke this summer from its two-year long stupor. Our quick take on the latest numbers? This recovery is real and will be sustainable. We were quite bemused when some notable economists rushed at the last minute to revise their GDP forecasts downwards. It didn't make much sense to us. (Our own forecast called for a 3.4% growth.) Based on the data we saw today, the chance of a double dip recession has now slipped to below 20%.

This GDP report is actually quite revealing on several levels. After 12 straight months of declining economic activity, the economy confidently bounced back with its best performance in two years. Fuelling this latest spurt in growth was consumer spending, which jumped to a 3.4% pace, the biggest increase since the first quarter of 2007. Much of the surge in spending should be attributed to the "cash for clunkers" program and the $8,000 tax credit to first time homebuyers. Both programs played an important role in accelerating consumer expenditures this summer. But looking ahead, we believe other non-governmental factors will help to support economic growth. First, this positive GDP report should provide a powerful psychological boost to Americans as they grow more confident the economic crises is over. What this means is that 90% of Americans in the labor force who are working will be eager to spend again. They've effectively shut down spending for more than two years, the longest such retrenchment since the Great Depression. During that time households have accumulated a considerable pile of savings. How much you ask? According to the GDP report, total personal savings climbed from $178.9 billion in 2006, the year before the recession began, to a nearly $450 billion rate so far this year, the most in history!! Some of that savings is already being used to fuel a fresh round of spending. A hopeful sign for retailers this holiday shopping season.

But it's not just consumers that contributed to the latest pick up in GDP. Companies were also more inclined to spend. Expenditures by business rose at an 11.5% clip-- the first increase in seven quarters!! Even residential investment shot up at a 22.3% rate this summer, the first upturn since the start of the recession– and the biggest single quarterly jump 23 years!

Adding to the lift in GDP were also federal outlays, which increased a 7.9% rate, following an 11.4% climbed the previous quarter.

One of the more interesting facts to come out this report can be found under the addenda section of the GDP. Gross Domestic Purchases --- which essentially reflects demand for goods and services by Americans regardless of whether the item bought was made in the US or imported --- surged by a 4.0% rate in the summer quarter, following seven quarters of declines. Another similar category, Final Sales of Domestic Product, looks at US and foreign purchases of just American products (and excludes the change in inventories) and it too leaped an impressive 3.0% last quarter, the best showing since the first three months of 2006. Both of these subsets tell us that the US economy is benefiting from strong domestic and foreign demand.

How has inflation behaved in the meantime? What inflation? Aggregate retail prices are still falling! In other words, even with this impressive jump in economic activity, inflation remains non-existent. The PCE price index **fell** 0.6% in the third quarter from its year ago level, and that was an even bigger decline than the 0.2% drop in the second quarter. Excluding food and energy, the PCE index rose just 1.3% the past 12 months, the smallest annual increase in 44 years!

Ok, so far so good. However, let's not lose sight of the damage done by this recession and the long road still ahead. The economy shrank 4% this recession on a peak to trough basis, the biggest contraction in the post WWII period. We just emerged from four consecutive quarters of decline, the longest stretch since at least 1947 when the government first tracked quarterly GDP changes. Moreover, too many companies are still refusing to hire workers. The banking sector is still struggling under the weight of bad loans, overpriced assets, insufficient capital, and the threat of yet more losses from commercial real estate failures. In short, this economy, while improving, is still nowhere near able to go it alone. Government assistance will be necessary to support growth through most of 2010.

Nonetheless, we are beginning to feel more confident that the policies put in place by Congress and the Administration are at least working. The stock market picked up these signs earlier in the year and ran with it. Housing shows every sign of stabilizing. Manufacturers are ramping up production to satisfy the jump in demand for factory goods. The weakened dollar has revived US exports. Consumer spending has increased as Americans prepare to unleash some of their pent-up demand. Layoffs are diminishing as employers begin to reassess their staffing needs. (By the way, new claims for unemployment insurance fell 1,000 in the latest week to 530,000, and the four-week moving average continues to decline. The total number of Americans collecting unemployment benefits fell to 5.79 million, the lowest since March.) Indeed, if you stand back to get a broad historical perspective, you see all the earmarks of a traditional recovery in place. The two sectors that typically lag in a recovery are employment and bank lending. The former is slow to pick up because businesses are able to rely on their existing workforce and on some temps to satisfy the increase in demand at the start of the recovery. And the latter doesn't usually pick up until later in the business cycle as households and businesses use up their in-house savings to finance consumption and investments and later rely more on credit. Lastly, let's not forget that the bulk of the stimulus program will makes its way into the economy the next 12 months or so.

Our final take: The wheels on this US economic locomotive, after spinning in place for so long, are now finally getting real traction and moving forward. By this time next year, this train should gather enough steam and forward momentum to move on its own.
==============================