

THE ECONOMIC OUTLOOK GROUP



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ECONOMIC TALKING POINTS

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GDP: An Encouraging First Peak Shows Consumers Are Ramping up Spending

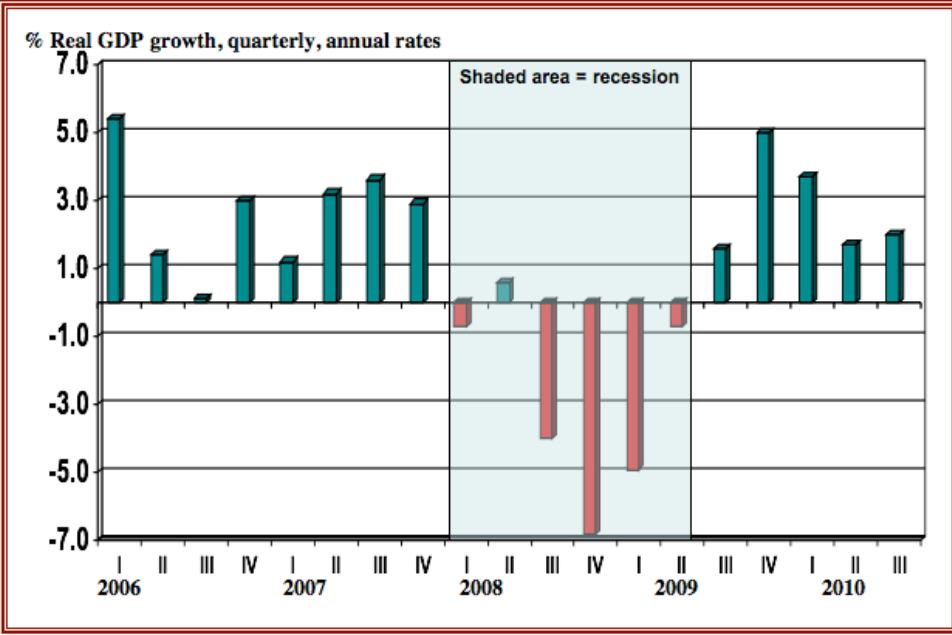
When it comes to the advance report on GDP, caution is advised in how to interpret the data. The initial preview of the economy's performance is rushed out just four weeks after the third quarter has ended and nearly 55% of the release is based on estimates by government statisticians, not from actual data.

With that cautionary note out of the way, the main message from this report is that the economic recovery appears to be gathering fresh momentum. Credit for this goes to the sector that matters most in this recovery: consumer spending. Slowly but surely, worries over job security and income growth appear to be subsiding and household inhibitions to spending are easing. This augurs well for the upcoming holiday shopping season.

Let's begin with a few notable facts in this GDP report.

- Real output rose by 2.0% in the previous quarter, the fastest pace since the fourth quarter of 2007. Also noteworthy is that the economy has now recovered 99% (yes, we want to be precise here) of the output lost during the 2008- 2009 recession. In other words, the size of the economy is now back to where it was prior to the downturn. Quite an impressive achievement considering that residential and commercial real estate is still in a depressed state.

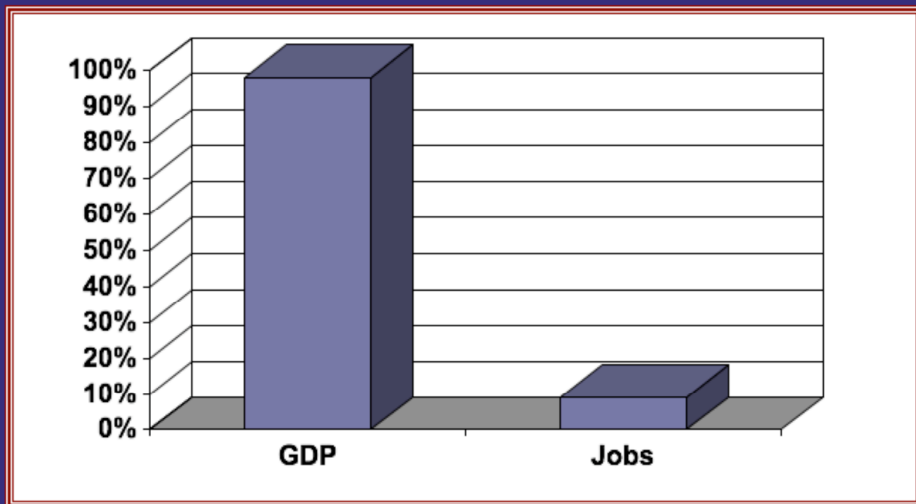
Economic Recovery is Picking Up Steam
Consumer spending has accelerated in each of the last three quarters.



Source: Bureau of Economic Analysis

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Economy has regained 99% of its pre-recession size;
But only 9% of the 8.4 million laid-off have so far been re-hired.



Source: Commerce Department, Labor Department

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Just how strong has the economy been over the last 12 months?

GDP growth has increased 3.1% from its year ago level, the best such annual performance in five years!

The takeaway message here is that the second quarter growth of 1.7% will likely be the weakest of this recovery.

- Most of the credit for the latest acceleration in economic activity should go to consumers. Personal consumption expenditures jumped at a 2.6% rate this summer, the biggest increase since the end of 2006 --- a year before the economy turned south. In fact, household spending has now accelerated in each of the last three quarters. Once again, outlays on durable goods remain robust and this has significance. Durable good purchases tend to be expensive (e.g., cars, refrigerators, furniture), often require financing and are considered more on the discretionary side of spending. Outlays on durable goods are thus extremely sensitive to how comfortable consumers feel about job and income security. Since durable good spending continues to grow faster than nondurables (e.g., pants, vegetables, and shoes) or services is one of the reasons why we place so little value on the latest batch of weak consumer confidence numbers. More on that point later.
- The GDP report shows business investments did decelerate lately, rising at a 12.8% pace in the third quarter compared to increases of more than 25% in each of the previous three quarters. But if we continue to see sustained increases in both consumer spending and exports (as we expect), corporate outlays will likely rebound too. Standby for an upward revision on business spending with the next GDP release.

One surprise in this report was the substantial jump in the change in private inventories – up \$115.5 billion last quarter, compared to \$68.8 trillion in the second and \$44.1 billion in the first. The first impulse is to conclude that this inventory increase was unintended and that it may cause firms to cut back production in the next two quarters. That is a reasonable conclusion, but it is based on the assumption that consumer and business demand will turn sluggish again, leaving stockrooms and backlots filled with unsold goods. However, since the inventory - sales ratio for business still remains near a historically low 1.27 months, we do not view the latest bump up in inventories as problematic for companies.

The other surprise was the increase in spending on structures (roads, bridges, tunnels) and we assume that is largely a product of the infrastructure projects built into the \$1 trillion Obama stimulus program. Outlays on structures rose by a 3.9% rate in the third quarter, the first quarterly rise in two years. It does take time to get these projects underway which is why we're looking at more such spending to show up in the GDP accounts the next few quarters.

- That point leads us to the next category, which is the large jump in federal spending. Nondefense expenditures rose by 9.6%, with federal outlays overall up 8.8%. This swamps the 0.2% drop in spending at the state and local level.

What's the GDP report telling us?

The main takeaway from the preliminary GDP release is the willingness of consumers to further increase spending. What's so amusing is that none of this has been captured in any of the recent consumer confidence surveys. In fact, there is a widening divergence between what Americans tell pollsters on how they feel ---- and how they actually behave. It is intuitive to expect a worried consumer will curtail shopping, and that a consumer with an optimistic outlook would feel more comfortable about spending. But don't bet on this logic.

Case in point: This morning the University of Michigan reported that the mood of consumers fell in October to the lowest of the year. Indeed, it has been plummeting sharply since June, when the index hit 76. It now stands at 67.7. Earlier this week, the Conference Board released its consumer confidence measure for October and the index grudgingly inched up to 50.2, from a seven-month low of 48.6 the month before. That queasiness should spell trouble for household spending.

Yet, personal expenditures accelerated in the third quarter as saw in the latest GDP report! The monthly indicators tell the same story. Retail sales grew in September--- for the third straight month! If you use the broader measure of personal spending (which includes services, unlike retail sales), it too has been on the rise. Indeed, when you adjust for inflation, personal spending has been climbing for four straight months!

Want more proof of the delinking between psychological mood and behavior? Earlier this week, State Street, an investment management firm, released its global investor confidence index for October. It has been on the decline all year and this month the index dropped to 86.2. Year to date, investor sentiment has fallen 17.6%. A pretty ugly number. When you break it down for the North American component, the results are dismal too. Since the start of 2010, investor sentiment index plummeted 21.4%.

These numbers would suggest that investors we so nervous about the global and North American economy, they would shunned equities.

Yet, the opposite occurred. Morgan Stanley's (MSCI's EAFE) global stock index remains positive for the year (as of October 28). As for North America, the S&P 500 index is up 6% so far this year and Canada's TSX index has risen 7%.

The point we want to make is that surveys, which solicit one's mood, sentiment, and feelings, are about as statistically mushy as you can get and bear little relationship to how people actually behave in the near and medium term. Worse, the portrayal of weak confidence among investors and consumers often obscured what the economy is really up to.

What is our favorite confidence measure right now? Home buying. Total home purchases (both existing and new home sales) surged 9.7% in September, and that followed a 6.9% jump in August. This improvement has occurred without the benefit of tax incentives. What could be driving up home sales in the last two months? Well, aside from record low mortgage rates, excellent home prices, and the rise in stock prices which

lifts household net worth, it appears labor market conditions are improving as well. Applications for unemployment benefits last week declined to the second lowest number of the year.

True, the weekly numbers on jobless claims bounce a round a lot. But even the less volatile four-week moving average dropped to a level we have not seen since the week of July 24th. In addition, two other labor-related indicators put out by the BLS show progress on the job front. Mass layoffs in September fell for the third straight month. In fact, the number of mass layoff events—which is defined as job cuts involving at least 50 people from a single employer—dropped to 1,486, the lowest level since last May. And earlier in the month, the JOLT report (Jobs Openings and Labor Turnover) showed there are now more job openings than we have seen in nearly two years.

This all sets the stage for a very interesting coming week. We're projecting that growth in private payrolls in October climbed above 120,000, though the unemployment rate may edge to 9.7%, or a bit higher as more Americans join the labor force looking for work. The Federal Reserve will also formally launch its second round of quantitative easing. We expect the program will be more modest and deliberate, with purchases on the order of \$100 billion a month for mostly Treasury securities. There's also a reasonable chance the Fed will announce the temporary elimination, or a scaling back, of the 0.25% interest paid on excess bank reserves. After all, to hear the Fed chastise banks for not lending more to the private sector, and at the same time reward banks for keeping those reserves idle by paying them interest, just doesn't make sense. Eliminating or reducing those interest payments (and a steeper yield curve) will incentivize banks to make more loans to small and mid-size business where it is most needed.

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