

THE ECONOMIC OUTLOOK GROUP



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ECONOMIC TALKING POINTS

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The Economy Exited 2009 On a High Note

Skeptics of the economic recovery have a little explaining to do. It was their core belief that this economy is so reliant on government spending and on the temporary lift in inventory investment, that once these two begin to wind down later this year, economic activity will enter a deep freeze. However the GDP numbers out today threw some cold water on that view. The latest report shows an economy where the private sector is exhibiting fresh resilience as consumers, businesses, and the role of exports together have stimulated economic activity more than first thought. Meanwhile, the government's role last quarter has been negligible. What is intriguing about the GDP numbers is not that the economy grew by a faster than expected 5.7% rate (which exceeded even our 5.1% forecast), but the mix of components that permitted such strength.

Consumers

Household spending (personal consumption expenditures) rose for the second quarter in a row. True, the latest 2% increase in consumer outlays was less than the 2.8% pace we saw during the summer quarter, but we need to keep in mind two factors. First, there is fundamental shift underway in household behavior. Americans are relying much less on debt or on the liquidation of their savings to finance consumption. The days of excessive borrowing and spending are gone --- at least for the next several years. At the same time, it is important to note that the deleveraging by households does NOT mean

consumers are shutting down spending. What we will see instead is that consumption will align itself more closely with income growth, and our forecast calls for personal income to increase more rapidly as hours worked and employment pick up in the coming months.

Business Spending

Most impressive was the 39.3% jump in overall business expenditures last quarter, the largest quarterly increase in 25 years! Leading that charge are two sectors that are vital to the sustainability of this recovery: residential construction (up 5.7%) and spending on equipment and software (up 13.3%, the best performance in nearly four years). Their combined rise more than offset the 15.4% plunge in commercial real estate construction.

But what about business spending later this year? Will companies continue to increase investments, or curb them?

Business capital spending should remain strong the rest of the year. After all, corporations are sitting on a pile of cash. S&P 500 companies, for example, had a total of \$800 billion in cash on hand as of September. That's up 24% from \$647 billion in the year-ago period. The reason for such huge cash balances is simple. The financial crises brought the economy to the brink of collapse in 2008, and there were widespread fears a Depression was near. Such a climate of grave uncertainty and dread force companies to hunker down and preserve the cash they have. But there's a downside to that practice too. The capital stock of companies will end up depreciating at a faster rate than the investments to replace it. The result: factories increasingly end up operating with aging equipment and antiquated machinery. The problem, of course, is you cannot successfully compete in the global marketplace if you're not operating as efficiently as your competitor. And so with the recession over, corporate cash at multi-decade highs, and fourth quarter earnings coming in stronger than analysts expected (profits rose by more than 70% last quarter), businesses are ready to accelerate capital expenditures the next few quarters.

One counter argument often heard is that there is still so much excess industrial capacity in the economy, there's really no incentive to lift such spending. It's true that current capacity utilization is just 72%, far less than the average of 81.1% the last 40 years. The main problem with this argument is that it's not the amount of capacity lying idle that matters, but the quality of it. Since companies have held back spending for more than two years, a growing percentage of that capacity has eroded in quality and that has to be corrected if companies are to operate productively. For this reason we expect to see a new round of business expenditures this year, even with the current low level of capacity utilization.

Business Inventories

In addition, companies are ramping up production to satisfy the increase in sales. What came out of the latest GDP report, however, was that even this increase in output was not enough to keep with sales. Overall inventory levels continued to shrink but at a much smaller \$33.5 billion pace in the fourth quarter, compared with the \$139.2 billion fall in the previous quarter. This slowdown in the depletion of inventories between the third and fourth quarter added another 3.39 percentage points to GDP growth the last three months. (Confused? Another way of looking at the change in inventories and its impact on GDP is that the rise in production last quarter edged closer to matching overall sales, though it still fell short. Thus while the amount stockroom goods continued to decline, it did so at a much smaller pace this latest quarter. That improved effort to match production with rising sales contributed to GDP growth.)

Net Exports

Foreign trade was another important addition to growth last quarter. As international economies strengthen, the demand for US exports has picked up. Export sales jumped by 18.1% in the fourth quarter, exceeding the 10.5% rise in US imports. This improvement in our trade balance added another 0.5 percentage points to GDP. But we do not expect this trend to continue. The setbacks to growth in Europe and Japan, along with efforts by China to cool its own economy, will end up slowing export orders. At the same time, the US economy will be growing faster than most industrial countries and this will increase our appetite for imports. Thus the U.S. trade deficit will widen this year and act as a drag on GDP growth.

Government Expenditures

What impact did government spending have on the GDP last quarter? Well, frankly, not much. Total federal, state and local spending actually fell by 0.2% last quarter. Sure, much of that was due to the 0.3% drop in state and local expenditures. Federal outlays in the last quarter did increase, but by just 0.1%. These numbers are all so low, that together, government spending actually SUBTRACTED 0.02 percentage points from GDP growth.

GDP Addenda

Finally, we urge clients to look at two subset statistics in the latest GDP report because they provide some additional insight on the underlying strength in the economy.

- “Final sales of domestic product” measures actual purchases made last quarter --- excluding the change in inventories. This is done to get a purer gauge of just demand in

the economy. It rose at a 2.2% rate the final three months of the year, the strongest performance in 6 quarters.

- “Gross domestic purchases” is another interesting data point because it looks at total purchases made just by U.S. residents (consumers and businesses) and excludes orders from foreigners. Here we got more encouraging news. Domestic demand surged 5.1% last quarter, the largest jump in more than 6 years!

Bottom line:

With the latest GDP report we have further confirmation that the recession is over. Indeed, we ended the year on a high note. Consumer spending did not collapse, as many feared it would. There remains a massive amount of pent-up demand that is now gradually being unleashed. We’re going to see it materialize most in sales of cars and homes this year. Purchases of motor vehicles have been well below the normal replacement rate in recent years, but this is now in the process of being corrected. Home sales have also been way below the pace of household formation. The extended and expanded tax credit, plus concerns of rising mortgage rates later this year, should motivate a lot more prospective homebuyers to strike a deal in 2010. Lastly, we do expect to see employment numbers turn positive in the payroll survey this quarter. This turnaround in the job market will improve consumer psychology and encourage more spending.

The one large remaining economic roadblock to more robust growth is tight credit. Banks are still in the process of deleveraging and of beefing up their capital. The White House has also put additional pressure on lenders. President Obama last week asked Congress to limit the size of banks, reduce their ability to carry out proprietary trading, and disallow investing in hedge funds and private equity funds. The objective, of course, is to prevent a repeat of the financial crises. Yet one has to wonder how comfortable banks will be making loans this year when there is such a full court press on by Washington to restructure these institutions.