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
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It's the GDP Mouse That Roared

The modest pick-up in GDP growth last quarter will no doubt be sliced and diced by both the Romney and Obama campaigns for political ammo. And there will likely be enough material for both camps to use. In the end, however, the latest report on the economy tells a fairly simple story: The recovery continues, but at an agonizingly slow pace. How can it be otherwise when there is ubiquitous talk of a fiscal cliff that could well cause a recession in 2013? With the outlook so unclear, the inclination by all is to remain hypercautious about spending.

As for the GDP report itself, the 2% gain in the third quarter was a tad stronger than many had forecast. Yes, it's better than the 1.3% pace in 2Q, but the economy has been averaging a 1.8% quarterly pace so far this year, which is precisely how much it grew in all of last year. This is an economy still swimming upstream in peanut butter.

Source: BEA

Three sectors kept the economy out of real trouble in 3Q: consumer expenditures, residential construction and defense spending. Personal consumption expenditures rose by 2% in 3Q (vs. 1.5% in 2Q) and that contributed 71% to overall GDP growth last summer. Households increased spending on pricey durable goods (up a robust 8.5% rate compared to a drop of 0.2% in the 2Q quarter), with autos and home appliances the most popular items.

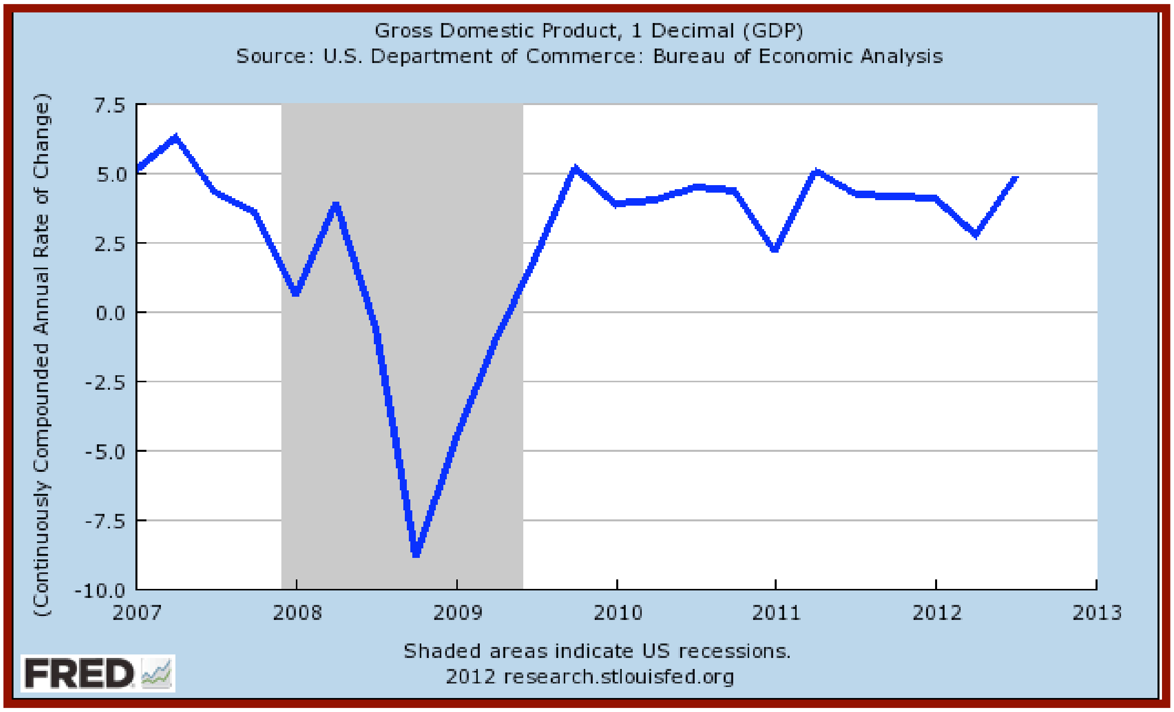
Homebuilders also gave a boost to economic activity. Residential construction spending leaped by a 14.4% rate (compared with 8.5% in 2Q). By the way, the rebound in residential building so far this year has been the strongest in nearly three decades!

One jaw-dropper has been the sharp 9.6% boost in federal spending, which came about after an unusually large 13% pick up in defense outlays this summer. One plausible explanation is that the Pentagon took the precaution of accelerating spending this summer in advance of the growing threat of sequestration, which if implemented will amputate much of the defense budget next year. So who can blame the DOD for ramping up spending this summer given the war in Afghanistan, worries about a military clash with Iran this winter, and an expanding US naval presence in the western Pacific as China makes a unilateral grab for resource-rich islands in the East China Sea?

The biggest drags on growth in 3Q were business capital spending and exports. Purchases of equipment and software were flat. It has actually been decelerating every quarter since the summer of 2011. Again, the looming threat of the fiscal cliff is mostly to blame for that. What business leader would want to commit to a major investment project, or hire many more workers when there is such a profound lack of clarity on the economic outlook?

One particular concern, however, is the fall off in exports. During past US economic downturns, we were able to rely on stronger exports to keep the American economy out of serious trouble. That's not the case this time because we face a synchronous decline in global economic activity. As a result, US exports fell 1.6% in 3Q. This is the first quarterly drop in exports since the deep 2009 recession. Imports also dropped (0.2%) as firms protected themselves against getting stuck with unwanted inventories in the event the US economy tanks in 2013.

One rather bizarre data point was the 5% increase in nominal GDP, which includes price increases. That was the second biggest increase since late 2009. What is puzzling here is that it doesn't quite mesh with the spate of disappointing corporate earnings this summer. Given how lean companies are operating, the evident rise in sales and pricing power this summer should have brought stronger 3Q earnings. What this suggests is that we may see some downward revisions to 3Q GDP growth next month.



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475 Wall Street
Princeton, New Jersey 08540

www.EconomicOutlookGroup.com
Tel: (609) 529-1300

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