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ECONOMIC TALKING POINTS

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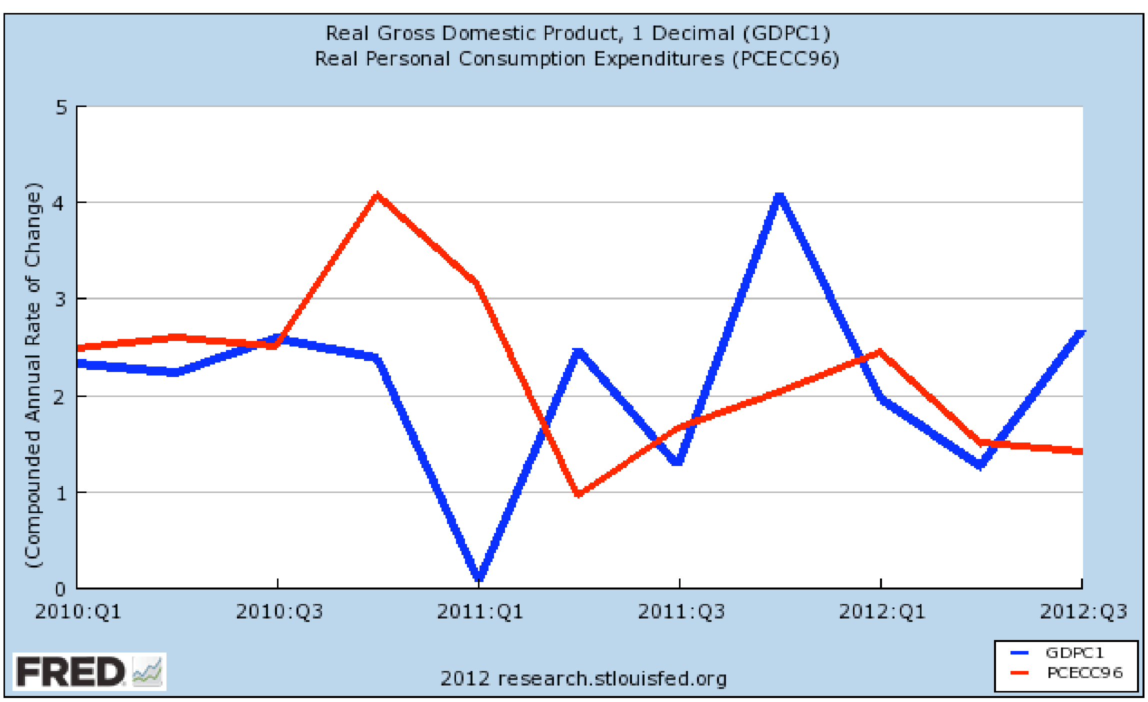
A Hollow GDP for the 3rd quarter. But Stay Tuned…

There are two takeaways from the jump in 3rd quarter GDP growth.

First, the improvement we saw in GDP for the summer quarter is a hollow one. Let's get that obvious point out of the way, since a key factor for the increase in growth from 1.3% to 2.7% is due to the federal government ramping up spending in advance of mandated cuts under sequestration should we go over the fiscal cliff next year.

Quarterly GDP Growth vs. Personal Consumption Expenditures



In fact, every sector of the economy has had to recalibrate their strategy so as to brace themselves for the worst. Certainly the business sector turned hypercautious. After all, why bother expanding operations or hiring lots of new workers when the economic outlook for the next 12 months is so frustratingly unclear? That corporate mindset led to a 2.7% plunge in outlays for equipment and software, the first quarterly drop in more than three years!

Now let's look at households. Yes, consumer confidence has been holding up well. Many Americans sense the real economy is actually poised to grow at a faster rate. Yet, they are not fools. Washington is a town known for acts of great folly too. Thus, any optimism has to be tempered by the realism that a fiscal cliff still exists and that it can do much damage. After being exposed 24/7 by pundits warning of a possible recession and higher joblessness in 2013, it easy to see why Americans chose to play safe and curb spending. Personal consumption expenditures squeaked out a 1.4% gain, the smallest quarterly increase in more than a year.

So with nearly 80% of the entire economy (PCE plus business equipment and software) applying the brakes on spending for fear of a pending economic downturn, one is hard-pressed to find any solace in what otherwise would have been a respectable GDP number.

What kept the economy out of trouble during the summer was not the private sector but the government, after a hefty 9.5% jump federal expenditures (led by a 12.9% surge in defense outlays, the biggest quarterly rise since 2Q 2009). Of course, we know this kind of official spending will cease in the coming quarters.

To be fair, we did see a solid increase in at least one area of the private economy, residential construction, which rose at a 14.2% rate in the last quarter --- though that too had been revised down from 14.4% from the initial estimate. But let's get real here. No one should expect homebuilders to keep up this pace of home construction if the economy dives off the fiscal cliff.

From our perspective, the rise in GDP growth occurred for the wrong reasons. We want to see the private sector make a far greater contribution to economic activity, and the government much less.

Having said all this, we now turn to our second takeaway.

Worries about the fiscal cliff are certainly justified. But if we see more adults emerge in Washington to complete at least a credible framework for a deficit reduction plan before the end of the year, then the US could be on the **precipice of a major economic upturn in 2013.** How so? There are many key metrics moving in the right direction.

- US banks are better capitalized with stronger balance sheets and showing more profitability. They have begun to ramp up lending. Commercial and industrial loans have jumped by double-digit rates in the each of the past five quarters. Residential mortgages also increased during this time. It appears lenders are now more willing to help finance consumer and business activity.

- Households have also worked hard to clean up their own balance sheets by significantly reducing outstanding debt. Their debt service burden is now the lowest in nearly two decades. In addition, with home values rising and labor market conditions improving, consumers are ready, willing and able to play their traditional role as the key driver of economic growth.

- Both residential and commercial construction activities are looking brighter as well. Housing starts in October rose to its best level in four years. Confidence among homebuilders jumped in November to its highest in 6 years. On the non-residential side, the Architecture Billings Index, a leading indicator for future commercial real estate construction, leaped to a two year high last month. This measure has now had three straight months of impressive gains.

- Let's not forget that companies are still sitting on a near record pile of cash reserves ($1.7 trillion), money that is anxiously waiting to be put to productive use once the economic outlook clears up.

- Even the investments to rebuild and fortify structures damaged or lost from the hurricane Sandy will add to economic growth next year. If can get past the fiscal cliff, these expenditures in the Northeast can add about a 0.4% percentage point to national GDP in 2013.

Bottom line:

The 2.7% GDP growth rate in the last quarter cannot be taken seriously. Its composition of weak private sector spending and a temporarily stronger government sector is the perverse of what would constitute healthy economic growth.

So what happens next? Where the economy goes from here depends entirely on whether wisdom and statesmanship prevails in Washington. If the country can avert the fiscal cliff --- which we believe is the likely scenario --- then we expect to see economic growth surprise on the upside. Our forecast calls for GDP to expand by 3.5% next year, a pace that should bring the jobless rate down to around 7 % by year's end.

Remove that fiscal cliff anchor and you have an economic engine that is raring to bounce back.

United States

	I 2011	II 2011	III 2011	IV 2011	I 2012	II 2012	III 2012	IV 2012	I 2013	II 2013	III 2013	IV 2013
Real Gross Domestic Product (GDP):												
%	0.1	2.5	1.3	4.1	2.0	1.3	2.7	2.2	3.3	4.1	3.5	3.9
Personal Consumption Expenditures:												
PCE	3.1	1.0	1.7	2.0	2.4	1.5	1.4	2.7	2.8	3.8	3.4	4.0
Inflation, end of period, year-over-year:												
CPI %	2.7	3.6	3.9	3.0	2.7	1.7	2.0	2.2	2.5	3.0	3.2	3.5
Unemployment Rate (end of period):												
%	8.8	9.2	9.1	8.5	8.2	8.2	7.8	7.9	8.2	7.7	7.5	7.3
Non-farm Payrolls, monthly avg. thousand:												
	192	130	128	164	225	66	174	150	168	210	240	275
Treasury 10-yr Note Yield % (end of period)												
	3.5	3.1	1.9	1.9	2.2	1.7	1.6	2.2	2.8	3.3	3.5	3.5
Federal funds rate % (end of period)												
	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3