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ECONOMIC TALKING POINTS

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Preliminary 3rd GDP Report Was OK, But It Doesn't Merit A Cheer

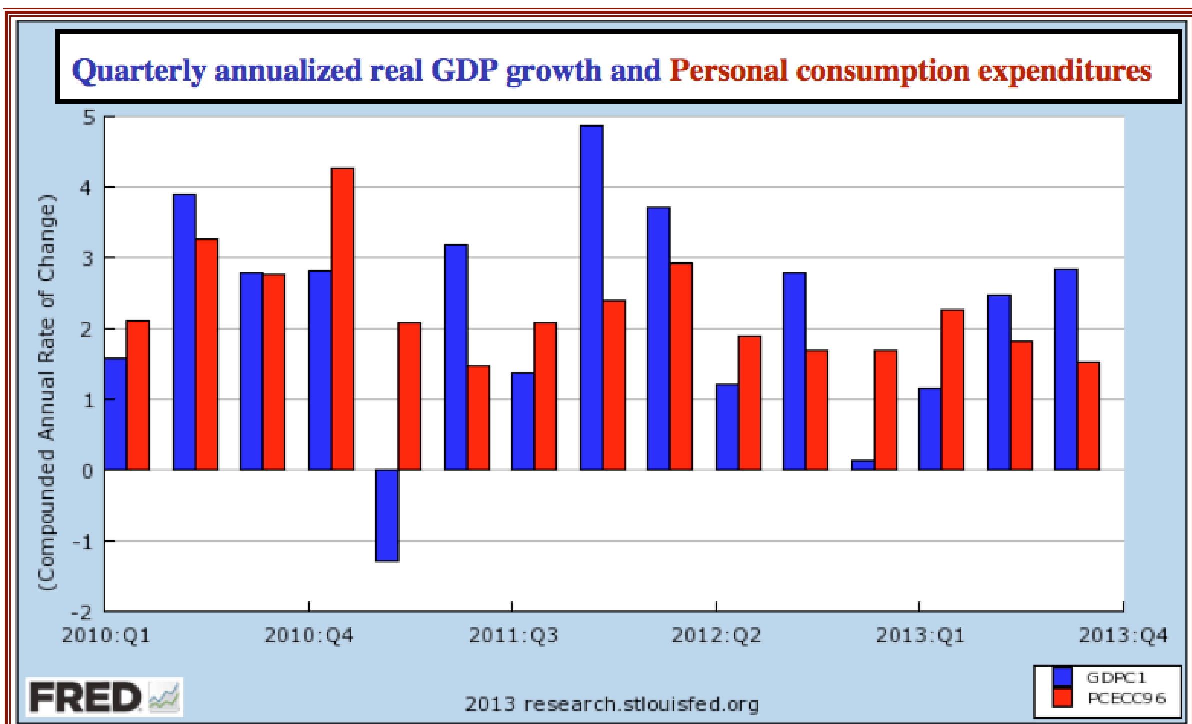
As you know, we have been quite bullish on the prospects for economic growth next year. And while today's report on third quarter headline GDP growth was better than expected, we were frankly disappointed with its underlying components.

Yes, the summer quarter expanded at a comfortable 2.8% annual rate, the fastest in a year. But the composition of that growth left us unimpressed.

The metrics we like to focus on are those that gauge the vibrancy of the private economy --- and here the data has been quite mushy of late.

For example, personal consumption was up just 1.5% last quarter, which was the weakest in more than two years. What is so curious about that data point is that consumer spending on services crept up a miniscule 0.1%, the smallest since the second quarter of 2009, a time when the recession hit its nadir. Keep in mind that services account for about 65% of all consumer spending so it has a real measurable impact on overall GDP activity too.

What's so odd about that 0.1% crawl is that Americans typically consume more services during the summer than at other times of the year. So could this first reading be significantly off the mark and likely to be revised up in subsequent revisions?



We think so based on the greatly improved state of household finances, record net worth of Americans, and comments from the lodging and hospitality industry indicating stronger demand this past summer. The result: Expect an upward revision on services in the next release.

A another problematic category was the deceleration in non-residential fixed business investment. It increased a fairly anemic 1.6% pace. The key factor dragging it down was business spending on equipment. It ***contracted*** (-3.7%) for only the second time since the recession ended in June 2009. Not a good sign…if accurate. What ultimately lifted aggregate business investments was the double-digit increase in spending on structures for the second quarter in a row (with, again, the lodging industry leading the charge). Unfortunately, capital spending on structures is very much a lagging indicator and so has limited value in terms of the current state of the economy…and even less value as a predictive measure. Again, we will need to wait for more comprehensive data on the next go-around of the GDP report.

So what were the principal drivers that lifted real GDP by 2.8%?

- Clearly business investments in commercial and residential construction were big players. Both contributed three-quarters of a percentage point to GDP growth.

- Companies also boosted spending on inventories to an $86 billion pace last period, the fastest since the first quarter of 2012. That added another 0.83% to GDP.

Why have businesses chosen this summer to refill stockrooms and back lots?

Three reasons:

(1) Retailers and wholesalers were more optimistic about the upcoming holiday shopping season. Consumer confidence was on the rise and household balance sheets remain in their best shape in decades. Consumers have been eager to spend on big-ticket durable item, as we have seen with sales of autos and homes.

(2) The improvement in the international economy resulted in greater demand for US products. New orders for exports expanded throughout the summer, according the ISM's purchasing managers index.

(3) Inventory purchases are financed with credit and you will recall there was wide expectation the Federal Reserve would begin to roll back on quantitative easing in the Fall. Since that step will kick market interest rates higher, inventory managers were motivated to rush in and lock up lower borrowing rates to avoid paying higher fees later.

Even state and local governments contributed .

One noteworthy sector that made a contribution to economic growth (albeit a minor one) was state and local government spending. Although it added only a miniscule 0.17% to growth last quarter, the more meaningful point is how well state and local revenues have bounced back as a result of a stronger economy. With the improvement in their fiscal finances, S&L government outlays increased a 1.5% rate, the biggest quarterly jump in four years! That upward trend will likely continue as local economies gain even more traction in 2014.

Inflation a worry?

Some have raised concern that inflation turned out to be a little hotter than forecast in the summer period. The Fed's preferred measure of price behavior is the PCE price index and it did shoot up a 1.9% annual pace this summer. This followed a bout of deflation (minus 0.1%) in the second quarter.

So what should we make of this inflation whiplash? While the Fed does monitor inflation at the more volatile quarterly level, let's remember that policy is usually based on how prices have performed over the year. On a year-over-year basis, the PCE price index held at a sleepy 1.1% increase in the 3rd quarter, with the core up at 1.2%. By any reasonable measure, inflation remains very subdued.

What does today’s GDP report tell us about the current quarter?

Very little. Look, we just got a preliminary reading on third quarter growth, one that rests heavily on government estimates, not actual data. In addition, the report covers a period when the backdrop was one of increased anticipation the Fed would commence tapering in September, and heightened tensions over the prospects of a government shutdown and possible debt default. These are the kinds of variables that can temporarily sway decisions on spending and investments, and thus distort the true picture of the economy’s health.

The fourth quarter will lose “some” momentum as a result of the 16-day government shutdown and the bloviated talk about breaching the debt ceiling. Both clearly made consumers and business managers more anxious about the future. But our assessment is that they will, in the final analysis, have only a small impact on growth the final months of the year. Our forecast calls for GDP growth of 2.2% in the fourth quarter, about three-tenths off what would have been the case in the absence of those two events. Helping to offset the two detrimental factors will be greater retail sales this holiday (assuming no further episodes of deadly violence at shopping malls), rising exports to Europe and China, and the diminishing effect of sequestration.

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