THE ECONOMIC OUTLOOK GROUP

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ECONOMIC TALKING POINTS

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Dismiss the 4Q GDP; Economy to show surprising growth in 2013

The surprise negative GDP growth for the fourth quarter immediately brings to light an old quote: *Assumptions is the mother of all screw-ups*.

This very preliminary release on economic activity in the final three months of the year contains lots of assumptions, estimates and some anomalous spending patterns by the defense department. The point here is that the 0.1% drop in GDP last quarter should not be taken seriously by investors, business leaders and even policymakers. That negative figure will have a life span of a month before it is revised to show positive, albeit still soft economic growth.

So what contributed to the fourth quarter decline – and what should we make of it?

In essence, the BEA had to estimate several key components because not enough actual data had been compiled in time for this report. As a result, assumptions were made on manufacturing, wholesale and retail inventories, changes in exports and imports, and on construction (residential and commercial).

Complicating matters even more was the unprecedented swing in defense spending during the third and fourth quarters. The Pentagon, worried that a plunge off the fiscal cliff and the automatic sequestration cuts would slash the defense budget, took the precaution of aggressively ramping up

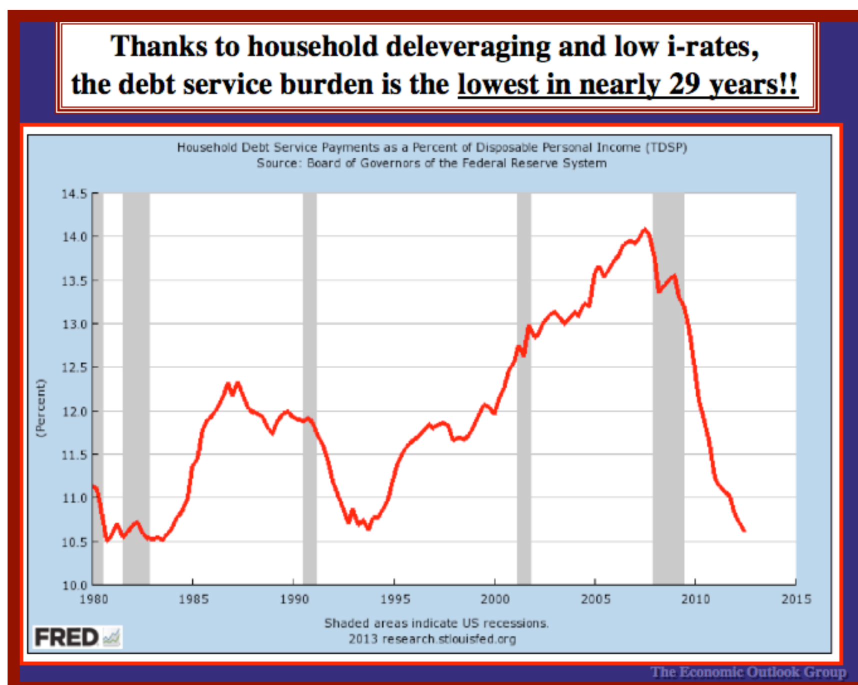
purchases in the third quarter by a 12.9% rate (the biggest jump in more than three years), only to scale it back in the final quarter to show a 22.2% decline off the summer pace (the largest quarterly slowdown since 1972). Just that whiplash in defense outlays alone managed to subtract 1.28 percentage points from growth.

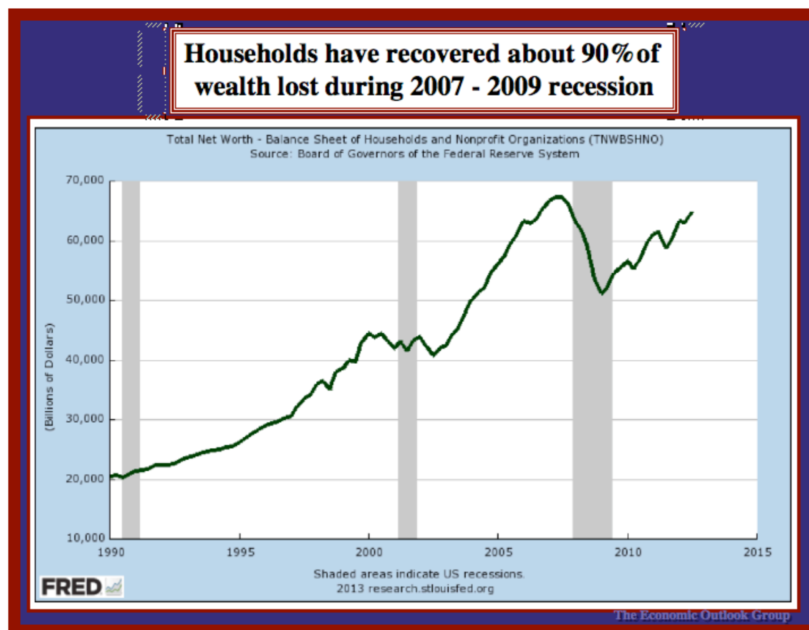
Now, if you add another reduction of 1.27 percentage points in GDP growth from the government-estimated change in inventories, then both categories (inventories and defense) effectively wiped out the contributions to growth made by the two most important sectors of the economy --- consumer spending and corporate investments on capital goods. The latter two are really the most newsworthy part of the latest GDP report.

Consumer outlays jumped at a 2.2% rate in the final three months, the strongest since the first three months of 2012, and second biggest increase in seven quarters.

Will consumers continue to show even more resilience in 2013? Absolutely. All the key economic metrics that underpin household spending are moving in the right direction:
(1) Labor market conditions are improving
(2) Real incomes are finally increasing (check it out: real disposable personal income in the 4Q jumped by a 6.8% rate, best in more than four years)
(3) Home values are rising again
(4) Household debt-service burdens has plunged to a 29-year low
(5) Personal delinquency rates keep sliding
(6) Household wealth is climbing; it has now recovered about 90% of the $16 trillion lost during the 2007- 2009 recession.

Equally important is the enormous pent-up demand by consumers that will begin to be unleashed this year.





Businesses are also prepared to ramp up capital spending projects. They had resisted such spending last year because of the profound lack of clarity on how the economy would perform in 2013. Pundits constantly warned of a recession if no deal is struck to avoid the fiscal cliff. There were worries about a collapse in the Eurozone, a hard landing for China's economy, and threats of a war in the Middle East. Given the multitude of uncertainties, it should come as no surprise that spending on equipment and software in 2012 was the weakest since 2009. But companies have begun to accelerate such investments in the final months of the year, a harbinger of what we can expect to see this year.

Nor should we forget other important fundamentals that support faster growth in 2013.

(1) Corporate balance sheets have never been stronger, with firms eager to put a record $1.7 trillion in liquid reserves to productive use.
(2) Banks are much better capitalized, have higher quality assets and are more willing to lend now that the government has settled charges of improper mortgage lending practices and on how foreclosures were processed in the past.
(3) The all-important housing market has come back to life. New and existing home sales, starts and permits, along with homebuilder confidence have all rebounded last year.
(4) With the economies of China, Asia, and Latin America improving, trading activity will accelerate and fuel more US exports.
(5) The cost of credit remains historically low, and the FOMC statement released this afternoon has repeated the Fed's commitment to keep it these levels.

Other important fundamentals have improved!

- ☑ Corporate earnings have been strong. S&P 500 profit margins widest ever. Firms sitting on record pile of cash.
- ☑ Banks are better capitalized, with healthier balance sheets, higher quality assets, and are lending more.
- ☑ Housing market comes back to life. Sales, home prices, new construction, permits, homebuilder confidence ALL improving.
- ☑ Exports picking up as foreign orders recover.
- ☑ Cost of credit remains at historic low levels.

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Can the policy paralysis in Washington sabotage the economy in 2013? We strongly doubt it.

We are not as concerned as others about the risk that sequestration cuts will impair or derail economic growth. This is so for several reasons.

First, from our perspective the biggest threat to the economy was the first phase of the fiscal cliff, specifically what to do about the Bush tax cuts. After a series of tortuous negotiations that lasted into the early hours of the new year, an accord was reached whereby some 99% of Americans will see no increase in income tax rates. With that agreement, we feel recession is now off the table.

Second, we saw last week how House Republicans realized the futility of using the debt ceiling as a negotiating tool to secure large government spending cuts from the White House. Fortunately, the debt ceiling debate has now been punted to mid-May, and thus no longer a looming threat.

The risk of implementing the sequestration cuts, however, is more real. Indeed, we may well see these mandated cuts commence for a few days or weeks just so House Republicans can demonstrate they can play hard ball. Nevertheless, we do expect to see a compromise emerge on federal spending cuts and higher tax revenues (by scaling back deductions and exemptions) fairly quickly. What's key here is that no draconian spending cuts are expected to occur up front, but will be spread over the next ten years. In other words, the economy will feel the effects of some fiscal drag this year and next -- but nowhere near a magnitude that puts the brakes on economic growth.

It will be left to the private sector to shift the economy into faster gear. The spotlight has begun to rotate away from the histrionics and ineptitude of Washington, and more towards the vibrancy in the private sector. (Check out stocks lately?) The melodrama of Washington politics is now a movie Americans have seen before and they they know how it will likely end --- last minute deal on controlling government finances but without a near term fiscal shock.

Bottom line:
The preliminary report on IVQ GDP does not accurately reflect what happened in the final three months of the year --- and it certainly does not portend where the economy is headed this year. Our expectation is for growth to bounce back to a 2.3% pace in this first quarter, and then accelerate towards a 3% pace the rest of the year. For the financial markets, it means we are likely to surpass the previous highs in the DJIA and S&P 500 during the first quarter. At the same time, Treasury 10 year notes will continue to fall in price and drive yields to at least 2.2% by March.

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