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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A Respectable GDP Report: Solid Private Sector Growth With Less Government Spending

Disappointed by the downward revision in GDP growth? Does it suggest the US economy is losing steam?

The answer to both should be a resounding no!

The key message from the latest GDP revision is that the private sector economy is alive and well. *It grew close to a 3.5% pace in the first quarter.* Indeed, consumer spending alone in the first three months of the year turned out to be even better than first calculated and the strongest in more than two years.

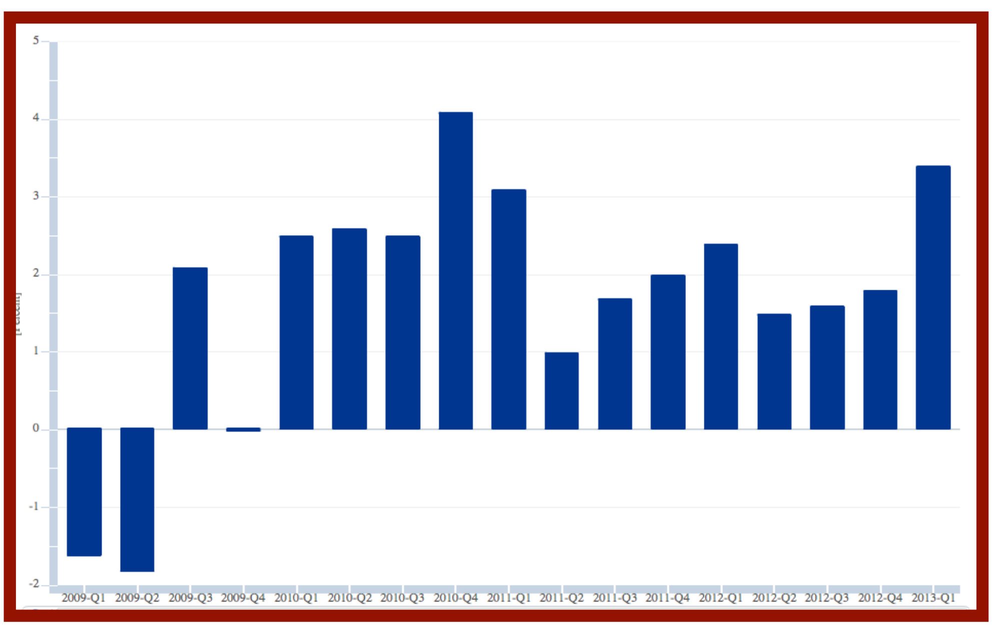
Does that mean the payroll tax hike had no effect at all on household expenditures? Not quite. The best we can say is that its impact was far less than many forecasters had expected. The reason? While the higher payroll tax did take a bite out of their wages and salaries, Americans were sufficiently comfortable about the economic outlook to keep up spending by scaling back on savings. The savings rate fell to 2.3% in the first quarter, the lowest since 3Q 2007. This drop is not a sign of financial distress. Just the opposite. Households feel less pressure to bolster personal savings when they observe their home and stock portfolios consistently rise in value. Stay tuned next week because we expect the Federal Reserve's flow of funds report (on June 6th) will show that total household wealth has reached a record level!

As for business investments, it was scaled back from the initial estimate, to show an annual rise of 9% instead of 12.3%. Yet even the revised figure remains the highest in more than a year.

What ultimately drove overall GDP growth down to 2.4% was the decline in government outlays, which fell 4.9%. Spending cuts at the federal, state and local governments effectively slashed 0.97 percentage points off GDP growth. (Net exports lobbed off another 0.2 points as struggling foreign economies bought fewer goods and services from the US.)

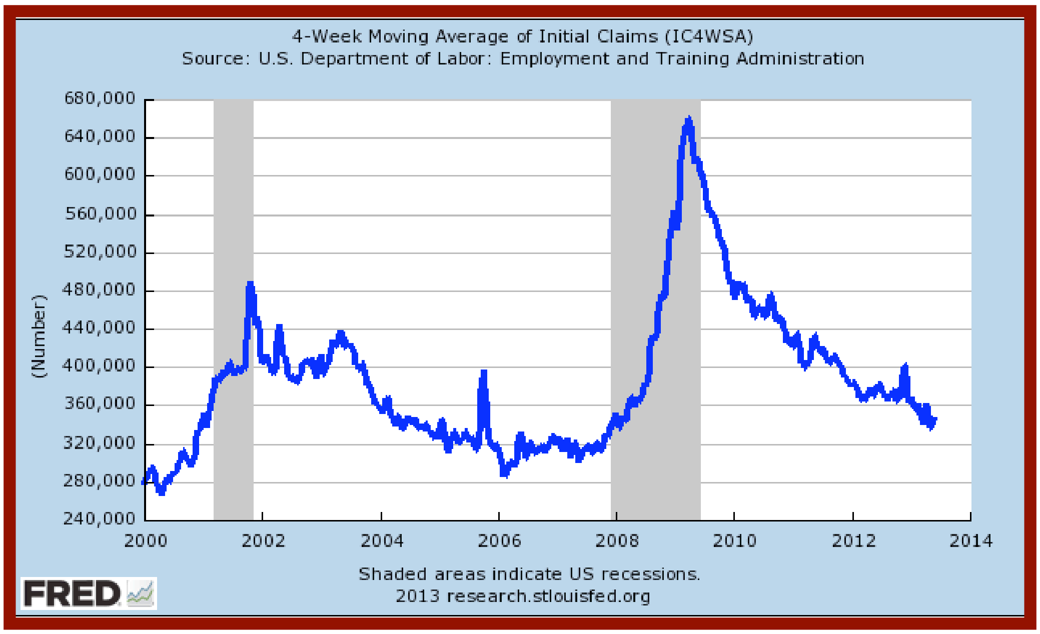
So, if you now combine the healthy performance in the private sector with the significant retrenchment by all levels of government, you get a net top line reading of 2.4% in the first quarter.

Personal consumption expenditures



If you step back from all these statistics, an interesting picture begins to emerge. CEOs and consumers are confidently ramping up spending in Q1 versus Q4 of last year --- just as the federal budget deficit as a percentage of GDP is falling at the fastest pace since WW II. *That's hardly a bad combination*.

Nor are we concerned about the 10,000 pick up in claims for unemployment insurance, to 354,000 in the latest week. The overall 4-week moving average in jobless benefits continues to fall, even if in a serrated manner. As long as the private economy keeps its current 3.5% growth pace, we expect to see no diminution in the pace of hiring by business.



Another encouraging metric out today was pending home sales (PHS) by the National Association of Realtors. The index rose 0.3% in April and stood 10.3% above the year ago level. The PHS index, which is based on contracts signed and thus a leading indicator, jumped to106 last month, the highest level in three years. That underscores the rather unique role of housing in this particular business cycle.

Historically, homebuying and new housing are among the first levers that lift an economy out of recession. This has been the case in every economic cycle for more than 60 years. But housing did not play its traditional role in the 2008- 2009 recession or in the early phase of the recovery. Instead, we have seen this sector only begin to show genuine signs of life in just the past year, and this is important. The late rebound in housing activity should provide the economy a second wind as it enters its fifth year of recovery.

What does this all mean for monetary policy?

Simply this: The Federal Reserve still believes it is premature to scale back purchases of treasury and mortgage securities. After all, the jobless rate remains elevated and prices are still showing a disinflationary trend. They can hardly say “job done” under these circumstances. As a result, there is virtually no chance of any change in QE policy in June, in our opinion. We have assigned a 25% probability that a reduction in security purchases will commence in the final quarter of 2013, and 75% in the first half of 2014.

But that is only part of the story as far as the Fed is concerned. Also looming large now is the probability that Bernanke will not stay on for another term when his current tenure expires in January. We have all heard of the possible candidates to succeed him-- Janet Yellen, Bill Dudley, Stanley Fisher, and Larry Summers. The danger is a prolonged guessing game will at some point add upward pressure on market rates and endanger what has been accomplished so far with the economy. We believe there is a need for greater clarity --- and soon --- on who will be at the helm when the Fed begins the delicate task of retreating from QE.