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ECONOMIC TALKING POINTS

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Benchmark GDP Revisions, the ADP Employment Report, and the Federal Reserve

What are the main takeaways from the revised GDP report? What does it tell us about the current health of the economy and where it is heading? Finally, what are the implications for Federal Reserve policy?

Let's begin with the benchmark GDP Revisions.

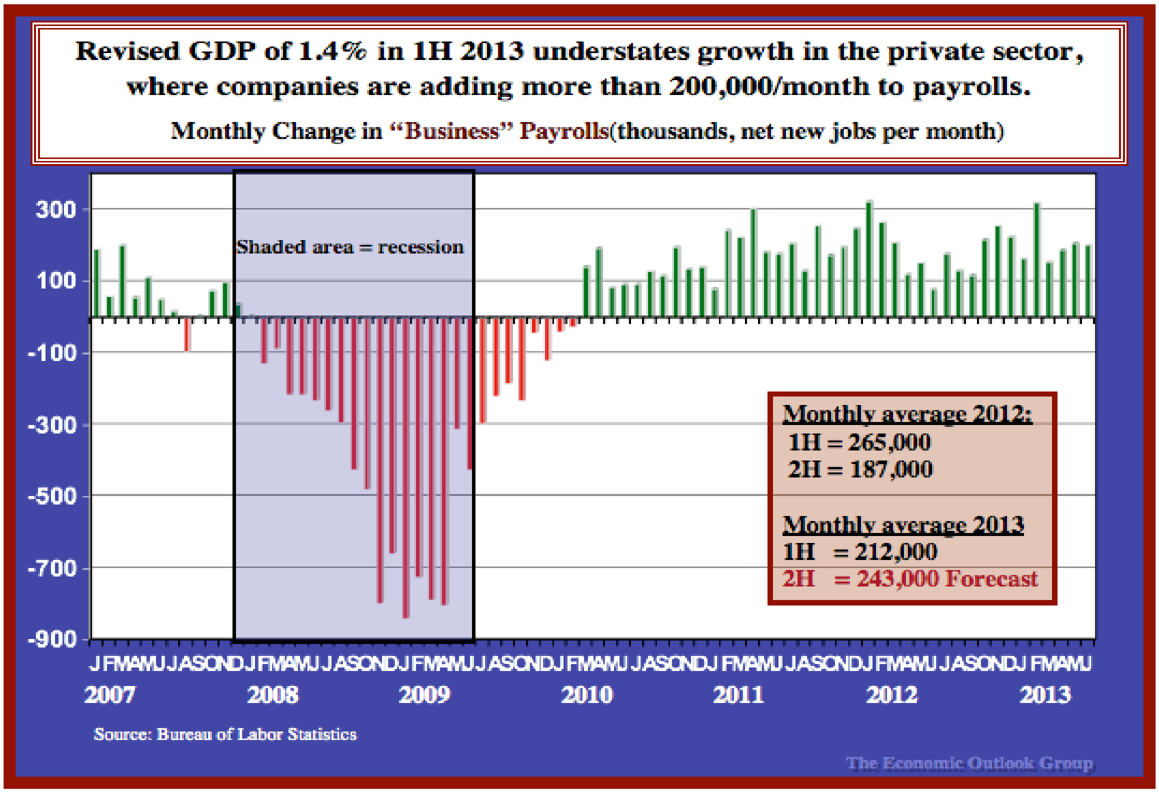
What stands out in the new data is that the meek headline GDP numbers of recent quarters utterly fail to capture the impressive strength in the private economy. In the last three quarters, top line GDP growth has averaged a sleepy 1% pace! An economic crawl so slow, it's virtually indistinguishable from a recession.

Now, take a look at some other important metrics released at the same time and see how it draws a far different picture on the strength of the economy.

- Layoffs have been plunging during this period, with businesses hiring an average of more than 200,000 a month.
- Virtually every survey published (from consumers to CEOs to investors) show that optimism has been building and now stands at multi-year highs!

• Check out second quarter corporate earning so far. Not quite what you expect for a sleepy economy. With about 55% of the S&P 500 companies reporting results, 56% have beaten revenue expectations (up from 41% in the first quarter) and 67% exceeded profit estimates.

• How about consumer purchases of big-ticket items? Home and auto sales would not be as strong if there were concerns about the strength and sustainability of this recovery



The point we want to make is that there is a clear disconnect between the lackluster top line GDP numbers in the first half and the resilience we find in the private sector.

What's behind this divergence?

While GDP growth of 1.1% and 1.7% in the first and second quarters were unexciting, the fundamentals of the US economy are a lot stronger than that. Keep in mind, two main factors were responsible for depressing headline GDP.

Source: BEA

(1) The first is the drag imposed from cuts in federal spending. Federal outlays in Q2 dropped at a 1.5% annual rate. While that was a smaller decline than the two previous quarters, it still constrained overall growth. (Interestingly, state and local government spending rose for the first time in a year, which itself is a positive omen for the second half of the year.)

What is noteworthy here is that most Americans have begun to look past the political battles in Congress, the sweeping budget cuts, and even the higher payroll taxes this year. These negative influences were more than offset by the impressive rebound in household wealth and brighter job numbers. In short, consumers and CEOs have come to realize there is life after the sequester and tax hikes.

(2) By far the biggest drag on GDP growth in Q2 was the sharp increase in imports, which caused net exports to slice 0.81 percentage points off GDP growth in Q2. However, this rebound in imports, which turned out to be the biggest quarterly increase in two and half years, underscores the booming demand from American consumers and businesses, another good sign. Exports rose as well (though obviously not enough to offset the jump in imports) and this pick up in sales to foreign customers also suggests the global economy, especially Europe, is finally picking up some steam. That would help boost US economic activity the rest of this year.

What else do the latest revisions tells us that is new?

On a broader historical scale, we see the U.S. economy has been growing at a faster pace than originally thought. It expanded last year by 2.8%, not 2.2%, and that the 2008 – 2009 recession was slightly less severe than first believed, since it contracted at an average annual pace of 2.9%, not 3.2%.

To a large degree these changes have occurred because government economists overhauled the methodology to compute GDP so it includes the output of intangible investments (such as R&D) and entertainment (including movies, music and books). As a result, "intellectual property products" now will be listed in the front GDP tables, alongside investments in equipment and building structures.

In the event some conspiracy theorists believe there is some hidden political agenda behind these upward historical revisions, they won't have much fodder. The benchmark changes have not re-written economic history. The annual changes to growth over the last 80 have been fairly modest. Since 1929 the US economy has grown an average of 3.3% a year, instead of 3.2%. And in the last decade (2002 to 2012), it appears the economy expanded at a 1.8% yearly pace, not 1.6%.

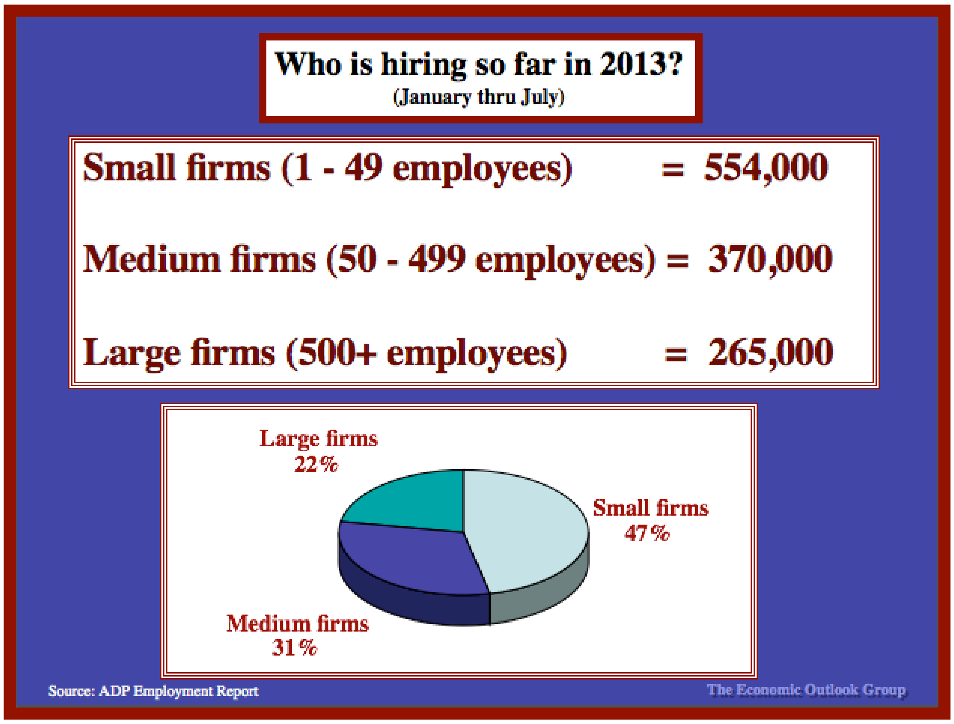
Implications for the second half of this year?

Our expectation is that economic activity will accelerate in the second half of the year, with growth averaging around 3%, or twice as fast as the first half. Continued improvement in the job market will foster more consumer spending. Moreover, companies are also routing more of their record cash holdings to productive investments. With the cost of capital still low (but soon to rise) and both the domestic and foreign economies looking better, the hurdle rate has likely declined enough for firms to ramp up capital expenditures.

ADP Report

Our optimism for the second half of the year was reinforced by the release of the ADP employment report for July. One value of the ADP release is it tells us who is doing the hiring among the small, medium and large-sized firms. The numbers have turned out to be quite surprising given all the worries about how the cost of the Affordable Care will deter small firms from hiring workers. Well, this hasn't been manifest in the data!

So far this year thru July, the smallest firms (1 – 49 employees) have hired 554,000 people (or 47% all private hiring), medium-size firms (50 – 499 employees) took on 370,000 new workers (31%), and the largest companies (above 500 employees) hired 265,000 (22%). Thus, small and mid-size firms now account for more than 80% of all new employment. Historically, these two sectors have been far more cautious about hiring because they are more sensitive to increasing overhead costs than larger firms. The fact that small and mid-size firms have ramped up this year reflects their optimism about the economic outlook.



The FOMC speaks --- and says nothing new.

Today's FOMC statement offered little in the way of a timetable to scale back QE. What is interesting, though, is that they chose not to include even a whiff of a change on monetary policy at this time, even though there has been good news on employment, home and auto sales, and the fact balance sheets at households, banks and other companies are much healthier.

So what is the Fed waiting for? Our assessment is that if the economy continues to generate more than 200,000 jobs a month in July and August and the unemployment slips below 7.5%, the FOMC will have sufficient votes to begin to taper. For now, the odds the Fed will act in September have lessened only slightly. From this point on, one has to monitor closely any new economic data and see if it leads to a change in nuance from Bernanke's own comments in the coming weeks on the subject of tapering.

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