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ECONOMIC TALKING POINTS

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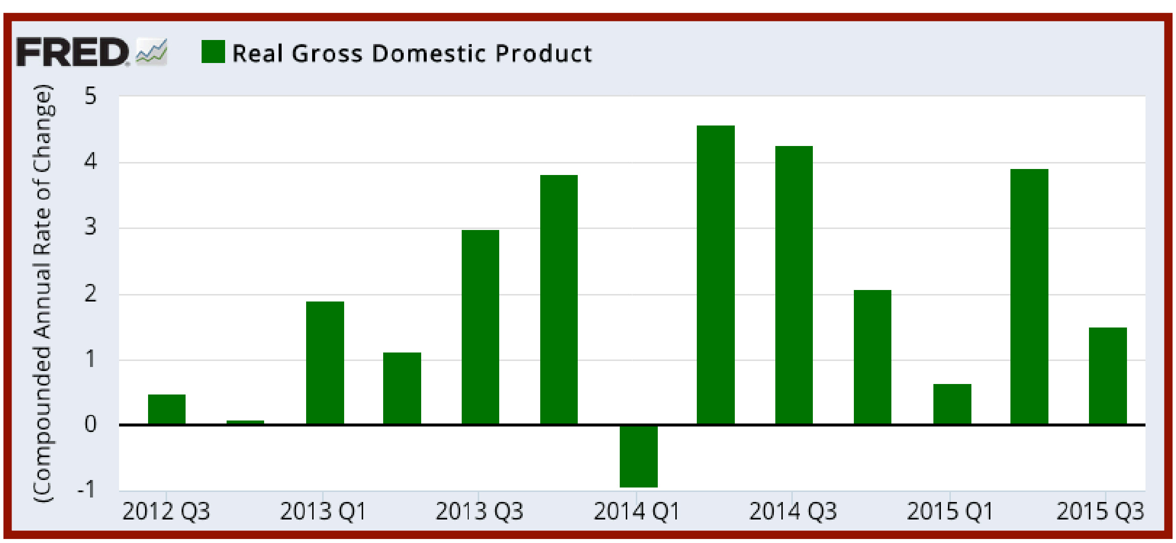
Will 1.5% GDP Growth End Any Chance of a Fed Rate Increase This Year?

For many Fed followers the weak top line GDP growth of 1.5% in the 3rd quarter essentially forecloses any chance of a Fed rate increase this year. After all, how could the Fed possibly start to tighten monetary policy *now* with such an anemic economic performance?

That sentiment is understandable if you simply rested your analysis based on the headline figure. We're not in that camp, however, largely because if one digs a little deeper into the GDP report, what emerges is a portrait of an economy that is actually quite robust and poised to show faster growth in the coming quarters.

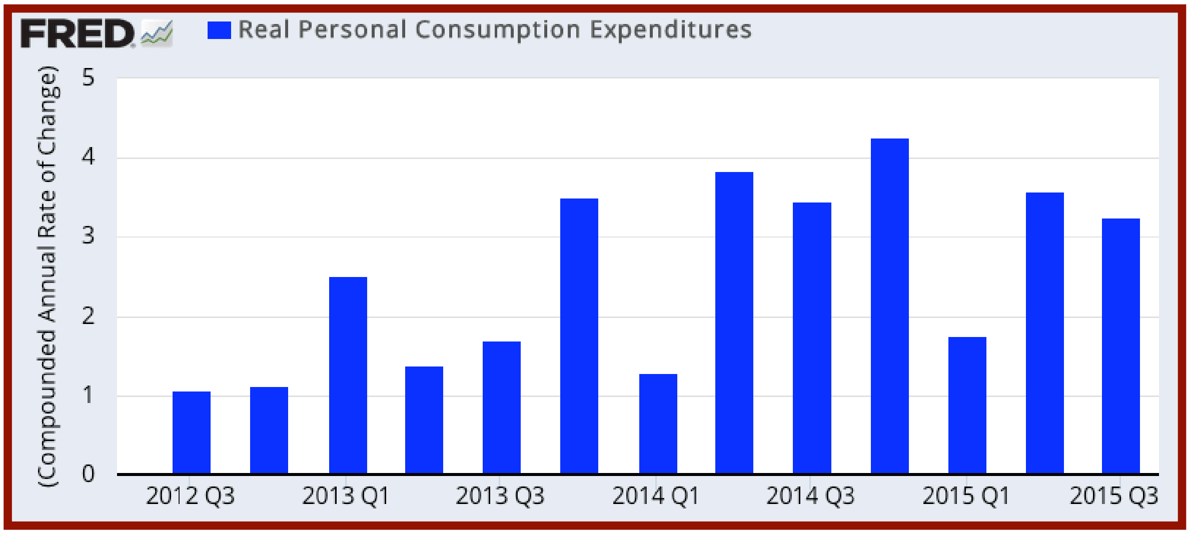
Chart A: Economy slows to 1.5% pace in 3Q



Here are the salient facts to consider:

1. The most important drivers in the economy are consumers, and they seem to be willing to continue spending. Personal consumption expenditures rose at a 3.2% rate in the 3rd quarter, following a 3.6% jump the previous period. These are solid numbers and they make perfect sense. An improving job market, rising real income, growing household wealth, and cheaper energy prices have encouraged Americans to keep shopping.

Chart B: Consumer spending held up well during the summer.



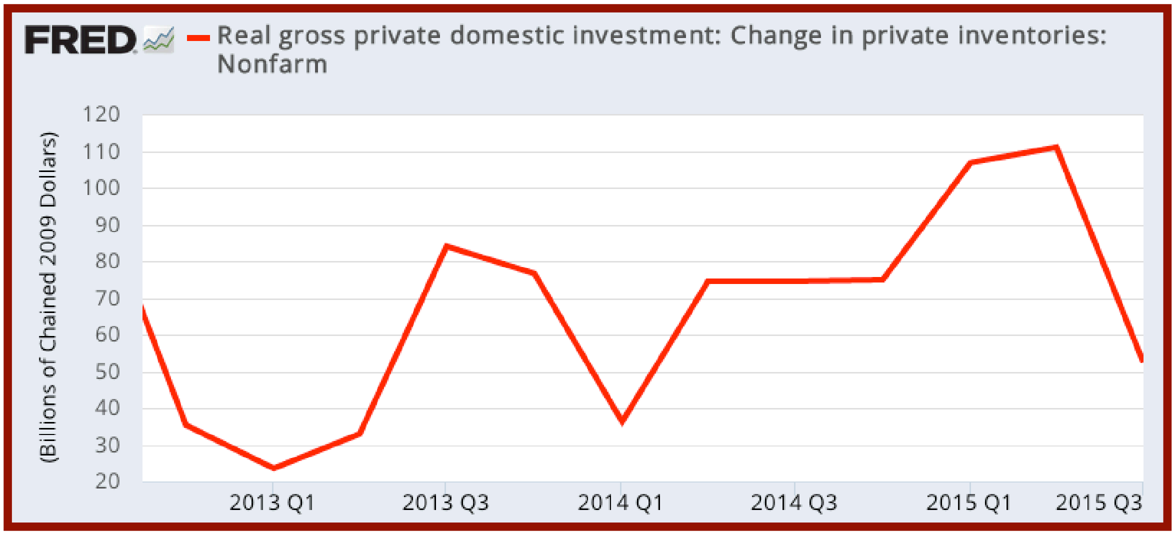
What is especially meaningful is the readiness with which consumers are purchasing durable goods, which increased a 6.7% rate, after an 8% rise in the second quarter. Durable goods are typically pricey items, often financed with credit cards or loans, and consist mostly of discretionary products (autos, furniture, home electronics, for instance.) Spending on durable goods and consumer optimism about the economic outlook usually go hand in hand.

2. Business capital spending *outside of oil and gas* also looked quite strong. Corporate investments in equipment jumped 5.3% this summer, the biggest increase in a year. What caused gross private domestic outlays to decline 5.6% were two factors:

• ¨The drop in spending on structures, and here we put most of the blame on energy firms cutting back investments in mining and on petroleum facilities.

• The second factor was the slowdown in inventory purchases. Companies chose to fulfill the strong demand for goods from consumers and firms by drawing down existing stockpiles, a process that wiped 1.44 percentage points off GDP growth. Yet by emptying stockrooms, companies have set the stage for rebuilding their inventory in subsequent quarters, especially as domestic and foreign demand continues to improve. It is one of the reasons we project GDP growth to increase by 3% in the final quarter.

CHART C: Firms satisfied 3Q orders by drawing from inventories, which subtracted from GDP growth



3. The US trade balance is also moving in the right direction. Exports actually grew at a slightly faster pace than imports in IIIQ, with an increase of 1.9% and 1.8%, respectively. Now---that may not seem much of a difference at first glance, but it suggests the impact of the strong dollar on US exports has begun to diminish. In other words, much of the dollar's appreciation in FX markets is now behind us and this should provide support to US exporters in the months ahead.

What other factors might the Fed be looking at as it considers a change in monetary policy in December? Certainly high on the list will be continued strong momentum in consumer spending. The housing market appears to be in recovery mode. The fundamentals of the job market look good, given the demand for workers (5.4 million job vacancies) and that applications filed for jobless benefits remain at 40 yr lows. Moreover, core inflation, while still far below 2%, is at least crawling in the right direction---higher. Lastly, concerns about global economic instability have also receded since September. China's decision this month to again lower its benchmark rate and reduce reserve requirements shows Beijing is committed to keeping its economy growing between 6% to 7%.

In short, we believe the Fed will look beyond the latest soft headline GDP number and conclude that the core of the US economy -- consumer and business spending --- is strong enough to absorb a 25 basis point increase in December.

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