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GDP Decline Masks Strengthening Consumers, Business

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A surprise economic contraction masked accelerating growth in consumer and business spending that may bode well for this year, while the Federal Reserve hinted Wednesday that conditions are improving even as it stuck with its massive bond-buying program.

Q4 gross domestic product fell at a 0.1% annual rate, the Commerce Department said Wednesday in its initial reading, the first decline since Q2 2009.

Analysts expected a 1% rise. For the year, growth picked up to 2.2%, from 1.8% in 2011.

Stocks shrugged off the surprise economic retreat and a separate report showing solid private-sector hiring in January. But they retreated modestly in the afternoon after the Fed's improved tone raised some doubts about how long it will continue the flood of monetary stimulus.

Defense spending sank at a 22% annual rate in Q4 after jumping 9.5% in Q3. Overall federal spending fell 15% in Q4, the steepest decline in nearly 40 years, contributing to a 1.25-percentage-point drag on GDP.

Lower inventory restocking also slashed another 1.3 percentage points off GDP, following a 1.1-point bounce in Q3. Exports sank at a 5.7% rate in Q4, the first quarterly drop since early 2009.

But consumption rose 2.2%, the most since Q1 2012, led by a surge in durable goods spending. The housing recovery fueled a 15.3% increase in residential investment, more than in Q3 and Q2.

Business investment rebounded to 8.4% growth after a 1.8% fall in the prior quarter. Investment on equipment and software leapt 12.4%, the most since Q3 2011. The gains came despite uncertainty over the fiscal cliff at year's end. Such signs of strengthening consumers and businesses could mean they are looking past a pattern of political crises followed by last-minute deals, said **Bernard Baumohl, chief global economist for the Economic Outlook Group.** "The private sector is going to take charge and show less anxiety about Washington," he said. "There's a sense that people have seen this movie before."

He sees the Q4 contraction eventually getting revised up to show expansion, with quarterly growth speeding up past 3% throughout this year helped by the release of more pent-up demand.

While the improvement in consumption is positive, it remains well below its long-term average of about 3.4% and even further below what's needed in a recovery stage, said Dan North, North America chief economist at Euler Hermes. The growth in final sales — which exclude inventory changes — also ought to be much stronger than Q4's 1.1%.

Even when leaving out government spending and inventories, "you're still left with a really bad report," he said. "You're still chugging along in this subpar recovery."

Higher payroll taxes this year also will hurt consumption in Q1, and uncertainty lingers over what lawmakers will do about steep automatic budget cuts, including to defense.
The economy's underlying trajectory remains stable yet weak, North added, and what's needed to get out of that trend is a credible, long-term plan to rein in federal budget deficits and debt.

The GDP report reinforces views that the Fed will continue its bond-buying program through 2013. Minutes from the December meeting showed some policymakers want it to end in mid-2013.

As expected, the central bank left its quantitative easing unchanged at $85 billion a month. Policymakers noted that growth in economic activity "paused" recently due in part to Superstorm Sandy.

But overall they were less gloomy, saying they "expected" moderate growth to continue and the jobless rate to decline. The December Fed statement said they were "concerned" that job conditions wouldn't improve without heavy stimulus.

The private sector created 192,000 jobs in January, topping forecasts of 172,000, and the fifth straight month of accelerating hiring, according to payroll processor ADP. Small-business hiring was the best in seven years. But large companies shed jobs and factories reduced staff for the sixth time in seven months. Construction firms did add 15,000.

The Labor Department releases its monthly employment report Friday.

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