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TRENDMACRO LIVE!

On Q3 GDP

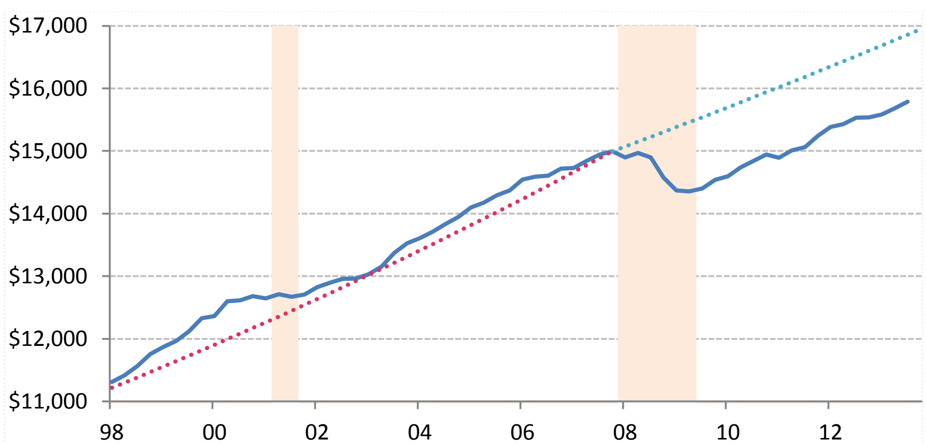
Thursday, November 7, 2013
Donald Luskin

Big upside surprise, small downpayment on the output gap. Therein lies the opportunity.

Real Q3 gross domestic product growth reported this morning at 2.8% was a significant beat versus consensus expectations for 2%.

- Throughout the Not So Great Expansion following the Great Recession, we've always hastened to pour cold water on upside surprises. Not now. We have come to have conviction that the growth-crippling era of global contagion, political instability and high energy prices has come to an end (see "A Major Upgrade to our Strategic Outlook" September 12, 2013) -- so from here, when we get a little good news now and then, we're going to accept it at face value.
- To be sure, real growth of 2.8% is only a tiny downpayment on digging the US economy out of its record output gap (please see the chart below, and "Data Insights: GDP" November 7, 2013). Even if we posit that the average trend growth rate from the 2007 cycle peak is only 2% -- significantly below the 3% peak-to-peak trend rate from 1973 to 2007 -- the output gap is still a very wide 6.8%, having shown no improvement at all from the bottom of the Great Recession.

Real GDP --- 1973-2007 trend 3% --- Post '07 trend 2% Recession
SAAR, USD billions



Source: BEA, NBER, TrendMacro calculations

Update to strategic view

US MACRO: Q3 GDP growth at 2.8% is a significant upside surprise. After six years of reflexively dismissing good news as spurious from first principles, we are now both expecting and believing surprises like this. With conservative assumptions about potential growth rates, the US economy still has a 6.8% output gap to peak capacity, virtually unchanged since the trough of the Great Recession. In the less risky and more growth-friendly world we now expect -- in which long-dormant virtuous cycles can come back to life, that's an opportunity, not a barrier.

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- For us, that is the properly benchmarked definition of an "L-shaped recovery" -- which is to say no recovery at all. It's been a sad symptom of how many serious problems we have faced, and still face. But if we are right that the world has become a less risky and more growth-friendly place, then that output gap can indeed be closed, as output gaps in the past have always been closed.
- For that to happen, the US economy would have to put on the scoreboard GDP growth numbers that, right now, feel somewhere between inconceivable and laughable.
- Maybe so. But even closing half the output gap would feel like a boom. We're not calling for a turning point here that will feel like a sharp corner -- rather, a gradual reorientation unfolding over the coming two to six quarters, as long-dormant virtuous cycles come back into operation. When that starts happening, suddenly the output gap will feel like an opportunity, not a barrier.

Bottom line

Q3 GDP growth at 2.8% is a significant upside surprise. After six years of reflexively dismissing good news as spurious from first principles, we are now both expecting and believing surprises like this. With conservative assumptions about potential growth rates, the US economy still has a 6.8% output gap to peak capacity, virtually unchanged since the trough of the Great Recession. In the less risky and more growth-friendly world we now expect -- in which long-dormant virtuous cycles can come back to life, that's an opportunity, not a barrier.

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