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Soft Where?

Friday, April 27, 2007

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There's still no evidence whatsoever of housing contagion, and lots more evidence of inflation.

No doubt the economic bears are finding considerable confirmation for their pessimism in today's GDP release showing real growth of just 1.3% in the first quarter. To be sure, that is a disappointing rate of expansion by any standard. But breaking down the data into its various components indicates that the underlying economic reality is considerably more upbeat than the headline number would suggest. At the same time, the inflation figures in today's release can provide the Fed with no comfort that the long hoped for turn lower in core inflation is at hand, leaving the credit markets trading lower today despite the weak looking headline GDP print.

Update to strategic view

US MACRO: A seemingly soft GDP report was only an artifact of a continued housing bust and slower net exports, while consumption and income grew at healthy paces. This demonstrates that there is still no contagion into the consumer economy from weakness in housing. At the same time, inflation pressures continue to visibly mount.

INFLATION PLAYS (US RESOURCE STOCKS, US ENERGY STOCKS, GOLD, COMMODITIES, US DOLLAR): A seemingly soft GDP report is likely to prolong the Fed's pause, even as inflation continues to mount. Inflation-sensitive assets should continue to work higher (and the dollar lower).

[see Investment Strategy Dashboard]

NO HOUSING CONTAGION Probably the most significant take-away from today's data is that they offer no evidence that the effects of the housing downturn are spreading economy-wide. Yes, another horrific quarter for residential investment yielded another full point decrement to the GDP growth rate. But this was more than offset by a 3.8% surge in consumption spending and a return to plus territory for business fixed investment, with equipment and software spending showing a 1.9% gain after dropping 4.8% in the fourth quarter last year. Together, these components accounted for a 2.9% positive contribution to growth.

OTHER FACTORS In addition to housing, major factors weighing on the growth rate were net exports at -.52% and inventories at -.3. The net export figure was pulled lower by a rebound in import growth, which is certainly no indication of economic weakness, and a $4 billion decline in exports following a $33 billion increase in last year's final quarter. Whether that holds up in subsequent revisions, however, is open to question. For one thing, the initial estimate of trade flows is calculated with plug-in assumptions for March, since little hard data is yet available, and it's plausible to think that the export figure could well be revised higher. But with the global economy continuing to

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expand at a robust pace, whatever export fall-off might have occurred in the last quarter is unlikely to be sustained.

INVENTORIES The negative inventory contribution reflected a second consecutive quarter's decline in inventory accumulation. But the decline was substantially less than in the fourth quarter of '06 ($7.6 billion versus $33 billion) suggesting that the inventory correction has probably come close to running its course, setting the stage for an increase in production in coming quarters.

INFLATION As for inflation, the Fed's attention will surely be drawn to several of the price indexes contained in the GDP release which showed significant jumps higher in the quarter. The overall GDP deflator was up at an annual rate of 4% in the quarter, versus 1.7% in the fourth quarter of '06, while excluding fuel and energy it increased by 3%, compared with 2.3% in the previous quarter. The Fed's preferred measure, the core personal consumption deflator, also showed a notable quarter-to-quarter boost, rising from 1.8% to 2.2%. For a central bank anxiously seeking confirmation for its forecast that core inflation is slated to fall from levels above the top end of its 2% "comfort zone," none of this can be considered good news. Meanwhile, with gold up by nearly $5 and the dollar trading at new all-time lows against the euro and near all-time lows on a trade-weighted basis, the most inflation-sensitive markets appear entirely nonplussed by the notion that a slowing rate of growth should tend to diminish inflation pressures. Rather, these price moves reflect the judgment of market participants that a supposedly "soft" GDP release can only increase the Fed's reluctance to return to tightening mode to remove the monetary accommodation that remains evident in its current policy stance.

BOTTOM LINE: Despite the anemic-looking 1.3% growth rate for first quarter GDP, we take note that there remains no evidence pointing to a housing contagion spreading through the economy. Consumption and business investment were strong, and the major drags on growth -- aside from residential investment -- were net exports and inventories, neither of which reflect a significant softening in the domestic expansionary impulse. In important respects, the sluggishness reflected in today's report presages far better results in quarters to come. And with inflation showing no signs of easing from levels that the Fed already considers "elevated," any notion that policymakers might have entertained about the possibility of easing has been effectively foreclosed. At the same time, though, there's little doubt that this data will further buttress the Fed's inclination to remain on hold, even at its inflation-biased stance continues to erode the purchasing power of the unit of account.