Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist
Thomas Demas, Managing Director

INTELLECTUAL AMMUNITION

It's an Old New Era

Friday, May 1, 2009

Donald Luskin

There's no Q1 retrenchment of consumption -- there's a shock to investment.

Update to strategic view
US MACRO: The first quarter GDP report shows an economy in credit shock, with little evidence that the US consumer is headed for a secular trend of retrenchment.
[see Investment Strategy Dashboard]

Wednesday's first quarter GDP report is a startling portrait of event-shock in action. The most recent two quarters put together -- covering the period since the near collapse of global credit markets last September -- are the second worst for *real* output, and the third worst for *nominal* output, in the history of the data going back to 1947. Before that near collapse, at that point three quarters after what has since been officially designated as the last business cycle's peak, cumulative output was still positive on both a real and a nominal basis. If it had not been for the shock-induced decline of the most recent two quarters, there would have been no reason to declare an official recession at all. So hats off to the forecasters who correctly foresaw the magnitude of the present recession, and got it right *for the right reasons* -- by identifying the lethal fragility in the credit sector and the shock that would issue from it.

The GDP data shows that some other bears got it right *for the wrong reasons*. For purposes of looking forward from here, it's important to recognize the distinction. The wrong reasons were various issues living under the general rubric of so-called "global imbalances" -- such as the US trade deficit, the low US savings rate, and the over-indebted US consumer. Variations on these themes have been rattling around for years, and now that a sharp recession is upon us, those who have advocated them are declaring victory and forecasting a "new era" marked b a secular reversal of these themes. For example, late last year we noted that former Merrill Lynch economist David Rosenberg was forecasting a "frugal future" of "epic changes" marked by the collapse of demand from the tapped-out US consumer (see "Is This a 'New Era' Recession?" December 29, 2008). But the data coming out of the recession so far would seem to confound such predictions.

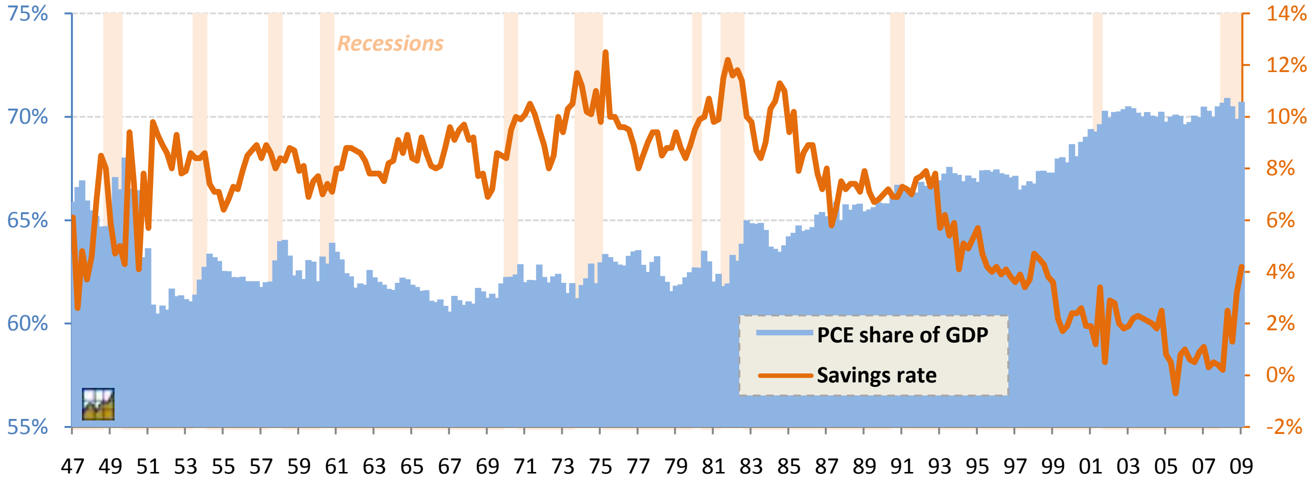
The key statistic symbolizing this consumer-centric view is the large share of US GDP taken up by personal consumption. This is often cited as evidence of a long episode of binge behavior by US consumers -- spending rather than saving, importing rather than exporting, and borrowing rather than earning. The consumption share of GDP hit an all-time high of 70.9% in the second quarter of 2008, and with the sudden onset of sharp recession, it was expected to drop as the

http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com
tdemas@trendmacro.com

Offices:
Menlo Park CA
Parsippany NJ
Charlotte NC

Phone:
650 429 2112
973 335 5079
704 552 3625

savings rate rose. It *did* drop in the third quarter of 2008, and again in the fourth quarter, getting as low as 69.9% (a two-year low). But now in the first quarter of 2009, it has bounced back to 70.8%, the second-highest reading on record (see the chart below). This is despite the fact that the personal savings rate has risen to 4.2%, from 2.5% in the second quarter.



How can the consumption share of GDP and the savings rate have risen at the same time, when the idea was that the indebted US consumer doesn't save enough, and has no further capacity to borrow? In part, it is because real disposable personal income rose at an annual rate of 6.2% in the first quarter -- when disposable income rises, one can consume more, save more and borrow less at the same time. A better question is how could disposable income have risen in the midst of a sharp recession? In fact, *overall* personal income *didn't* rise, but rather it fell at a 3.5% annual rate in the first quarter. *Disposable* income rose in part due to lower taxes -- with lower incomes last year, fewer taxpayers had to pay the IRS more than they had already withheld, more taxpayers got refunds, and there were some positive effects from the new lower withholding tables enacted as part of the "stimulus" bill -- and all of this hit in the first quarter. Call it a one-time effect, but nevertheless it reveals the continued propensity to consume, even in the face of economic calamity -- not the "frugal future" that had been widely expected.

More fundamentally, the consumption *share* of GDP can rise even if the absolute amount of consumption falls. In fact, personal consumption grew at a 2.2% annual rate, but that strong performance wasn't necessary for *share* to rise -- that would happen regardless of the growth of consumption, so long as all the other components of GDP grew less. What the consumption *share* tells us is that the structure of preferences in the economy -- specifically, the preference for consumption -- remains intact.

Perforce, if consumption share grows, then some other factor's share has to fall, and in the second quarter it was private investment that took the hit. Even excluding the change in inventories, which came in with the largest drop in 21 years, investment accounted for 6.04% out of the 6.1% decline in overall output (which means that all other factors essentially cancelled each other out). At 11.2% of GDP, the investment *share* is now the lowest on record. In part this is due to the very weak residential and non-residential construction sectors (that is, housing and commercial real estate), as well as the large drop in inventories. But even looking only at the equipment and software component of private investment (which is what's left when you remove the other components just mentioned), its share of GDP in the first quarter was the smallest since 1964.

This all tends to confirm our view that the extreme weakness of the last two quarters has been the result of a specific shock -- specifically, the shock to global credit markets -- rather than a secular shift in consumption patterns. It's not that consumers suddenly don't want to consume -- or can't afford to. It's that investors don't want to invest -- or with capital so expensive, can't afford to. And that's a problem that's on its way to being solved, by the extraordinary efforts of government to underwrite credit risks that no one else has been willing to take (see "Unknown Unknowns" January 30, 2009). Thanks to those efforts, credit spreads and risk premiums are well off the panic levels observed since the crisis of last September (see "Sorting Out the Spreads" April 27, 2009), and the S&P 500 financial sector has rallied almost 75% from its early March lows. This seeming relief is illusory to the extent that it relies entirely on government life-support, and the critical test in the short term will be to see whether private capital begins to re-assume the risks now being shouldered by government. Ironically, government itself is in the way of that essential step to recovery -- as private capital must cautiously evaluate the possibility that government will unwittingly set off another panic. That's a non-trivial risk, as by our reckoning the incompetent handling by government of last year's financial firm failures was at the epicenter of the global credit shock (see "Death by Rescue" November 17, 2008). The next checkpoint on that risk is the upcoming revelation of the Treasury's "stress test" results, about which we will have more to say early next week.

Recommended reading
The Financial Crisis: An Inside View Phillip Swagel, Brookings Papers on Economic Activity, Spring 2009
[Recommended Reading home]

Longer term, we don't expect a wholesale change in US consumers from *profligacy* to *thrift* (to borrow the morally-tinged terms the consumer-centric bears usually use). The long-term risk actually runs the other direction. Frightened by the global credit shock and the recession in its aftermath, consumers have lurched to the political left in the expectation that government-mandated redistribution can assure the uninterrupted flow of goods and services (such as, prominently in the Obama budget, health care). Government intervention now in distressed credit markets has likely put an effective floor under the worst-case scenario of a market meltdown -- but once the crisis has passed, intervention in credit markets, and everything else, will just as likely put an effective cap on the upside. So it's not the US consumer that worries us. It's the US voter, and the government whom he believes is here to help him.

BOTTOM LINE: The first quarter GDP report shows an economy in credit shock, with little evidence that the US consumer is headed for a secular trend of retrenchment.