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TRENDMACRO LIVE!

On Q3 GDP

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Still no "new era" of consumer retrenchment -- but no investment renaissance, either.

This morning's third quarter 2009 gross domestic product release underscores many of the strategic themes we've been developing as the economy has come out of recession.

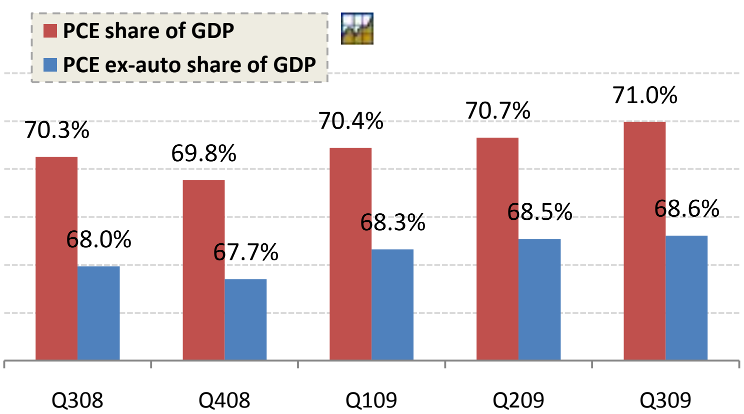
Update to strategic view

US MACRO: Q3 GDP shows no sign of the widely expected consumer retrenchment, with the PCE share moving to new all-time highs. Despite a potentially illusory recovery in housing, fixed investment continues to be the economy's big problem, and we don't expect a return to robust growth until it shows signs of durably turning around.

[see Investment Strategy Dashboard]

WHERE'S THE "NEW ERA?" The personal consumption expenditures share of GDP rose to a new all-time high in Q3, at 71.0%, topping the previous all-time highs in Q1 and Q2. *We repeat emphatically that there is simply no evidence in the data for the widely expected secular shift toward consumer retrenchment* (see "Still Waiting for that 'New Era'" July 31, 2009 and "It's an Old New Era" May 1, 2009). To be clear, the rising PCE share of GDP means that consumers are more than indexing their consumption to their production -- which means there is no downward shift in their fundamental propensity to consume.

DISTORTED BY "CLUNKERS"? Consumption data is perturbed in Q3 by the "cash for clunkers" program. This likely explains the large 1.01% contribution of auto sales to overall GDP growth of 3.53%, and raises issues about the legitimacy and sustainability of a seemingly very positive quarter. But it doesn't change our view about the absence of a consumer retrenchment -- the ex-autos consumption share of GDP is at all-time highs, just as the overall consumption share is.



SO MUCH FOR "GLOBAL IMBALANCES" Net exports made a negative contribution of 0.53% to overall GDP growth of 3.53%, thanks to faster growth in imports than in exports. This is the first negative contribution after three quarters of positive ones, during

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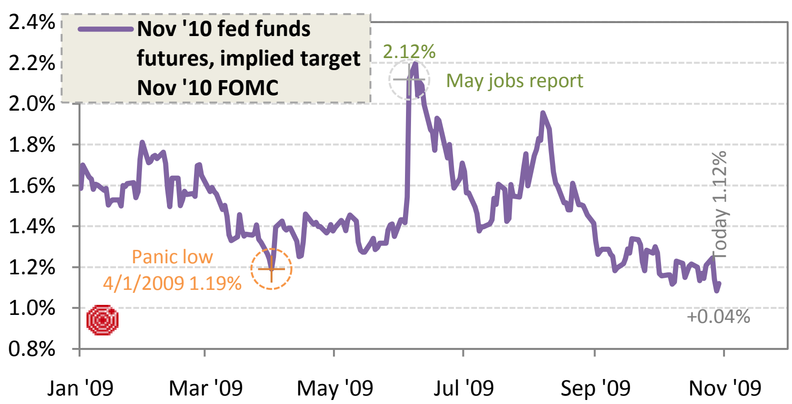
which those who believe in the doctrine of "global imbalances" argued that a US consumer retrenchment and a falling dollar would force a reversal of persistent US trade deficits. It is more likely the case that the rise in net exports seen in the previous three quarters was indicative of nothing more than recession.

INVESTMENT IS STILL THE REAL PROBLEM We are not entirely comforted by the fact that fixed investment recovered somewhat in Q3, making its first positive contribution to GDP since Q207, the last quarter before the onset of the global credit crisis. Despite the uptick, fixed investment failed to keep pace, with its share of GDP falling to 12.1%, a new all-time low. We'll know that the economy has become capable of generating meaningful levels of growth again when we see an uptick here -- this morning, we're not seeing it.

DISTORTED BY BUYER'S CREDIT? More than the entire 0.28% contribution by fixed investment to Q3's 3.53% overall GDP growth is explained by the 0.53% contribution by housing. That's a good thing on the face of it, as housing has made nothing but large negative contributions since Q405. But some indeterminate portion of its Q3 contribution is likely explained by the first-time buyer's credit.

INFLATION Inflation as measured by the GDP deflator came in at just 0.66% year-on-year, a figure which is being bruited about as the lowest since 1955. True, but bear in mind that is based on the year-ago comparable of Q308, when oil peaked at $147. A more meaningful view of the inflation situation is the sequential quarter rate of 0.75% -- a low number to be sure, but a reversal from last quarter's negative 0.02%, signaling that the economy has moved away from the risk of deflation and turned instead toward inflation.



IMPLICATIONS FOR THE FED While this morning's GDP data has been greeted by markets as an upside surprise, it has made almost no impact in the markets for Fed expectations. Over the last two days the funds rate target implied by year-ahead futures contracts fell to all-time lows, and today's data has hardly reversed that move at all -- this despite media buzz that the Fed will alter its promise to keep rates low for "an extended period" (see "Promise Keepers" October 27, 2009).

BOTTOM LINE: Q3 GDP shows no sign of the widely expected consumer retrenchment, with the PCE share moving to new all-time highs. Despite a potentially illusory recovery in housing, fixed investment continues to be the economy's big problem, and we don't expect a return to robust growth until it shows signs of durably turning around.