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

TRENDMACRO LIVE!

On Q4 2009 GDP

Friday, January 29, 2010

Donald Luskin

Waiting for that "new normal" -- a "new era" of frugality -- is getting mighty old.

Update to strategic view

US MACRO: This morning's GDP data is proof positive that the recession is over. But driven mostly by slowing in the rate of inventory liquidation, it's evidence of mere recovery, not yet true expansion. The consumer continues to defy consensus expectations for a "new normal" -- but fixed investment still lags, not a good sign for robust growth ahead.

FED FUNDS: The Fed will look at this morning's strong GDP report and nevertheless see a huge "output gap." Seeing this as a barrier to both full employment and inflation, interest rates will continue to stay near zero as far as the eye can see.

[see Investment Strategy Dashboard]

This morning's report of Q4 2009 gross domestic product must have been a true upside surprise -- because the stock market didn't immediately collapse on the news, as almost all individual stocks have done this earnings season even when they strongly beat apparent expectations (see "Under-Seasoned" January 15, 2010).

INVENTORY STORY In case anybody's still wondering, the recession is definitely over. But don't read too much into the Q4 numbers. There's not a lot here to provide evidence of anything more than mere recovery -- as opposed to robust expansion. The reality is that 3.39% out of this morning's reported real GDP growth of 5.7% -- more than half -- came from change in inventories. There's nothing wrong with inventories, except that someday someone has to actually buy them. The problem is that inventories *fell* in Q4, by $33.5 billion at an annual rate. That's nevertheless counted as a positive contributor to growth, because it's better than Q3's decline of $139.2 billion. In the counterintuitive world of GDP inventory accounting, it's the change in the change that counts -- so a smaller sequential liquidation contributes to growth. We saw the same thing in Q1 2002, when it was definitely a false alarm for growth -- which would then take more than another year to really take hold (see "That Was the Quarter That Was(n't)" May 28, 2002). Filtering all that out, real final sales -- GDP less changes in inventories -- was reported this morning at 2.2%, up from 1.5% in Q3, but not exactly a booming number.

NO "NEW NORMAL" For us the big story in this morning's report was the continued robustness of the supposedly retrenching consumer. The consumption share of nominal GDP was reported at 70.9%, the second highest reading in history, and down only 20 bp from Q3's all-time record high (please see the chart on the following page). We keep re-emphasizing this (see first, among many, "Is This a "New Era" Recession?" December 29, 2008) because there remains such a strong consensus in the economics community and among our clients that we face a "new era" of frugality, in which flat consumption growth will be a perpetual economic

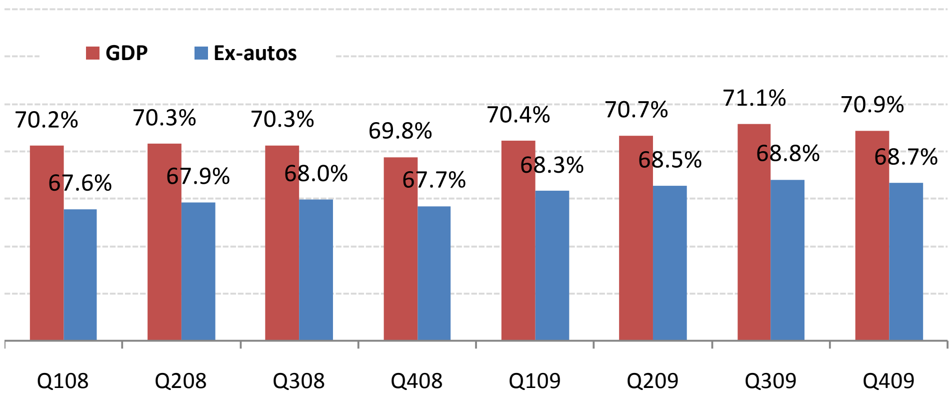
http://www.trendmacro.com
don@trendmacro.com
tdemas@trendmacro.com

Offices:
Menlo Park CA
Charlotte NC

Phone:
650 429 2112
704 552 3625

drag. We're aware of, and sympathize with, all the good reasons for expecting this. But the fact remains, quarter after quarter, that it is simply not showing up in the data.

Personal consumption expenditures share of gross domestic product
Seasonally adjusted, nominal

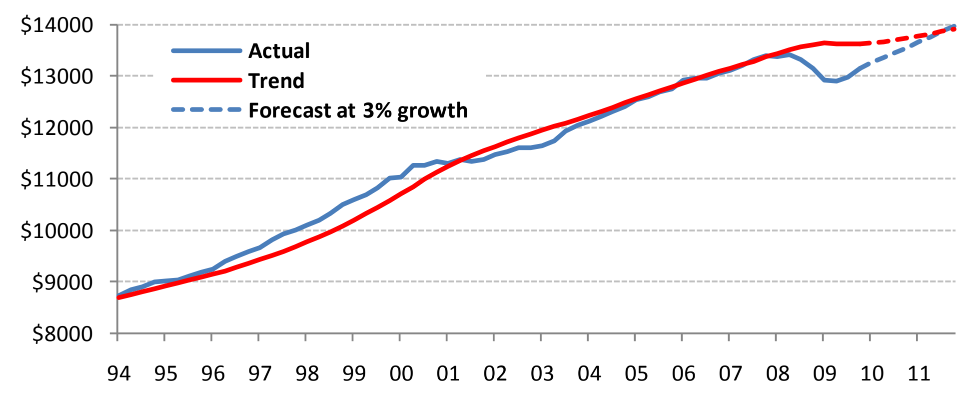


Source: Bureau of Economic Analysis, TrendMacro calculations

NO INVESTMENT RECOVERY The flip-side of the continued strength in consumption is the continued weakness in investment. Despite a positive contribution of 0.43% out of this morning's reported real GDP growth of 5.7%, the fixed investment share of GDP fell to 11.9%, the lowest in history. We continue to believe that the recession was primary the result of a global collapse in investment, and until we see more vibrant signs of life in that growth-critical sector, we'll continue to call for only a gradual recovery.

GOVERNMENT SPENDING GROWS Government consumption and investment *subtracted* 0.02% out of this morning's reported real GDP growth of 5.7%. But federal non-defense consumption was strong -- growing at a 6.9% annual rate, contributing 0.22% to overall growth. Its share of GDP now stands at 2.3%, perhaps a small number in grand scheme of things, but nevertheless the highest since the era of big government in the mid-1970s and early 1980s. The increase in this relatively unproductive category's GDP share does not bode well for robust future growth.

Real gross domestic product versus trend: the "output gap"
10-year linear trend



Source: Bureau of Economic Analysis, TrendMacro calculations

STILL A HUGE "OUTPUT GAP" From here, it will take two years of uninterrupted 3% growth at an annual rate to return GDP to trend -- and a decelerating trend, at that (please see the chart at left). That will close the "output gap" -- a good proxy for the challenge of returning the economy to full employment. Unless the economy can grow more rapidly than that, which would steepen trend growth, then "full employment" in two years should be expected to entail a somewhat higher unemployment rate than in the past. Fed vice-chair Donald Kohn warned in a speech this morning, moments before the GDP data were released, that "as the economic recovery gains traction, it will be appropriate at some point for the FOMC to raise rates." We take this as only a pro-forma statement, because the labor market will take a great deal of "traction" to show any improvement at all -- and rates aren't going to be hiked until that happens. All the more so, considering that the Fed regards the "output gap" as insurance against the risk of inflation. The market seems to agree that this morning's GDP doesn't move the Fed any closer to raising rates. As of this writing, despite the big upside GDP surprise, year-ahead fed hiking expectations implied in the futures market have fallen to almost two-month lows. So it would be a mistake at this point to abandon reflation-oriented investment positions for fear of the Fed's "exit strategy" -- that remains a long way off.

BOTTOM LINE: This morning's GDP data is proof positive that the recession is over. But driven mostly by slowing in the rate of inventory liquidation, it's evidence of mere recovery, not yet true expansion. The consumer continues to defy consensus expectations for a "new normal" -- but fixed investment still lags, not a good sign for robust growth ahead. The Fed will look at this morning's strong GDP report and nevertheless see a huge "output gap." Seeing this as a barrier to both full employment and inflation, interest rates will continue to stay near zero as far as the eye can see.