TrendMacro

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TRENDMACRO LIVE!

# On Q1 2010 GDP

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**A weak quarter: no "new normal," but no "V-shaped recovery" either.**

First quarter 2010 gross domestic product was reported this morning at 3.2% real growth. Our view that the economy is no longer in recession -- but not in expansion either -- is confirmed. Clients have criticized us for that in-consensus view, but the facts are that the out-of-consensus bets -- both by the bears with their "new normal" and the bulls with their "V-shaped recovery" -- are being proven wrong.

**Update to strategic view**

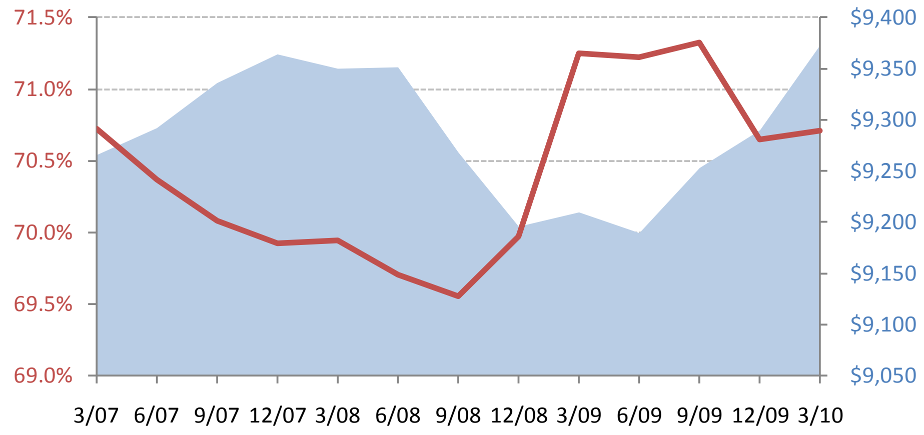
**US MACRO:** Q1 2010 GDP confirms that the economy is in recovery, but not expansion. The dominance of inventories again argues for a weak Q2, and the failure of fixed investment to get any traction means that the hard part of economic rebuilding hasn't even begun.

[Strategy Dashboard home]

## "New normal" nowhere in sight

As we've been saying throughout the recession (see, most recently, "The Consumer: QED" April 16, 2010), the supposedly over-indebted US consumer is not a problem factor for the economy. There is still no evidence of a "new normal," a "new era" of "scrimp and save." In Q1 personal consumption expenditures grew at a 3.6% annual rate, the best in three years. The *level* of real PCE achieved new all-time highs (please see the chart below). The PCE share of GDP grew to 70.7%, approaching the all-time highs reached in Q3 2009, just when the "new normal" advocates

🟦 **Personal consumption expenditures** ▬ **PCE share of GDP**
Real, seasonally adjusted annual rate



Source: Bureau of Economic Analysis, TrendMacro calculations

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said it should have collapsed.

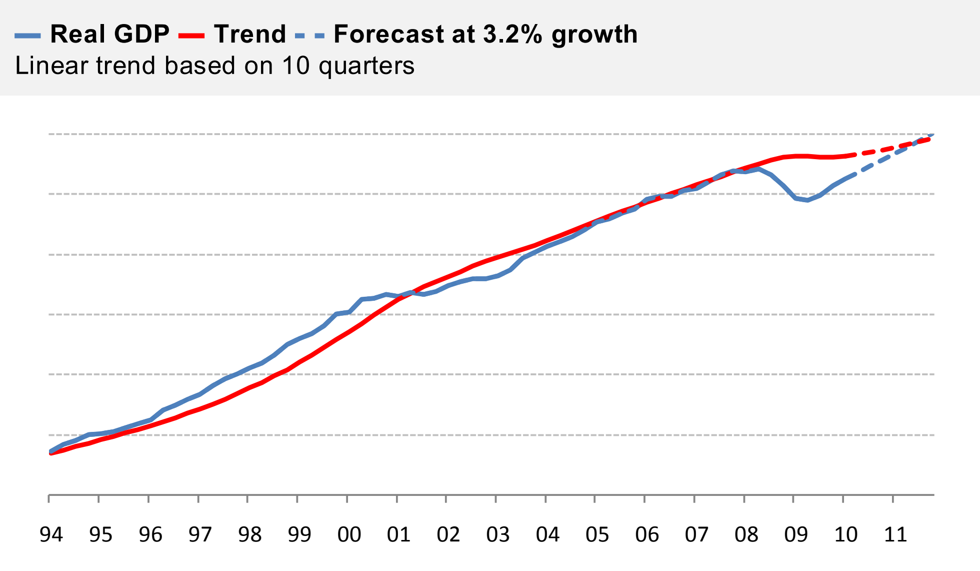
## Inventories still dominant

We knew Q1 GDP would be lower sequentially, because the prior quarter's 5.6% growth rate was dominated by the 3.8% contribution from change in private inventories (see "The Case for Ambivalence, Volume Three" March 4, 2010). Historically, after quarters with such a strong inventory contribution, the following quarter is lower overall almost 80% of the time -- and so it was in Q1. And inventories contributed almost half the reported growth in Q1 -- 1.57% out of 3.2%. So based on historical averages, that sets up Q2 to be lower overall by 1.5% -- that is, Q1's 3.2% would fall to 1.7%.

In Q1 the change in private inventories was positive, rather than just *less negative* as it was in Q4 2009. From an output measurement standpoint this makes no difference at all. But it may encourage those who believe in "the inventory cycle." We caution that there is no such thing. Inventories are a necessary evil, a dead-weight cost that businesses would eliminate entirely if they could. Production inventoried in one quarter (adding to GDP) is hopefully sold the next (subtracting from GDP). There is a "sales cycle," to be sure -- and inventories follow in its wake. They are not a push factor in the economy -- they are pulled.

## Where's the V?

If this is a V-shaped recovery, the right side of the V is not as steeply sloped as the left. It ought to be *more* steeply sloped, in order to get output not just to new highs, but back to trend. As it stands, "you can't get there from here." If you assume that trend growth is 3.2%, and if you are starting from a *below*-trend output *level* -- as we are, thanks to a long recession --



Linear trend based on 10 quarters

Source: Bureau of Economic Analysis, TrendMacro calculations

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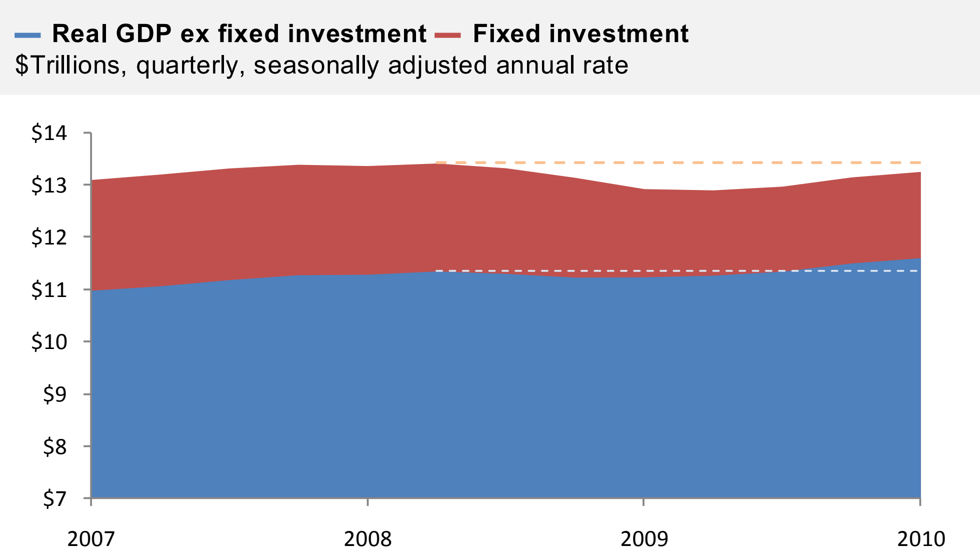
then you can never get back to the trend *level* of output with quarters like Q1, because you are only growing at the trend growth rate of 3.2%. To get back to the trend *level*, you need to grow for a while at an above-trend growth rate. Even if you assume that the trend itself has been bent lower by the long recession, we don't get back to it until Q3 2011 (please see the chart at the bottom of the previous page).

Just about the only way it *can* happen is if the sectors of the economy that were most beaten down in the recession come roaring back, putting huge percentage growth numbers on the scoreboard from a low base. Today those sectors are the three components of fixed investment -- equipment and software (that is, capital goods), non-residential structures (commercial real estate) and residential structures (housing). But again, it's not happening. Though starting from an all-time low share of overall GDP, in Q1 2010, fixed investment contributed only 10 bp to the quarter's 3.2% overall growth rate.

But this is where the V-shaped recovery has to come from, if there is to be one. It's highly unlikely to come from other sectors of the economy that have *already recovered*. Can personal consumption expenditures do it? Maybe, but they're already at an all-time high. In fact, the portion of GDP that is everything else but fixed investment was already at an all-time high in Q4 2009 (see, again, "The Consumer: QED"), and now it's even higher (please see the chart below).



Source: Bureau of Economic Analysis, TrendMacro calculations

The collapse in fixed investment was the unique signature of the recession. The failure of that sector to get any traction means that the economy hasn't begun to really take on the hard work of regenerating itself. The recovery so far has been about picking off low-hanging fruit, such as consumption. Even *that* is at risk, going forward, if fixed investment doesn't pick up. You can't consume what you haven't produced, and you can't increase production without fixed investment.

## Bottom line

Q1 2010 GDP confirms that the economy is in recovery, but not expansion. The dominance of inventories again argues for a weak Q2, and the failure of fixed investment to get any traction means that the hard part of economic rebuilding hasn't even begun.▶