630-517-7756
www.ftportfolios.com

First Trust

Sep 20, 2010

Monday Morning Outlook

Brian S. Wesbury - Chief Economist
Robert Stein, CFA - Senior Economist

Be Careful of the New Normal

In the spring of 2009 (as the Panic of 2008 was subsiding), the consensus forecast a "new normal" real GDP growth rate of 2% or less in the second half of 2009 and first half of 2010. We were forecasting 4%. As it turns out, our optimism caused us to overshoot by exactly the same amount as the consensus's pessimism undershot – real GDP actually expanded by 3%.

Fast forward to mid-2010 and the consensus is still forecasting 2% real GDP growth, with some of the "double dip" crowd shifting to a forecast of a "growth recession" – whatever that means.

By contrast, we are predicting an average growth rate of 3% in the second half of 2010. This combines a tepid growth rate of 2% in the current quarter and a 4% rate in Q4.

The underlying trend in productivity growth remains strong, the political environment is turning more positive, corporate profits and balance-sheet cash are near record highs, and the Fed is still holding rates near zero.

In addition, the threat of higher tax rates in 2011 is likely to shift some economic activity into late 2010. Even a small shift in spending will boost annualized growth in Q4 significantly. Here are the assumptions behind our forecast for real GDP growth in Q3 and Q4.

Consumption: August "core" retail sales (ex-autos, building materials, and gas) were an annualized 2.7% above the Q2 average. After adjusting for inflation, we expect a 2.5% annual rate of consumption growth in Q3 and Q4. Real (inflation-adjusted) cash earnings are up at a 4% annual rate so far this year. Meanwhile, consumers' financial obligations are below the average for the past 30 years. Consumption will add 1.4 percentage points to GDP in Q3 and 2.2 in Q4.

Home Building: Home building is flat in Q3 but is still operating at unsustainably low levels. Even if it takes until early 2013 to deplete the excess inventory of homes, residential builders are going to have to ramp up housing starts by about 150% over the next few years to avoid an eventual shortage. Housing will be neutral in Q3 but add 0.5 points to real GDP growth in Q4.

Business Investment: Commercial construction will still be a drag on growth thru year end. However, corporate profits and cash on the balance sheet are near record highs. And with interest rates so low, that cash is not earning much. Meanwhile, with 3% real GDP growth in the past year, capacity utilization has grown from 68% to 75%. In another year, it may be at the long-term average of 80%. The consensus is missing the fact that industrial capacity is depreciating rapidly and needs to be updated. We are on the cusp of a boom in investment in equipment and software. Business investment should add 0.1 points to growth in Q3 and 0.8 points in Q4.

Government: Data on defense spending and public construction suggest government will contribute nothing to the real GDP growth rate in Q3. For Q4, we are penciling-in 0.3, the low side of the long-term average.

Trade: Domestic purchases were very strong in Q2, growing at an almost 5% annual rate. This strength drove imports up rapidly, which caused the trade deficit to soar in Q2, subtracting almost 3.5 points from the real GDP growth rate. We think the trade deficit grows a bit more in Q3, subtracting 0.2 points from growth, and then, in Q4, trade turns around and adds 0.4 points to real GDP growth.

Inventories: In 2008 and 2009, companies cut inventories to the bone. Inventories started growing again this year and recent figures suggest the re-build is accelerating in Q3, adding 0.7 points to the growth rate of real GDP. For Q4, we expect the inventory rebuild to decelerate slightly, subtracting 0.2 points from real GDP growth.

Adding up all these components of GDP gets you to our forecast of 2% real growth in Q3 and 4% in Q4. In other words, be careful about looking at the Q3 growth rate as a sign that the new normal is real. Just when the conventional wisdom starts to believe growth will remain near 2%, fourth quarter growth will already be accelerating.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
9-21 / 7:30 am	Housing Starts – Aug	0.550 Mil	**0.535 Mil**		0.546 Mil
9-23 / 7:30 am	Initial Claims - Sep 18	450K	**452K**		450K
9:00 am	Leading Indicators – Aug	+0.1%	**+0.1%**		+0.1%
9:00 am	Existing Home Sales - Aug	4.100 Mil	**3.870 Mil**		3.830 Mil
9-24 / 7:30 am	Durable Goods - Aug	-1.0%	**-2.1%**		+0.4%
7:30 am	Durable Goods (Ex-Trans) - Aug	+1.0%	**+1.9%**		-3.7%
9:00 am	New Home Sales - Aug	0.295 Mil	**0.290 Mil**		0.276 Mil