

More Plow Horse

Brian S. Wesbury – Chief Economist
Robert Stein, CFA – Senior Economist
Strider Elass – Economic Analyst

From mid-2011 through mid-2012, the economy grew 2.1%, very close to the 1.9% growth of the prior year. We think this trend of mediocre growth continued in the third quarter, with real GDP up at a tepid 1.7% annual rate.

If we see any theme in the third quarter, it was that the consumer had growing purchasing power while businesses temporarily pulled back from investing in plant and equipment. Usually, that kind of retreat in business investment would have us more concerned. Almost every time machinery orders are down 10% from the year before, like they are now, we are near recession. But we think many companies are temporarily waiting until after the election to decide what to do.

The US is obviously not in recession; the economy is still growing. But equally obvious is that we're not enjoying anywhere close to the rapid growth we've had during prolonged periods of improved public policy, such as in the 1980s and 1990s, when government spending was shrinking relative to GDP.

For now, our base case is more of the same for the fourth quarter and 2013, with growth averaging roughly 2%, unless we see a change in policy. As we have described it before, pockets of entrepreneurial brilliance offset by the weight and uncertainty of government spending, regulation, and taxes.

Here's our "add-em-up" calculation of real GDP growth in Q3, component by component.

Consumption: Sales of cars and light trucks were up at a 10.6% annual rate in Q3, while "real" (inflation-adjusted) retail sales ex-autos were up at a 2.8% rate. However, services make up about 2/3 of personal consumption and they grew at about a 1% rate. So far, it looks like real personal consumption of goods and services combined, grew at a 2.1% annual rate in Q3, contributing 1.5 points to the real GDP growth rate. (2.1 times the consumption share of GDP, which is 71%, equals 1.5.)

Business Investment: Business investment in equipment & software and commercial construction both look like they

shrank in Q3, by about 3% and 7%, respectively. Combined, they shrank about 4%, which should subtract 0.4 points from the real GDP growth rate. (-4 times the business investment share of GDP, which is 10%, equals -0.4.)

Home Building: Residential construction is headed for its sixth straight positive contribution to real GDP. The growth is still led by apartment buildings, but single-family construction is also rebounding sharply. Home building appears to have grown at a 21% annual rate in Q3. This translates into 0.5 points for the real GDP growth rate. (21 times the home building share of GDP, which is 2.4%, equals 0.5.)

Government: Military spending grew in Q3 but no more than it usually does in the final quarter of the government's fiscal year. Meanwhile, state/local government construction is roughly unchanged from the prior quarter. On net, real government purchases grew at about a 0.5% rate in Q3, which should add 0.1 percentage points to real GDP growth. (0.5 times the government purchase share of GDP, which is 20%, equals 0.1.)

Trade: At this point, the government has only reported trade data through August. On average, the "real" trade deficit in goods has grown compared to the Q2 average. As a result, we're forecasting the trade sector subtracted 0.4 points from the real GDP growth rate.

Inventories: As always, inventories are the wild card. This is more true in Q3 than usual because of the drought, which often shows up in farm inventories late in the year. Inventories outside the farm sector look strong in Q3, but given the downside risk from agriculture, we are assuming inventories generate only a 0.4 point addition to the real GDP growth rate in Q3.

Add-em-up and you get 1.7% real GDP growth for Q3. Like last quarter, nothing to write home about – just another plow horse report.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
10-24 / 9:00 am	New Home Sales – Sep	0.382 Mil	0.380 Mil		0.373 Mil
10-25 / 7:30 am	Durable Goods – Sep	+7.0%	+9.2%		-13.2%
7:30 am	Durable Goods (Ex-Trans) – Sep	+0.9%	+1.2%		-1.6%
7:30 am	Initial Claims – Oct 20	372K	372K		388K
10-26 / 7:30 am	Q3 GDP Advanced	1.8%	1.7%		1.3%
7:30 am	Q3 GDP Chain Price Index	2.0%	2.0%		1.6%
8:55 am	U. Mich Consumer Sentiment	83.0	83.0		83.1