

More Solid Growth Ahead

Late last year, when the consensus expected an anemic recovery of 2.8% real GDP growth in the second half of 2009, we laid out a case for a growth rate of 4.7% (“Hold onto Your Hats: Strong GDP Reports on the Way,” 10/19/2009). In the end, real GDP grew at a 4.1% rate in the second half of 2009 (5.9% in Q4) vindicating our optimism versus the consensus.

Now the consensus is forecasting a growth rate of 2.7% for the first half of 2010. In contrast, we are predicting 4.5%, with faster growth in the second quarter than the first. The tilt toward Q2 is due to unusually harsh winter weather across much of the country.

The consensus is still underestimating the resilience and robustness of the US economy and remains stuck on expectations of a “new normal.” But, productivity is strong, monetary policy is (and will continue to be) easy, inventories are razor-thin, and corporate profits are growing rapidly.

Here are the assumptions behind our forecast for real GDP growth in Q1 and Q2.

Consumption: Despite blizzards, February retail sales (ex-autos) were an annualized 7.7% above their Q4 average. After adjusting for inflation, we expect a 3.3% annual rate of consumption growth in Q1 and Q2. The labor market is improving and consumer debt is down. Consumption will add 2.2 percentage points to GDP in Q1 and 2.5 in Q2.

Home Building: Home building hit rock bottom in Spring 2009, but, due to the weather, will dip slightly in Q1, subtracting 0.1 points from real GDP growth. This will reverse in Q2, when housing will add about 0.4 points.

Business Investment: Investment should be roughly flat in the first half of 2010. An increase in equipment and software

spending will be offset by a drop in business construction. Business investment should subtract 0.2 points from real GDP growth in Q1, but then add 0.4 points in Q2.

Government: Lower defense spending and weak public construction suggest government will subtract 0.3 points from real GDP growth in Q1. The recent pattern has been an offsetting surge in Q2, so we are penciling-in +0.7 for Q2.

Trade: Due to long-term dollar depreciation, the shrinking trade deficit has added, on average, 0.9 points to the real GDP growth rate over the past three years. We’re not likely to see such large contributions in Q1/Q2, but expect positive contributions of 0.2 and 0.3 points, respectively.

Inventories: In the past two years, companies cut inventories by \$134 billion, by far the largest reduction (relative to GDP) since World War II. Inventory-to-sales ratios at retailers and wholesalers are at record lows. Even a modest rebuild of inventories during the first half of 2010 will add noticeably to real GDP. The hard part is guessing the timing, but we suspect most of the inventory-related growth happens in Q1, so we assume inventories contribute 1.7 points to real GDP growth in Q1 and 1.2 points in Q2.

Adding up all these components of GDP gets you to our forecast of 3.5% real growth in Q1 and 5.5% in Q2. In other words, we expect more upside surprises for the “new normal” crowd as good news seeps into the conventional wisdom.

Nonetheless, “disbelief” remains the most common reaction to strong data. As a result, the stock market is forced to climb a wall of worry. That’s great news because all bull markets climb this wall. We continue to expect the Dow Jones Industrial Average to finish the year at 13,000.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
3-15 / 7:30 am	Empire State Mfg Index - Mar	22.0	29.0	22.9	24.9
8:15 am	Industrial Production - Feb	0.0%	-0.3%	+0.1%	+0.9%
8:15 am	Capacity Utilization - Feb	72.5%	72.4%	72.7%	72.6%
3-16/ 7:30 am	Housing Starts - Feb	0.570 Mil	0.557 Mil		0.591 Mil
7:30 am	Import Prices - Feb	-0.2%	-0.3%		+1.4%
7:30 am	Export Prices - Feb	+0.3%	+0.2%		+0.8%
3-17 / 7:30 am	PPI - Feb	-0.2%	-0.5%		+1.4%
7:30 am	"Core" PPI - Feb	+0.1%	+0.1%		+0.3%
3-18 / 7:30 am	CPI - Feb	+0.1%	0.0%		+0.2%
7:30 am	"Core" CPI - Feb	+0.1%	+0.1%		-0.1%
7:30 am	Initial Claims - Mar 13	455K	462K		462K
9:00 am	Philly Fed Survey - Mar	18.0	20.0		17.6
9:00 am	Leading Indicators - Feb	+0.1%	+0.2%		+0.3%