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First Trust

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Monday Morning Outlook

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"New Normal" Nowhere in Sight

There have been three distinct, and very diverse, sets of economic forecasts circulating in the past year. First, the end of the world forecast – call it, Depression II. Second, the "new normal" forecast of weak and anemic growth. And, third, our expectation of a V-shaped recovery and relatively strong 4% real GDP growth.

With GDP scheduled for release next week, our estimate for annualized second quarter real GDP growth is 3.5%. This is a significant reduction from our 5.5% forecast (made back in March). What's interesting is that the Depression II and new normal crowds have been emboldened by this.

But this makes little sense. One year ago today, the consensus of all forecasters was that the US would grow at an average annual rate of 2% in the second half of 2009 and first half of 2010. We were forecasting 4%.

Since mid-2009, US real GDP has grown at an annual rate of 3.5% - exactly where we have Q2 growth. In other words, the economy is certainly not in Depression and growth is nearly double what the new normal forecast expected.

Yes, some of this growth has been due to inventories. But that is normal for every recovery and the economy is now showing broader strength. Our forecast for Q2 includes a 3% growth rate for final sales (excluding inventories), the fastest for any quarter so far in the recovery.

We see no need to change our forecast. Productivity growth is strong, monetary policy is (and will continue to be) easy, inventories are razor-thin, and corporate profits are growing rapidly. For the next four quarters, ending in mid-2011, we again anticipate growth at around a 4% rate.

Here are the assumptions behind our estimate of 3.5% real GDP growth in Q2.

Consumption: Retail sales grew at a 4.1% rate in Q2. Factoring-in services too, and then adjusting for inflation, we estimate a 2.3% annual rate of consumption growth in Q2. At 71% of the economy, this will add 1.6 points to GDP (71% of 2.3 equals 1.6).

Home Building: The number of new homes under construction probably fell again in Q2, but home completions – when much value is added – soared in Q2. In addition, home improvements rose steeply in late 2009 and early 2010 and likely continued to grow. As a result, we think overall residential construction increased at a 16% rate in Q2. But at only 2.4% of the economy, this adds only 0.4 points to the GDP growth rate (2.4% of 16 equals 0.4).

Business Investment: Investment appears to have grown at an 11% annual rate in Q2, the fastest pace in three years and on par with the late 1990s economic boom. Equipment and software increased at about a 14% annual rate while even commercial construction increased slightly. Overall, with business investment comprising 9.4% of the economy, this adds one full point to GDP growth (9.4% of 11 equals 1.0).

Government: Looks like government spending will add 0.7 points to real GDP growth in Q2. That's higher than the typical quarter, but nothing unusual. In the last three years, Q2 has been stronger than Q1 and has always been positive. Moreover, the strength in each Q2 seems linked to the weakness in each Q1. This year, government at all levels was a drag of 0.4 points on GDP. Look for a rebound in Q2.

Trade: Despite long-term dollar depreciation, a larger trade deficit will subtract 0.7 points from GDP growth in Q2, the third expansion of the trade deficit in four quarters. This suggests the direction of the trade balance is even more sensitive to US economic growth and less sensitive to exchange rates than we had previously estimated.

Inventories: In 2008-09, companies cut inventories by $134 billion, by far the largest reduction (even relative to GDP) since World War II. Companies increased inventories by $10 billion in Q1 and we estimate a $15 billion increase in Q2, adding 0.5 points to GDP growth. Part of this increase in inventories is due to falling prices, especially for commodities, which *increases* the real value of inventories.

Adding up all these components of GDP gets you to our forecast of 3.5% real growth in Q2, slightly above the 50-year average growth rate of the US economy. True, these are not blow-out numbers, but they are certainly not depression-like. And if this is the new normal, let's have even more of it in the quarters and years ahead.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
7-20 / 7:30 am	Housing Starts - Jun	0.576 Mil	**0.620 Mil**		0.593 Mil
7-22 / 7:30 am	Initial Claims - Jul 17	445K	**433K**		429K
9:00 am	Leading Indicators - Jun	-0.3%	**-0.3 %**		+0.4%
9:00 am	Existing Home Sales - Jun	5.100 Mil	**5.260 Mil**		5.660 Mil