Less Negative Is A Positive

Contact:
Thomas D. Higgins, PhD
Chief Economist
ph: 213 830-4302
email: thiggins@payden-rygel.com

Highlights

- We expect the US economy to grow at an annual rate of around 3% in the third quarter as an inventory rebuild adds to the positive influences from government spending and the shrinking trade deficit.

- Sustainability will depend on the performance of private demand in the form of consumer spending and business investment in the second half of this year.

The US economy shrank at an annual rate of -1% in Q2 2009. Real gross domestic product (GDP) has now declined for four consecutive quarters for the first time since the Commerce Department began keeping records in 1947. Still, the second quarter was a dramatic improvement over the prior two quarters when the economy contracted at annual rates of -5.4% in Q4 2008 and -6.4% in Q1 2009 after revisions.

Looking forward, there is good reason to believe that real GDP growth will rebound strongly in the current quarter as businesses move to rebuild inventories, adding to the already positive effects of a shrinking trade gap and increasing government spending. Beyond that, the question will be whether a sustainable rebound in private demand will materialize before the impact of the trillions in fiscal and monetary stimulus fade in late 2010.

Pent-Up Demand May Be Building

Government spending and an improvement in the trade deficit were the only two positive contributors to real GDP in the second quarter. The federal government increased spending at an annual rate of 10.9%, which added roughly 1.1 percentage points to economic growth. Government spending will remain supportive of private demand over the next year as the $787 billion fiscal stimulus trickles through the economy. Only about $101 billion of the spending increases and tax cuts associated with the stimulus package have been implemented.

The shrinking trade gap added another 1.4 percentage points to economic growth in the second quarter. As a share of GDP, the trade deficit has fallen from a peak of nearly 6% in Q3 2006 to less than half that level today. Although the improvement is primarily due to a sharp decline in imports as opposed to an increase in exports, it is likely to add between one and two percentage points to GDP growth in the second half of 2009.

Unfortunately, the positive impact of increased government spending and the declining trade deficit were overwhelmed by declines in consumer spending and business investment. Consumer spending was down at an annual rate of -1.2% in the second quarter, which more than erased the slight 0.6% gain made in the first quarter. High unemployment and declining net worth put pressure on households to allocate a higher portion of their incomes toward savings. In fact, personal savings as a share of disposable income has jumped to 6.9% in May from almost zero a year ago, which is in line with its historical average over the past fifty years. This may pave the way for a modest recovery in consumer spending in the second half of 2009 as households seek to satisfy pent up demand. Recent data on consumer confidence and retail sales already indicate that consumer spending may be stabilizing.

Business investment continued to slide in Q2 2009, falling at an annual rate of -8.9% during the quarter. However, this was a significant improvement over the -39.2% drop posted in the first quarter. Businesses have responded to sluggish consumer spending by sharply cutting inventories over the past five quarters. This process appears to have nearly run its course and companies will likely increase production to replenish depleted stocks in the second half of the year. This could add between three and five percentage points to real GDP over the next two quarters.

Contact:
Thomas D. Higgins, PhD
Chief Economist
ph: 213 830-4302
email: thiggins@payden-rygel.com

Sustainability Is the Question for 2010

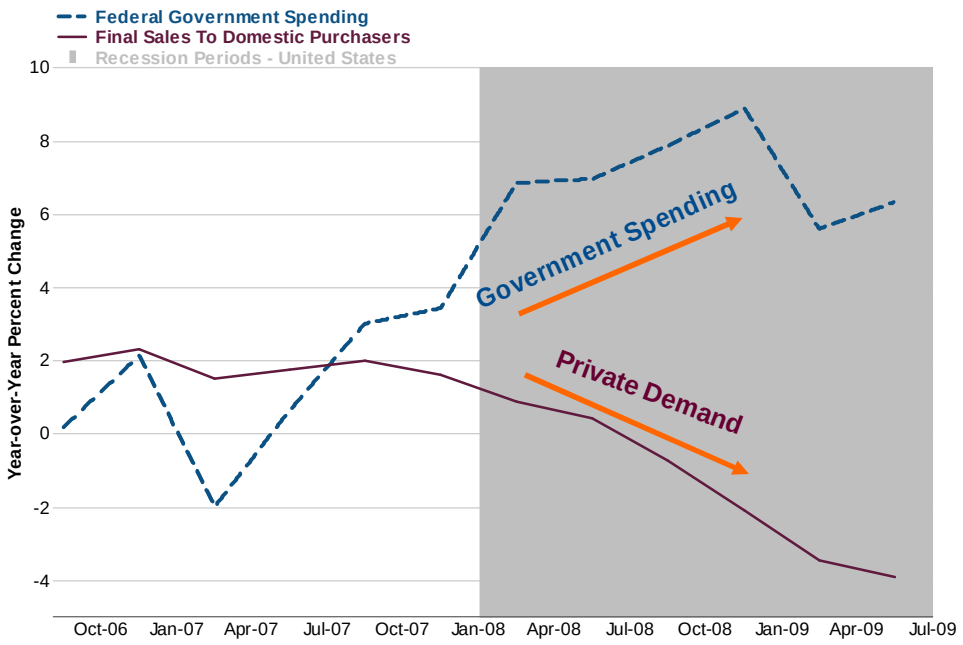
We expect the US economy to grow at an annual rate of around 3% in the third quarter as an inventory rebuild adds to the positive influences from government spending and the shrinking trade deficit. This is well above the current Bloomberg Consensus forecast for 1% growth during the quarter, which suggests that investors could be pleasantly surprised by the economy's performance in the next few months.

However, 3% growth rates probably cannot be maintained given the reduced leverage in banking system, increased savings rates, and high unemployment. Indeed, it is even uncertain as to whether the likely rebound in economic growth will lead to a lasting recovery. Sustainability will depend on the performance of private demand in the form of consumer spending and business investment in the second half of this year.

In the past, a revival in consumer spending was necessary before businesses were willing to bring on new hires and invest in plants and equipment. Therefore, it will be important to track indicators of consumer spending including retail sales and consumer sentiment in the coming months. If these series begin to turn down again, the risk of a double dip recession will increase as we head into next year.

But it is important to remember that the US economy has a tendency to grow. Over the past century, the economy was in recession only about 20% of the time. In other words, it was expanding about 80% of the time.

Will the Private Sector Pick Up Where Government Leaves Off?



Source: US Department of Commerce