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Payden & Rygel Economic**Research**

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The US Economy Expands At Fastest Rate in Two Years

Highlights

- Today's data is the clearest sign yet that the US emerged from recession sometime over the summer. The question going forward is whether the US recovery will be sustainable.
- The drop in auto sales that has occurred since the Cash for Clunkers program ended in late August will be a drag on consumption in the fourth quarter. However, other areas of consumer spending are likely to exhibit greater resilience.

The US economy grew at an annual rate of 3.5% in the third quarter of 2009. This marked the first increase in real GDP in more than a year and the fastest growth rate in two years. Today's data is the clearest sign yet that the US emerged from recession sometime over the summer. The question going forward is whether the recovery will be sustainable.

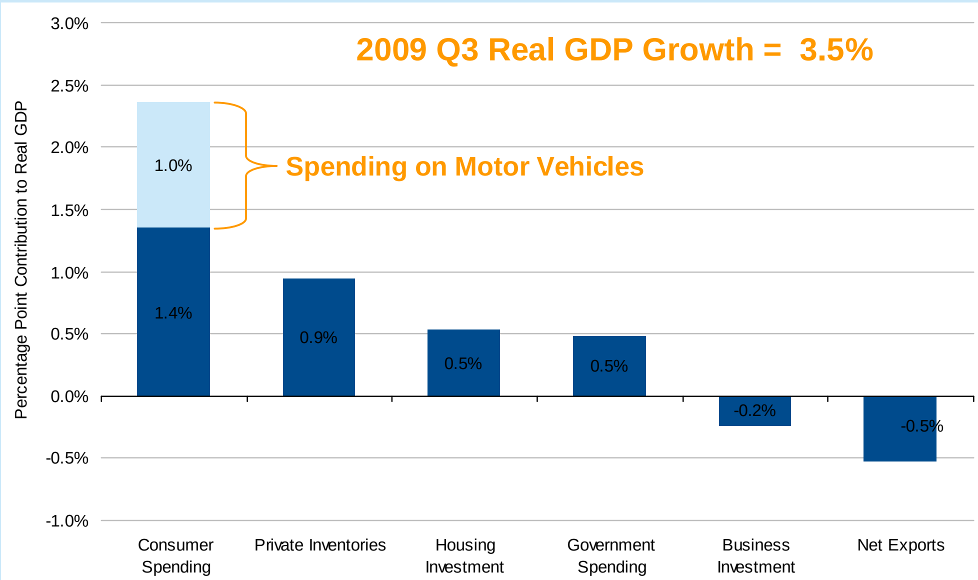
The evidence on this front is mixed. On the one hand, many of the factors driving the rebound in economic activity during the third quarter, including the Cash for Clunkers program and the slower pace of inventory liquidation, are temporary. On the other hand, most economic recoveries start out in the same fashion, and there are already signs that a self-reinforcing recovery in private sector demand is beginning to materialize. The one piece of the puzzle that is still missing is job growth, but this could change by the first quarter of next year.

Consumer Spending Was Not All 'Cash for Clunkers'

The primary driver of growth during the third quarter was consumer spending, which increased at an annual rate of 3.4%. A large portion of this gain resulted from a jump in spending on motor vehicles associated with the Consumer Assistance to Recycle and Save Act (i.e., Cash for Clunkers) under which the government provided cash incentives to households who turned in older less fuel efficient vehicles to purchase newer greener automobiles. Consumer spending on autos rose at an annual rate of 56% during the quarter and this contributed just over 1 percentage point to headline GDP growth.

The drop in auto sales that has occurred since the Cash for Clunkers program ended in late August will be a drag on consumption in the fourth quarter. However, other areas of consumer spending are likely to exhibit greater resilience. The September retail sales report showed broad based increases in sales at department stores, clothing retailers, and sporting goods stores. In addition, the rise in home sales since the beginning of the year should continue to fuel spending on home furnishings and appliances in the next few quarters. Historically, home sales lead consumer spending on these durable goods by an average of six months.

The Composition of Growth Was Better Than Expected



Source: The Commerce Department

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Highlights

- We expect the US economy to expand at an annual rate of 2.5% in the fourth quarter as a moderation in consumer spending is offset by a rebuilding of inventories and further investment in IT equipment.

- The one piece of the puzzle that is still missing is employment growth. We expect the US economy to begin generating jobs by early next year if our forecast for economic growth is correct.

If the turnaround in consumer spending can be sustained, it will sharply increase the odds that the US recovery will prove lasting. The latest figures on business investment offer another hopeful sign. Most economists had correctly anticipated that inventories would contribute positively to the third quarter growth numbers. But the pick up in spending on information technology (IT) came as more of a surprise. IT investment rose at an annual rate of 8.9% in the third quarter. Businesses will often test the waters by investing in IT equipment to boost productivity before expanding payrolls or increasing investment in plant and industrial equipment. New orders for non-defense capital goods excluding aircraft, a key indicator of future business investment, increased 2% in September indicating that the recent improvement has some staying power.

We expect the US economy to expand at an annual rate of 2.5% in the fourth quarter as a moderation in consumer spending is offset by a rebuilding of inventories and further investment in IT equipment. Although this is probably close to the long-run trend rate of growth for the US economy, the considerable amount of slack in product and labor markets will keep inflation at bay throughout 2010.

Employment Is the Missing Piece of the Puzzle

The one piece of the puzzle that is still missing is employment growth. We expect the US economy to begin generating jobs by early next year if our forecast for economic growth is correct. However, it will take two or three more quarters before the economy is creating the 150,000 to 200,000 or so jobs necessary each month to absorb new entrants to the labor force and keep the unemployment rate from rising. Therefore, we expect the unemployment rate to continue to rise through the first half of 2010 before peaking somewhere north of 10%. Moreover, even after the unemployment rate peaks and begins to come back down in the second half of 2010, the natural rate of unemployment is likely to be much higher than it was in the recent past as a result of lower economic growth rates caused by household deleveraging and structural changes in the labor market caused by the shift away from housing and manufacturing.

Our Own Worst Enemy

The greatest risk to our forecast is probably a policy mistake in which central bankers or legislators either remove stimulus too early or too late. Exit too early and the result could be a double dip recession or a liquidity trap in which neither monetary or fiscal policy is effective at stimulating private demand –*a la Japan*. Exit too late and policymakers risk fueling inflation or another asset bubble.

These dangers will undoubtedly be on the minds of members of the Federal Open Market Committee when they meet on Nov 3 and 4. Though interest rate hikes are unlikely before the middle of next year, the central bank has begun preparing investors for the time when it exits its ultra-easy monetary policy. Next week, the Fed may modify its policy statement to begin hinting that rates will not be at such low levels indefinitely. Indeed, the Fed's Treasury purchase program will end this month and it plans to complete its mortgage purchase program by March 2010. Beyond that point, it will only be a matter of time before interest rates rise.