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Economic Perspectives

Gross Domestic Product *less bad* in Q2 — What does it mean?

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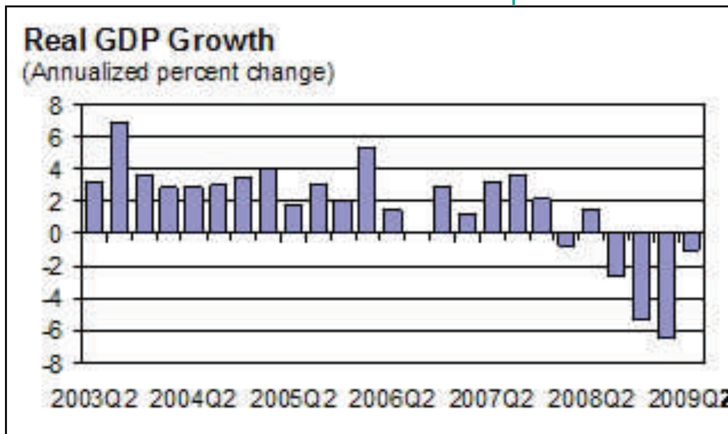
The nation's Gross Domestic Product (GDP) contracted at a less severe rate of 1.0% in the second quarter — a decline much shallower than the 6.4% decline experienced in the first quarter. The GDP is the top line measure of the nations economy as it represents the total of all goods and services produced. The numbers underlying the headline GDP are significant, not only for what they tell us about the second quarter but also for the clues they offer about what the short term economic outlook could be. The Commerce Department's Bureau of Economic Analysis makes a comprehensive revision to the accounts underlying GDP each July and this year's revisions are both significant and revealing.

The GDP decline of 1.0% in the second quarter of 2009 was better than the consensus estimate of about 2.0% going in to the quarter. This is an "advance" estimate and will be refined over the next two months as more data become available. The "preliminary" estimate will be released at the end of August and the "final" estimate in late September.

The second quarter data are consistent with an economy still on track to bottom out late in the second half of 2009 and perhaps squeeze out some anemic growth by the first quarter of 2010. Any growth, however, will not be enough to prevent employment from continuing its decline although employment decline will be less severe than experienced earlier in 2009.



SOURCE: HIS Global Insight

Key components of the GDP which contributed measurably to change included domestic spending which fell less rapidly in the second quarter although consumer spending was a big disappointment falling 1.2% compared to modest growth (0.6%) in the first quarter. Consumers continued to save more and spend less. Saving was up 5.2% in the second quarter. Savings had been running near zero and as low as negative 13% during the housing boom as many consumers spent more than they made with home equity lines of credit.

Higher savings may be a long term positive for the economy but it is currently a short term negative for GDP growth as consumers and the broader economy go through significant structural and what we believe will be long term change in spending and credit use habits.

Spending on durable goods (those expected to last three years or more) declined 19.7% while spending on nondurables (consumables) fell 13.1%. Spending on services rose 1.3%.

On the business side, fixed investment spending by businesses continued its downward slide by declining 60% quarter over quarter and 21% year over year. The quarterly decline was made up of a decline of 30.6% in fixed asset spending; 20.6% decline in equipment spending and a 9.6% decline in spending on structures.

Inventories also weighed heavily negative on the GDP declining 27.2%. Inventories have declined significantly for several quarters. The positive news in declining inventory level is that some manufacturers may need to ramp up production again in the not too distant future even in the face of recession level demand. This is, of course, an industry specific issue. Today, inventory to sales ratios remain elevated however that could change quickly given the speed at which inventories are declining.

The need to ramp up production is quickly becoming apparent in the auto and light truck sector. The recent *cash for clunkers* program has been remarkably successful. Originally a $1.0 Billion program, the House recently (July 31st) approved another $2.0 Billion for the program. At this writing, the Senate has not yet acted. It remains to be seen whether this program will prove to be a sustainable boost to

auto sales or merely a temporary blip on the radar screen. Our view is the latter.

The initial $1.0 Billion allocated for *cash for clunkers* could result in 225,000 sales however it is unclear how many of those were a direct result of the program. There were roughly 9.7 million auto sales recorded in June and we expect to see about 10.5 million recorded for July when the numbers are released this week.

Our view of manufacturing in general is that, while inventories are being slashed, sales remain at remarkably low recessionary level and even when restocking of inventories occurs, it is likely to be transitory and not sustainable long term. The bottom line, in our view, is that the fundamentals for sustainable manufacturing recovery are not yet in place. Consumer spending will need to increase and that will be driven by employment, wage growth and improvement in household balance sheets. Significant headwinds remain.

The nation's exports declined 25.6%. Imports declined by 72.8%. The result is a net positive for the GDP.

Government spending rose in the second quarter. Part of the increase was probably due to the economic stimulus program (American Recovery and Reinvestment Act) but most was not. Non defense spending rose 4.7% which, at 0.1% eased the severity of the contraction. Defense spending, however, rose 21.3%. Part of that growth was likely a rebound from first quarter contraction.

Finally, inflation was virtually non-existent in the second quarter, rising only 0.2%

Benchmark revisions. The Bureau of Labor Statistics of the Commerce Department continually revises the GDP as more data become available. The estimates are probably never really final but evolve over time. Each July the Commerce Department releases annual revisions that could date back several years. Additionally, a significant revision occurs every five years. That significant revision occurred last month.

This cycle, there were modest revisions to economic growth as far back as 1929. They were not especially significant however revisions in the current decade were.

Revised data show that the economy contracted — as evidenced by real GDP decline — at 3.9% over the last four quarters. That is the steepest peak to trough decline in post World War II history.

The revisions to the *National Income and Product Accounts* (NIPA) show that the economy grew long term at an average annual rate of 3.4%. That is 0.1% higher than previously estimated. From 1997 through 2008, the economy grew at a slightly slower rate of 2.8% which is also 0.1% above previously published estimates.

Significantly, the revisions clearly show that the current recession is now the worst since the Great Depression. It has now passed the early 1980s and the late 1950s in terms of its severity. The revisions also show that the inflation adjusted GDP rose just 0.4% for all of 2008 as compared to the original published estimates of 1.1%.

Revisions also show that the 2001 recession that plagued the job market for years now hardly measures as a sustained contraction. According to the BEA, earlier contractions showed little or no change.

Looking Forward. While a less severe contraction in the GDP is welcome news, it does not signal the end of the recession and a return to robust growth. We continue to believe that the recession will still come to an end, as measured by GDP, later this year or perhaps early 2010. It seems highly possible — perhaps even probable — that the National Bureau of Economic Research, Business Cycle Dating Committee, the official arbiter of the nation's business cycle, could declare a turn around during that time. That will not, however, signal a return to robust growth given the headwinds that remain.

The consumer will continue to face enormous difficulty even after the GDP turns positive. Employment is still likely to decline into 2010 and unemployment will remain elevated for quite some time. As we've written previously (see Economic Perspectives, July 5, 2009), many job losses in this recession, unlike others, have been permanent rather than cyclical. Many of the hardest hit employment sectors such as construction, business and professional services are not likely to bounce back quickly.

The consumer has lost significant wealth as a result of the housing and stock market downturns. It is unlikely we will see more than renewed stability in the housing market until 2012 and perhaps only sluggish growth for as long as a decade.

Florida will have an even tougher road to recovery. The Gross State Product (GSP) declined 1.6% in 2008. While GSP will likely turn positive in 2010, robust growth is highly unlikely. It will take the state several years to shake off the effects of the housing implosion. Significant housing growth is not likely before 2012 given the severity of the slump.

Tourism and retail trade in Florida will also take several years to bounce back given the significant decline in consumer spending. Florida tourism has experienced a 2.3% decline in the number of visitors since the second half of 2008. That was driven by weak domestic and foreign economies which forced many domestic and international visitors to curtail vacation and travel plans.

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