

Orlando's Outlook: Federated further boosts above-consensus GDP forecast

March 12, 2010

Amid the normal ebb and flow of recovery from recession, several key economic metrics have undeniably hit the pause button over the last several months.

But we believe that this choppiness is altogether understandable, due to the negative economic impact from normal seasonal weakness, the worst winter weather in half a century—particularly in February—and a hangover from the federal government's original November 30 expiration deadline for its \$8,000 tax credit for low-income, first-time home buyers.

Consequently, we expect the arrival of spring to bring with it better weather and a resumption of stronger economic news in employment, consumer spending, inventories and housing—changes reflected in a slight upward revision in Federated's above-consensus GDP forecast, the second such change this year. At our March 4 meeting, Federated's Macro Economic committee:



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- Kept our **first-quarter 2010 GDP growth** forecast unchanged at **4.4%**, versus a consensus gain of 2.8%.
- Raised **second-quarter 2010 GDP growth** from the previous 4.0% to **4.2%**, also compared with a consensus 2.8%.
- Lowered **third- and fourth-quarter 2010 GDP growth** from 4.0% to **3.9%** for each quarter, vs. consensus increases of 2.8% and 3.0%, respectively.
- Raised our **full-year 2010 GDP growth** forecast from 3.6% to **3.9%**, compared with a consensus rise of 3.0%.
- We also increased our **full-year 2011 GDP growth** forecast to **3.8%** from a prior 3.4%, vs. a consensus estimate for a 3.1% increase.

Weather did a number on the jobs data

Unlike many of our bearish competitors, we are not forecasting a double-dip back into recession for the economy, and we expect the National Bureau of Economic Research (NBER) to shortly confirm our forecast that the Great Recession ended in mid 2009.

First, as the committee dug into the important economic details, it was clear that employment was significantly impacted by the horrific February weather. With snow on the ground in all states but Hawaii last month, the government reported that a record 1.03 million people couldn't work due to bad weather. Normally, a quarter-million or so workers are affected by bad winter weather, so this was four times worse than usual.

So instead of reporting an estimated gain of 150,000 to 300,000 nonfarm jobs in February, the government instead reported a modest loss of 36,000 jobs. When factoring in the gain of 64,000 jobs we experienced in November 2009—which broke a string of 22 consecutive negative months of nonfarm payroll losses—and revised losses of 109,000 and 26,000, respectively, in December 2009 and January 2010, that means we've averaged about 27,000 lost jobs in each of the last four months.

Canaries in the coal mine

That's not great news, of course, except when we compare that to the revised 779,000 jobs we lost at the bottom of the cycle in January 2009—the worst month since the 834,000 jobs lost in October 1949. So we've made significant progress to climb back from the employment abyss over the past year, and we believe that we're at a critical job-creation inflection point right now.

How can we be so sure? Look at the canaries in the coal mine—employment, consumer spending, inventories and housing:

Employment

Weekly jobless claims—an important leading economic indicator—fell to a revised 442,000 for the week ended February 6, compared with the peak in weekly claims of 674,000 on March 28, 2009—the highest level since October 1982. Claims have increased due to bad weather over the past month, but they're starting to recede again, and positive net job creation usually starts when weekly claims approach the 400,000 level.

Temporary employment is another important leading economic indicator, rising by 48,000 jobs in February for its fifth consecutive monthly gain, totaling 250,000 temp hires since September 2009.

Additionally, manufacturing, private service-producing, professional & business services, and education & health care have all registered positive job creation over the past several months.

Moreover, the unemployment rate, a lagging indicator, may have peaked at a 26-year high of 10.2% in October. It's now down to 9.7% as household employment, historically a leading indicator, has surged by 849,000 jobs the past two months, its fastest growth in nearly five years.

Interestingly, the government is planning to hire as many as 1.15 million temporary census workers in the second quarter, but recent news reports suggest that they are having trouble finding enough out-of-work people to fill the jobs. The committee believes that sustainable net positive job may start as early as this month.

Consumers

Next up is consumer spending. Much to the bears' dismay, the consumer still has a pulse, and, as a result, Christmas wasn't canceled after all. Nominal retail sales for the three months that comprise the Christmas selling season—November, December and January—surged at a revised annualized rate of 7.6%.

In addition, with intentionally conservative inventory management, retailers did not resort to massive discounting, resulting in a very strong profit season because of solid revenue growth and excellent profit margins due to a 5.9% fourth-quarter decline in unit labor costs and a 6.9% surge in productivity.

Consequently, the economy's fourth-quarter GDP surge of 5.9% was comprised of a positive 1.7% contribution from consumer spending. We expect this trend to continue and accelerate, as February's nominal and core retail sales were surprisingly robust, up by 0.3% and 0.9%, respectively. Consumers—particularly the high-end—are clearly feeling better about themselves, and they're starting to satisfy their enormous pent-up demand.

Inventories

Third, inventories finally appear to be bottoming. The economy's aforementioned GDP surge of 5.9% in the fourth quarter was comprised of a positive 3.9% contribution from inventories. But inventories still fell in the fourth quarter by about \$17 billion; that was just much smaller than the \$139 billion and \$160 billion declines in the third- and second-quarters, respectively.

In fact, over the past four months, wholesale and business inventories were positive in October and November, negative in December, and flattish in January. So after a record 13 consecutive months of inventory liquidation through September, it appears that inventories have finally reached their inevitable inflection point.

This trend has legs. With foreign economies performing well and with the U.S. dollar still relatively cheap versus the euro, export volumes from U.S.-based multinational companies continue to surge. As a result, the trade deficit has fallen sharply over the past few years, due to strong export volumes outstripping import levels, and factory orders have been positive through January in nine of the past 10 months.

The commencement of this sustainable inventory restocking cycle will likely have a sharply positive impact on GDP for calendar 2010.

Housing

Finally, as we had expected, the housing market has been hurt over the past three months by seasonality, bad weather, and a buyer's hangover from the expiration of the original November 30 deadline for the tax credit. Annualized unit sales for new homes hit a record low in January 2010 of 309,000, eclipsing the previous record low set in January 2009 at 329,000 homes.

The committee remains encouraged, however, by improving housing fundamentals: record low mortgage rates; improved pricing for seven consecutive months off of a record bottom; affordability that has risen to a record high; inventories that are down sharply; starts and single-family permits that have risen off of record lows; vacant housing units that have peaked and are starting to recede; a fourth-quarter improvement in mortgage delinquencies; and a positive contribution to GDP in the second half of 2009 after a four-year negative drag.

There is no question that the sharp decline in home prices, record low mortgage rates, and the \$8,000 tax credit for first-time, low-income home buyers that expired on November 30 helped to stimulate demand. What we're waiting to see is if better weather, the coming seasonal summer peak, and an extended tax-credit deadline of April 30 will revive demand for housing in coming months, as we expect.

We're keeping S&P targets at 1,200 near term, 1,300-1,350 longer term

Bottom line, it appears to us that continued improvement in employment, consumer spending, inventories and housing will result in better-than-expected GDP growth for each of the next several quarters, which will likely drive further upside revisions in consensus estimates for both corporate revenues and profits.

Given the very benign back drop for core inflation—with January readings for the Consumer Price Index (CPI) and the Personal Consumption Expenditure (PCE) index running at year-over-year levels of 1.6% and 1.4%, respectively—we expect the Federal Reserve to remain on hold until at least the second half of calendar 2010, if not until 2011, before commencing a rate-hike cycle for fed funds.

Consequently, we enthusiastically concur with the new cycle high established by the S&P 500 today at 1,153, and we expect that stocks will continue to grind higher to our near-term price objective of 1,200 and our 12-month target of 1,300-1,350.

Views are as of March 12, 2010, and are subject to change based on market conditions and other factors. These views should not be construed as a recommendation for any specific security.

Gross Domestic Product (GDP): A measure of the retail value of goods and services produced in the United States.

Consumer Price Index (CPI): A measure of inflation at the retail level.

Personal Consumption Expenditure (PCE) Index: A measure of inflation at the consumer level.

S&P 500 Index: An unmanaged capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. Indexes are unmanaged and investments cannot be made in an index.

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