

ECONOMICS: US PERSPECTIVES—APRIL 29, 2011

US Outlook Tarnished After Weak First Quarter

■ **Joseph G. Carson**

US Economist and Director—Global Economic Research, (212) 969 6886

Following weak first-quarter growth, we've lowered our full-year GDP forecast. Production shortfalls in the auto industry are also likely to suppress growth in the second quarter. But in the second half, we expect renewed momentum for the recovery amid a rebound in several industries.

The US economy got off to a disappointing start in 2011. Real gross domestic product (GDP) advanced by a mere 1.8% annualized in the first quarter, according to preliminary estimates from the Bureau of Economic Analysis released this week (**Display 1**). Although this was in line with recently lowered consensus estimates, it fell well below our forecast of 3.2%.

Several strong indicators appear to contradict the sharp slowdown in economic growth in the first quarter. Business surveys point to corporate optimism while company earnings are beating consensus expectations. Employment has posted healthy gains, the unemployment rate has fallen sharply and manufacturing production is performing well. While the latest data are the official estimate of economic growth for now, our analysis of the GDP components suggests that an upward revision may be possible.

Spending Split

In the first quarter, real consumer spending increased by 2.7% annualized, about 0.5

point above our forecast, driven by a strong 10.6% gain in durable goods (mainly motor vehicles and technology equipment). Real business spending on capital equipment expanded 11.6% annualized, while merchandise exports rose 7.8%, both roughly in line with our estimates.

However, our forecast was off the mark in two areas: private nonresidential construction and defense spending. Real nonresidential investment contracted at an annualized rate of 21.7%, more than twice our estimate, and comparable to some of the quarterly declines seen during the recent recession. Although it's still impossible to determine how much of the decline in nonresidential investment was due to bad weather as opposed to weak fundamentals, we think there are some signs that provide guidance.

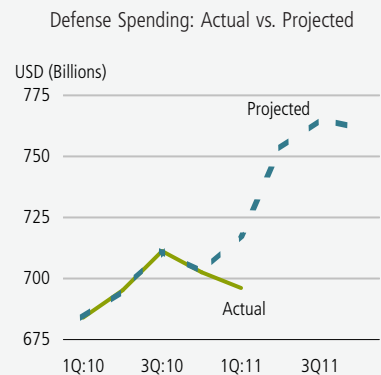
Nonresidential construction employment was flat compared with the fourth quarter, and both production and shipment data show a modest 3% gain in construction

Display 1
Slow Start to 2011



As of March 31, 2011
Source: Bureau of Economic Analysis and Haver Analytics

Display 2
Defense Spending Falls Short of Plans



As of March 31, 2011
Source: Bureau of Economic Analysis and Haver Analytics

materials and supplies in the period. In our view, this suggests that weakness in the sector might have been caused by bad weather delaying work on existing projects. In addition, surveys of nonresidential investment intentions indicate that there's plenty of new work in the pipeline.

But we're puzzled by the sharp contraction in defense spending (**Display 2, previous page**). Every year, the BEA translates the federal budget into GDP, and offers quarterly and annual estimates of defense and nondefense spending. According to the BEA, nominal defense spending was estimated to increase 9% annualized in the first quarter, but instead it contracted by 8%. It's possible that this discrepancy was caused by the congressional delay in finalizing the 2011 budget, which may have held up payments or postponed procurement in the defense sector. With overall spending expected to increase 7.3%, this implies there is a huge rebound in store in the remaining quarters of 2011.

Product Strength

On the product side of GDP accounts, a similar story has played out. The goods (or manufacturing) side of the economy grew by 9.3% annualized in the first quarter, essentially matching manufacturing production growth (**Display 3**). In turn, the relatively strong rise in goods output buoyed first-quarter real GDP by 2.5 percentage points—more than the overall GDP gain of 1.8%. The motor vehicle sector accounted for more than half of the gain in goods output, according to BEA. Our analysis suggests the gains were more evenly distributed, with technology and machinery making equally large contributions.

The structures component of GDP subtracted 1.2 percentage points from

first-quarter growth. Most of the decline was centered in nonresidential investment, but housing, state and local construction spending were also down. The service sector lifted first-quarter GDP by 0.4 point, with modest gains in consumer spending on services accounting for most of the increase.

Income Implications

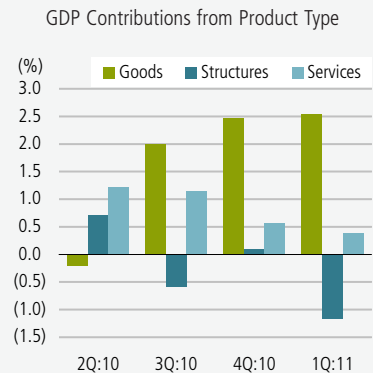
The preliminary GDP release only provides estimates of personal income and does not provide data on corporate profits. But the implied gain in profits and gross income can be assessed. According to the BEA, personal income advanced 8.2% annualized in the first quarter, the fastest quarterly gain since 2006. However, a third of the gain was a direct result of the payroll tax cut. We estimate that the preliminary first-quarter GDP figures imply a 6% gain in operating profits, and a slight, 1% (not annualized) contraction relative to the level of fourth-quarter profits. In our view, this looks very low based on incoming earnings reports, which suggest year-on-year operating profit growth of 15% to 18%.

This gap between implied and actual profit growth suggests that preliminary first-quarter GDP growth figures may be too low, yet this alone doesn't guarantee an upward revision. Indeed, GDP figures have not always been revised upward in several cases when growth in gross domestic income initially outpaced GDP. Still, given the amount of upbeat data, we think first-quarter real GDP growth will eventually be revised higher.

GDP Outlook

Weaker-than-expected economic performance in the first quarter, coupled with second-quarter output losses in the motor vehicle sector triggered by the March 11

Display 3
Strong Goods Output, Weak Structures



As of March 31, 2011
Source: Bureau of Economic Analysis and Haver Analytics

earthquake in Japan, have undermined our bullish outlook for US economic growth in 2011. Our most recent estimate of a 3.6% gain for 2011 doesn't look achievable, especially as lower motor vehicle output will cut second-quarter real GDP growth by at least one point to 3.5%.

We remain optimistic about growth in the second half. An expected rebound in the motor vehicle sector and a recovery in defense and construction spending should prompt GDP growth of 4% to 5% during the second half of 2011. However, those projected gains in real GDP assume some relief in commodity price inflation, especially oil prices. All told, in light of the preliminary GDP data, we're lowering our economic growth estimates to between 3.0% and 3.25%, which is still about 0.5% above consensus but not as robust as we had expected when the year began. ■

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