



Orlando's Outlook: What double-dip recession?

As of 10-28-2011

Bottom line *Much like unicorns, the Loch Ness monster and Bigfoot, yesterday's advanced report for third-quarter Gross Domestic Product (GDP)—which posted a solid gain of 2.5% due to stronger-than-expected trends in consumer spending, business investment and exports—refuted the bearish myth of a double-dip recession in 2011. Only a month ago, consensus GDP growth estimates for the third quarter stood at a muted 1.7% with whispers of a negative reading, implying that the U.S. economy had slipped into a double-dip recession over the summer months. But by earlier this week, the consensus forecast had risen sharply to 2.5%, with whispers of a positive 3.0% print, suggesting that perhaps the U.S. economy was back on a more constructive path of trend-line economic growth. What changed is that exports, consumer spending and corporate profits are all coming in much stronger than expected over the past four weeks, which has some investors throwing in the towel on their double-dip thesis and scrambling to cover their shorts, sparking a powerful 20% melt-up rally in the S&P 500 since October 4, with a 28% surge in the small-cap Russell 2000 index. Moreover, it appears to us that third-quarter GDP results could actually be revised up a few ticks next month, and that fourth-quarter GDP will benefit additionally from very lean inventory levels at present.*

We had expected a temporary economic soft patch during the first half of this year, largely due to the negative impact on business and personal consumption from surging food and energy commodity prices, brutal winter and spring weather, and supply-chain disruptions in Japan in the aftermath of the tragic earthquake and tsunami, which collectively resulted in first- and second-quarter GDP growth of only 0.4% and 1.3%, respectively.

But we also felt that those issues were largely transitory, a view that has been justified by yesterday's third-quarter GDP flash at 2.5%, a growth pace that is double second-quarter results and nearly triple the disappointing first half. So to us, the U.S. economy appears to be slowly extricating itself from a temporary soft patch, rather than one that is poised to roll over into a double-dip recession.

Here are the key details regarding yesterday's third-quarter GDP flash report:

Consumer spending rebounds Personal consumption expenditures, which account for 70% of GDP, leapt by solid 2.4% in the third quarter, which added 1.54 percentage points to third-quarter GDP. This compares with a disappointing 0.7% gain in the second quarter, a solid 2.1% increase in the first quarter and a powerful 3.6% jump in last year's fourth quarter—sparked by the most robust Christmas season in five years. While the spring and summer months are not terribly important for retailers, consumers clearly rallied in August and September to salvage the important Back-to-School (BTS) season. Given the historical 80-90% correlation between BTS and Christmas, that gives us some confidence that the important November-through-January holiday sales will be similarly decent, which should support solid fourth-quarter consumer spending and GDP. In addition, total vehicle sales have surged by 14% from June through September, due to the easing of the supply-chain disruptions in Japan. Moreover, energy prices fell by nearly 20% during the third quarter, which incrementally freed up some discretionary spending. The personal savings rate dropped to 4.1% in the third quarter (which was the lowest rate since the fourth quarter of 2007), down from 5.1% in the second quarter, so some of the increase in consumer spending may have clearly been fueled from savings.

Capex spending very strong Real business fixed investment rose by 16.3% in the third quarter (which added 1.72 percentage points to third-quarter GDP), compared with a solid 10.3% gain in the second quarter and a modest bump of 2.1% in the first quarter. Business equipment and software spending surged by 17.4% in the third quarter, compared with 6.2% in the second quarter and 8.7% in the first quarter—likely due to the accelerated depreciation component in the tax code that may expire at year end, if Congress chooses not to extend it. Volatile business structure investment, such as factories and office buildings, rose by a solid 13.3% in the third quarter, compared with a 22.6% surge in the second quarter and a 14.3% decline in the first quarter.

Trade remains strong The economic recovery in Japan, continued relative weakness in the dollar vs. the euro and decent overseas economic strength helped an improving trade gap to add 0.2 percentage points to third-quarter GDP growth. Exports increased by 4.0% in the third quarter, compared with gains of 3.6% and 7.9%, respectively, during the second and first quarters of 2011. In contrast, imports rose by a more modest 1.9% in the third quarter, compared with 1.4% and 8.3% gains in the second and first quarters, respectively.

Inventory growth moderates Inventory restocking slowed substantially in the third quarter, at a pace of only \$5.4 billion, compared with more robust gains of \$39.1 billion in the second quarter and \$49.1 billion in the first quarter. This sluggish pace of inventory accumulation actually subtracted 1.1 percentage points from third-quarter GDP growth, as businesses

were extraordinarily cautious with their inventory levels, in light of rampant double-dip fears. So if end-market demand remains stable or accelerates in the fourth quarter, which we believe it will, that will likely spark a much-stronger pace of inventory restocking into year end, which should similarly contribute to solid fourth-quarter GDP gains.

Housing positive Residential investment rose by 2.4% in the third quarter, compared with a 4.2% gain in the second quarter and a decline of 2.4% in the first quarter. While we're not expecting much out of housing before next summer at the earliest—and that's predicated on a much-improved labor market in the interim—it's encouraging that housing has contributed modestly now for the past two quarters, reversing a sizable drag in past years.

Government spending flat Total government spending was unchanged during the third quarter, compared with a modest decline of 0.9% in the second quarter and a much-sharper 5.9% decline in the first quarter, due to a first-quarter plunge in defense spending. The 4.9% decline in state and local spending during the third quarter was offset by a 5.2% increase in federal government spending.



Philip J. Orlando, CFA
Chief Market Strategist, Equity, Senior Portfolio Manager

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Gross Domestic Product (GDP) is a broad measure of the economy that measures the retail value of goods and services produced in a country.

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Federated Global Investment Management Corp.

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Federated®

Federated Investors Tower
1001 Liberty Avenue
Pittsburgh, PA 15222-3779
Telephone: 412-288-1900