First Trust
Monday Morning OUTLOOK
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GDP: Not As Bad As It Seems

Equities had a bad day on Friday, part of which was caused by a pretty dismal GDP report – with a large downward revision to first quarter real growth. Apparently, the economy grew at an anemic 0.4% annual rate, not 1.9%.

We didn't like it either, until we realized that most of this revision was due to fewer inventories, which, if anything, creates more room for future growth. Not all revisions were negative. Real growth in 2010 was revised up to 3.1% from a prior estimate of 2.8% and pre-tax corporate profits are now estimated to be 9% higher than originally thought. After-tax profits were revised up 15%.

It turns out, at least until the next big revisions, that the recession (in 2008) was worse and the earliest stages of the recovery in 2009 were slower. This helps explain, for now, why the unemployment rate went so high, so fast. It also makes the recession look more like a panic, which we believe it was.

The most consistent theme of Friday's revisions had to do with the mix of nominal GDP, the combination of real GDP and inflation. The report showed that real GDP has been lower – due to the recession and early recovery – while inflation has been higher. Nominal GDP changed little.

This must be quite jarring to the Keynesian mindset, both on monetary policy and fiscal policy. The Federal Reserve embarked on a second round of quantitative easing very late in 2010 and yet real growth slowed. Meanwhile, the payroll tax rate was cut by two percentage points this year and growth nearly petered out. If loose money and big budget deficits don't boost real growth the Keynesian bag of tricks is pretty empty.

More importantly, with the recession so deep and today's growth so slow, the Keynesian model says inflation can't exist. But it does, even though the jobless rate is 9.2%, manufacturing capacity utilization is still below 80% and the economy is operating far below its potential.

It's much easier to explain the rise in inflation with our model. The Fed has been holding short-term interest rates near zero, which is well below the trend in nominal GDP growth. Nominal GDP has grown 3.7% in the past year and at a 4.1% annual rate in the past two years. Continuing ultra-low interest rates in the face of much faster nominal GDP growth is going to keep inflation rising even if the economy remains weak, which we do not believe will happen.

It's not that we don't care about the GDP report; it's that it is old news. The second half of the year still looks very bright. The Fed is easy, there is some spending restraint on the way, auto production and home building are at an inflection point, and corporate America is in a great position to invest.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
8-1 / 9:00 am	ISM Index - Jul	54.5	**55.4**		55.3
9:00 am	Construction Spending - Jun	+0.1%	**+0.5%**		-0.6%
8-2 / 7:30 am	Personal Income - Jun	+0.2%	**+0.4%**		+0.3%
7:30 am	Personal Spending - Jun	+0.1%	**+0.2%**		+0.0%
sometime	Domestic Auto Sales - Jul	4.1 Mil	**4.1 Mil**		3.9 Mil
during the day	Domestic Truck Sales - Jul	5.1 Mil	**5.2 Mil**		5.0 Mil
8-3 / 9:00 am	Factory Orders - Jun	-0.8%	**-1.4%**		+0.8%
9:00 am	ISM Non-Man. - Jul	53.7	**53.7**		53.3
8-4 / 7:30 am	Initial Claims - Jul 30	405K	**397K**		398K
8-5 / 7:30 am	Non-Farm Payrolls - Jul	90K	**105K**		18K
7:30 am	Private Payrolls - Jul	115K	**130K**		57K
7:30 am	Manufacturing Payrolls - Jul	10K	**15K**		6K
7:30 am	Unemployment Rate - Jul	9.2%	**9.1%**		9.2%
7:30 am	Average Hourly Earnings - Jul	+0.2%	**+0.2%**		0.0%
7:30 am	Average Weekly Hours - Jul	34.3	**34.4**		34.3
2:00 pm	Consumer Credit - Jun	+$5.0 Bil	**+$6.0 Bil**		+$5.1 Bil