First Trust
Monday Morning OUTLOOK
January 21st, 2014

630-517-7756 • www.ftportfolios.com

Q4 GDP – Stronger than Keynes Predicted

Brian S. Wesbury – *Chief Economist*
Robert Stein, CFA – Dep. Chief *Economist*
Strider Elass – *Economist*

Please don't accuse us of ignoring "everything" John Maynard Keynes said. The truth is we ignore just 99%. What most people are taught about Keynes is that government spending is the equivalent of, or through the spending multiplier, more powerful than, private spending.

Very few ever try to argue with this idea, especially after teachers pull out the officious, yet full of hocus-pocus, IS-LM curves. Politicians want to believe the idea of the Keynesian multiplier because they really actually do believe they themselves are bigger than real life. As a result, politicians around the world have elevated Keynes to legendary status even though big government spending has left economic mayhem and poverty strewn everywhere.

The latest use of the nutty Keynesian theory was when the US government was partially shut-down in October, 2013. Many argued that an impending shutdown would hurt economic growth in Q3 and then an actual shutdown would send the economy reeling in Q4.

Federal workers and contractors would stop spending and then businesses, with demand drying up, would lay off other workers who would also stop spending, and so on and so forth until the "Keynesian multiplier" knocked the economy flat on its behind. And all of this nastiness came on top of the Sequester, which was cutting spending, a tax hike, and Obamacare. Keynesians were forecasting a recession and rising unemployment, while they begged Congress to do something – anything – to avoid tipping the economy back into the abyss.

And now…back to reality. As fears about an impending shutdown were supposedly gathering (negative) steam, the economy grew at a 4.1% annual rate in Q3, the fastest pace in almost two years. Inventories rose sharply, and real final sales (real GDP excluding inventories) grew at a 2.5% annual rate versus a tepid 1.7% pace in the prior year.

Late next week we get the first report on Q4 real GDP growth. Our "add-em up" calculations suggest the economy grew at a respectable 3% annual rate. This would bring full-year, 2013 real GDP growth in at 2.7%.

In other words, the Plow Horse economy is starting to trot. We expect this to continue and look for 2014 real growth of about 3%. The federal funds rate is still near zero, government spending has been falling as a share of GDP, and new technology continues to boost returns on investment and productivity.

Here is Q4 component by component:

Consumption: Auto sales declined at a 1.9% annual rate in Q4, but, despite the temporary weakness in autos, "real" (inflation-adjusted) retail sales were up at a 3.3% rate. Services make up about 2/3 of personal consumption and, with strength there, it looks like real personal consumption of goods and services combined, grew at a 3.7% annual rate in Q4, contributing 2.5 points to the real GDP growth rate (3.7 times the consumption share of GDP, which is 68%, equals 2.5).

Business Investment: Business equipment investment looks like it grew at a 9% annual rate in Q4, which would be the fastest pace in two years. Commercial construction looks like it was unchanged. This implies overall business investment grew at a 6% rate, which should add 0.7 points to the real GDP growth rate (6 times the 12% business investment share of GDP equals 0.7).

Home Building: The housing rebound continued in Q4, although more slowly than in recent quarters, a condition we think is temporary. But even if it grew at only a 3% annual rate it still added 0.1 points to the real GDP growth rate (3 times the home building share of GDP, which is 3%, equals 0.1).

Government: Military spending picked up in Q4, but less than it usually does. Meanwhile, state and local construction projects look like they fell. As a result, it looks like real government purchases shrank at a 2% annual rate in Q4, which should subtract 0.4 percentage points from real GDP growth (-2 times the government *purchase* share of GDP, which is 19%, equals -0.4).

Trade: At this point, the government only has trade data through November. On average, the "real" trade deficit in goods has contracted substantially versus Q3 (thank you, oil drillers). As a result, we're forecasting net exports added 1.0 points to the real GDP growth rate.

Inventories: Inventories surged in Q3. Now, with data only through November, it appears companies were accumulating inventories more slowly in Q4, subtracting 0.9 points from the real GDP growth rate.

Add-em-up and you get 3.0% for Q4. Not a bad way to end the year, and a signal of better times to come.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
1-23 / 7:30 am	Initial Claims – Jan 18	330K	**333K**		326K
9:00 am	Existing Home Sales – Dec	4.950 Mil	**4.930 Mil**		4.900 Mil
9:00 am	Leading Indicators – Dec	+0.2%	**+0.1%**		+0.8%