630-517-7756
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First Trust

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Monday Morning Outlook

Brian S. Wesbury - Chief Economist
Robert Stein, CFA - Senior Economist

Hold Onto Your Hats: Strong GDP Reports on the Way

Very early this year, when the consensus was predicting a 1% real economic growth rate for the third quarter, we were forecasting 3%. Now the consensus is up to 3% and we are at 4%. Meanwhile, our forecast for the fourth quarter has jumped to a super-charged 5.5%.

Back in mid-July we laid out the case for medium-term economic optimism ("How Can We Be So Optimistic About Growth," July 13), showing that production gains would come in the form of an end to severe inventory reductions, improving exports, a bottom in housing, and modest consumption growth, propelling the economy forward at least through the end of 2010.

Now we think the case for medium-term bullishness probably extends deeper into 2011, as monetary policy is likely to stay looser for longer into 2010. Eventually, of course, this more extended looseness will generate higher inflation and extra Fed tightening in 2012-14, but that's a story for another day.

In the meantime, the prospects for economic growth continue to brighten. Here are the assumptions behind our forecast for real GDP growth in Q3 and Q4.

Consumption: Cash for clunkers is impacting the pattern of consumption, lifting it artificially and then making it look soft by comparison later on. We're looking for a 3% annual rate of consumption growth in Q3 with zero change in Q4. While auto sales will be down in Q4 versus Q3, a rebound in retail sales outside the auto sector should offset this damage. The GDP effect of these growth rates is 2.0 in Q3 and zero in Q4.

Trade: Due to the long-term drop in the foreign exchange value of the US dollar, the shrinking trade deficit has added, on average, 1.4 points to the real GDP growth rate over the past two years. We're not likely to see such large contributions in Q3/Q4, in part due to a surge in imports related to cash for clunkers. But we expect to see positive contributions of 0.4 and 0.8 points, respectively.

Business Investment: Overall, business investment should be flat in the second half of 2009, with an increase in equipment and software offset by a drop in the construction of business buildings, like offices and retail space. Business investment should add 0.5 points to real GDP growth in Q3 and then subtract that same amount in Q4.

Home Building: After 4½ years, we think home building finally hit bottom in Q3 and will add about 0.2 points to the real GDP growth rate in each of the last two quarters of 2009, before adding significantly more next year.

Government: National defense spending increased at a 21% annual rate in Q3, while public construction increased at about a 9% rate, adjusted for inflation. These figures suggest government added about 0.6 points to the real GDP growth rate in Q3. For Q4, we'll pencil-in a more typical 0.3.

Inventories: In the first half of this year the US reduced inventories at the fastest pace (relative to GDP) since World War II. We think the "Great Destocking" continued in Q3 but at a slightly slower pace than in Q2, meaning inventories will actually add about 0.3 points to the real GDP growth rate in Q3. In Q4, we think the Great Destocking comes to an abrupt end, adding 4.8 points to the real GDP growth rate.

Adding up all these components of GDP gets you to our forecasts of a 4% growth rate in Q3 and 5.5% in Q4. Keep in mind that the one thing we know for sure is that we're bound to miss on some of our assumptions. For example, for Q3 we're assuming the trade deficit moves down in September to offset some of the jump earlier in the quarter. But since this data will not exist when the initial report on Q3 GDP is released, the assumptions made by government statisticians may distort the first estimate.

While forecasting government data is fraught with peril, our optimism is based on the facts above, not blind optimism.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
10-20 / 7:30 am	PPI - Sep	+0.0%	**+0.1%**		+1.7%
7:30 am	"Core" PPI - Sep	+0.1%	**+0.2%**		+0.2%
7:30 am	Housing Starts - Sep	0.610 Mil	**0.630 Mil**		0.598 Mil
10-22 / 7:30 am	Initial Claims - Oct 17	515K	**509K**		514K
9:00 am	Leading Indicators - Sep	+0.8%	**+0.9%**		+0.6%
10-23 / 9:00 am	Existing Home Sales - Sep	5.350 Mil	**5.410 Mil**		5.100 Mil