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First Trust

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Monday Morning Outlook

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First Trust Sees 4% Real GDP Growth in 2011

Sometime back in 2009, conventional wisdom argued that while the economy would appear to recover from the subprime crisis, the recovery would be tenuous. A growing chorus argued real GDP would grow at 2% or less, consumption would be lackluster, and any signs of real strength would be ephemeral – based on pent-up demand.

Of course, when real GDP grew at an annualized 4.4% over the winter (2009-10) and 3% in the first year of the recovery, the conventional wisdom had an excuse. "Most of it was inventories," they said, "and don't expect this to continue." So, when real GDP slowed to 1.7% annualized growth in Q2, they raised the stakes. They called it a "soft-patch" and argued that a "double-dip" was a real possibility. At most, they expected a 2% growth rate in the second half of 2010.

Instead, we were focused on three things. First, the economy was not broken. Once the panic ended, a natural recovery would start. Second, even without quantitative easing, the Fed was very easy. And third, productivity would remain robust. As a result, we predicted 3% growth for the second half (September 20, 2010 MMO).

That forecast looks pretty good. In fact, it may be too low. Real GDP growth clocked in at a 2.6% annual rate in Q3. All we need is a 3.4% growth rate in Q4 to get our 3% average, but the data suggest real GDP could expand by more than 4% annualized in Q4, possibly even 5%+.

Some of the acceleration in Q4 is because the economy is really picking up speed. But some of the acceleration in Q4 is also due to a problem the government is having seasonally adjusting oil prices. This problem artificially boosted growth in late 2009, but reduced growth in mid-2010. In other words, the soft-patch was never as bad as many thought. (For further discussion of the problem with oil prices, see our MMO dated November 8, 2010).

In 2011, we expect 4% real GDP growth. The biggest difference between the First Trust forecast and the conventional wisdom is deleveraging. We do not view the deleveraging process in as negative a light as the conventional wisdom. Once deleveraging begins to slow, it will not hurt the economy. If a consumer (or a business) pays down debt but pays down less than she did the prior year, then her spending can go up *faster* than her income (or profits). Higher saving is not going to be a negative for the economy.

Here are the assumptions behind our forecast for 4% real GDP growth in 2011.

Consumption: Auto sales in October/November were up about 30% from early 2009 levels, and JD Power and Edmunds.com are forecasting even higher sales in December. Still, the pace of sales remains below the long-term trend in "scrappage," suggesting further strong gains in sales in the year ahead. Meanwhile, consumers' financial obligations are now the smallest share of their after-tax incomes since 1995, and headed lower. Consumption will grow 3.3% next year, adding 2.3 percentage points to GDP.

Business Investment: Corporate profits and cash on balance sheets are at, or near, record highs. Meanwhile, capacity utilization has grown from a low of just 68% in mid-2009 to 75% and is on its way to 80% (the long-term average). Our industrial capacity is depreciating and needs to be updated. We are on the cusp of a boom in investment in equipment and software. Business investment should grow about 12% in 2011, adding 1.2 points to GDP growth.

Home Building: Home builders still face the headwind of substantial excess inventories. However, once those inventories are gone, the pace of housing starts is going to have to be about 150% higher than recent levels. It may take several years to get there, so we have home building growing 17.5% next year, adding 0.4 points to real GDP growth.

Government: Real government purchases will grow about 2.5% this year. We assume they will grow at a 1.5% rate next year (below the 30-year average of 2.2%), adding 0.3 percentage points to the GDP growth rate.

Inventories: Inventories were razor-thin by the end of 2009. They started to rebound this year and we expect that rebound to continue, but not accelerate significantly. As a result, we expect the inventory re-build to add only 0.1 point to GDP growth.

Trade: Unless the government fixes its measure of oil prices, expect a wild quarter-by-quarter ride of ups and downs for trade in 2011, just like this year. Either way, though, trade should, on average, subtract 0.3 points from the GDP growth rate, as the trade deficit expands slightly.

Add 'em all up and you get a 4% real GDP growth rate for 2011. Strap in, it's going to be better than you think.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
12-28 / 9:00 am	Consumer Confidence - Dec	56.4	**57.4**		54.1
12-30 / 7:30 am	Initial Claims - Dec 25	415K	**414K**		N/A
8:45 am	Chicago PMI - Dec	61.0	**62.9**		62.5