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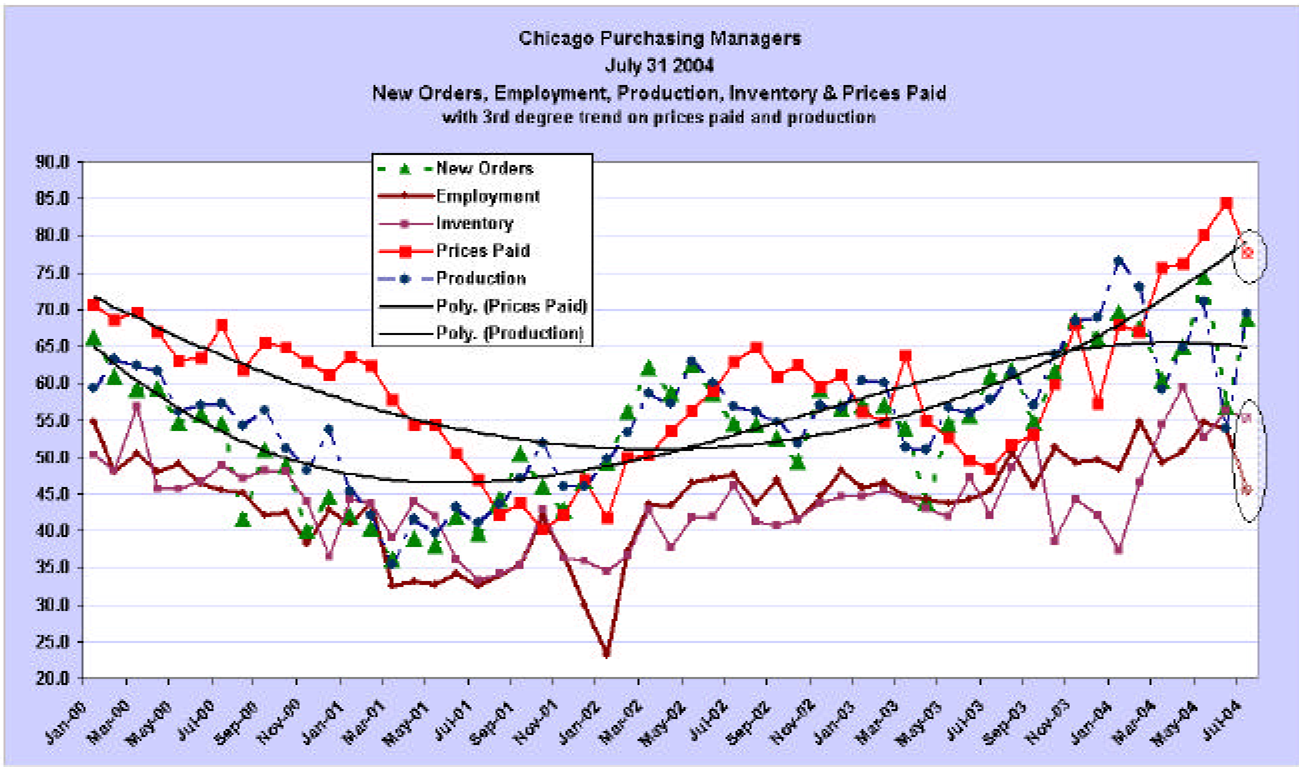
Advanced GDP and Chicago PMI: less growth, less inflation risk

The Advanced GDP Report with below expectations growth of 3.0% for QII (consensus 3.7%) surprised on another count as well. It depicted an improving picture on the inflation threat. That should keep the Fed ‘in train’ on its “moderation” course. The Chicago PMI supports this moderated inflation picture with a drop in the index on prices paid, although the production and orders index reversed prior month drops.



The prices paid series is suggestive the input supply pressures may be relenting a bit. That would be consistent with some other recent data, and would be a relief from the pronounced up trend that alarmed the Bond Market earlier in the year. Inventory behavior seems reflective of a very high degree of uncertainty in the business sector and is consistent with a quite moderate growth of inventory during QII seen in the Advanced GDP report. Inventories grew more rapidly in QI, and slowing inventory growth was a large factor in the slowing of measured GDP. Because of the precarious nature of the data, revisions will be looked at carefully, especially measuring inventory changes.

The beleaguered circumstances of the industrial work force shows through in this report as well from the clear lack of the former correspondence between rates of output growth and rates of employment growth.

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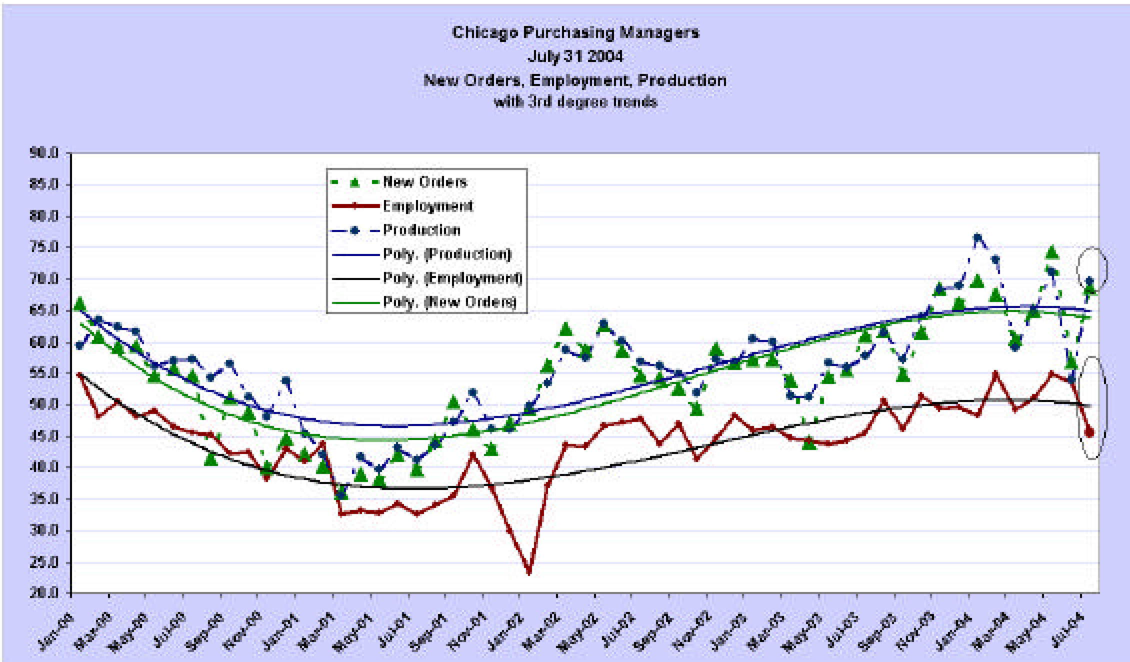
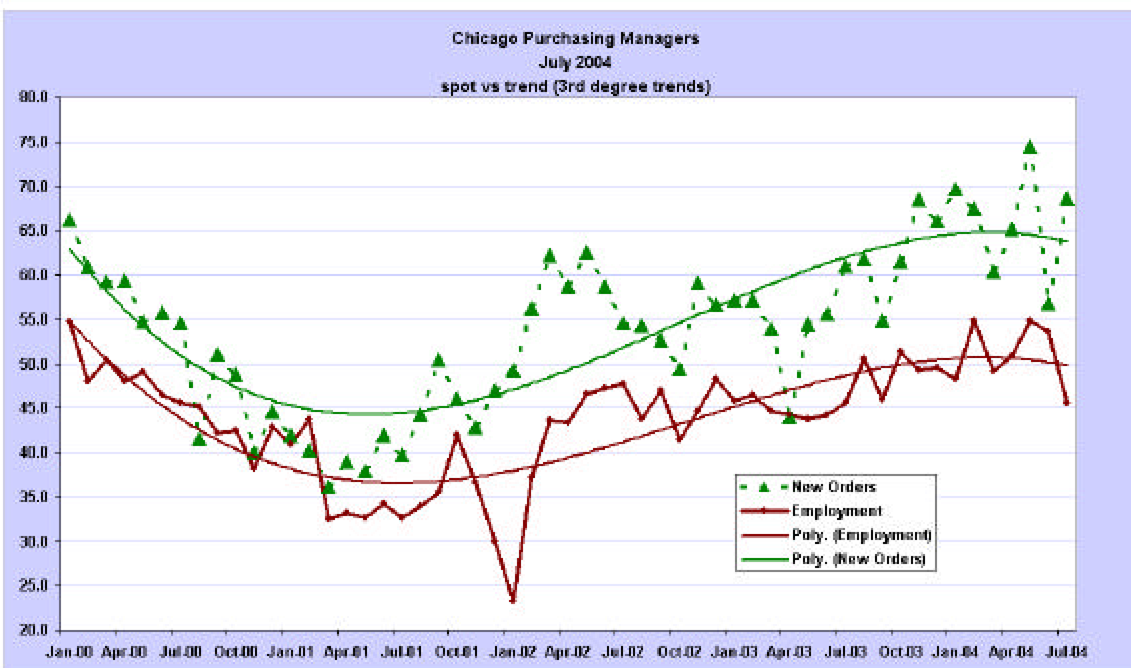
The close connection between employment changes and new order changes give us some insight into what to





expect from the manufacturing side (not surprisingly). Further, it could highlight how any uncertainty as to the future course of the economy can interrupt employment growth. In our view, the uncertainty shows up in the modest changes on the new order front and that then leads to exceedingly careful adjustment on the employment side. Of course, this is a conjecture on our part, but it seems quite reasonable. We can also note that this modest connection between new orders and employment amplifies what we have been saying about the skilled-non-skilled distinctions in the labor force as they are impacted by fragmentation. With much higher fringe costs, the long- term cost of a permanent hire can only be offset by a sustained pattern of new orders and thence to production changes.

Advanced GDP for QII. The advanced report on GDP for QII and the revisions to the GDP data were also released, but in some sense, they may add as many questions as answers. To be sure, the reaction of many observers was one of disappointment as GDP growth was recorded at 3.0%, sharply lower than the consensus of 3.7% and sharply lower than the 3.9% recorded in QI.

Personal Consumption Expenditures: The largest change quarter on quarter came in personal consumption expenditures that showed an increase in real terms of only 1% (as distinct from the 4.1% in QI). That change in consumption expenditures added only 73 basis points to growth in QII. Much of that downward shift in the growth rate came from motor vehicles and parts, (subtracting 33 basis points from the quarterly growth rate). Non-durable expenditures were sharply weaker in most categories. Service expenditures continued to expand (95 basis points), with continued expansion in the Medical Care field.

Gross Private Domestic Investment: Powered by residential housing expenditures (+15.4%) and equipment and software purchases (10%), and inventories (15%), fixed investment rose by 12.8%. That is an increase from 5.4% in QI and that had a sharp impact on GDP growth of nearly 2%! Residential investment added 81 basis points to the growth rate and equipment and software made a contribution of nearly75 basis points.

Net Exports: With all the talk of the very large current account deficit, it may come as a surprise that the U.S.Net Export position weakened growth some 8 basis points as exports surged while import growth moderated (subtracting some 133 basis points).

Government: One might have thought that the worsening fiscal situation at the Federal Level would have supplied a substantial and positive increment to growth, but that was not so. Government consumption and investment expenditures supplied a total of 43 basis points, 24 of that came at the State and Local level.

Comments:

The decline in the rate of growth of consumption was widely heralded, particularly as much of it came from shortfall in sales of autos. At the same time, there was a deceleration in inventory accumulation, but at the same time, there was an acceleration in exports and residential fixed investment. The core index for gross domestic purchases increased 2.4% in QII as opposed to 2.5% in QI. Non-residential structures increased by 5.2% reversing the fall of 7.6% in the prior quarter. **Equipment and software** investment increased by 10.0% as compared to 8.0% in QI. The issue of the day will now be whether these revised data suggest that SH2004 will be less zesty than FH2004. Much of the market action will depend on that assessment. At the least, however, the Fed received no incentive to alter its “measured” course in reducing the amount of accommodation that has been accorded the economy, but that may mean a slower path to neutrality unless the data in QIII begin to show some significant improvement from activity in June. The Chicago data suggest that the pause in Quarter II may be just that, but it is also true that corporate profits are not judged to be expanding their rate of increase. Higher rates, less zesty increases in corporate profits will create plenty of worries for investors during the second half. Add to that the current uncertainties arising from the political sphere and the Wall of Worry that an advancing market wants to climb may yet get higher. That suggests that after November 2, when the political situation in the U.S. is more settled, a relief rally may yet be in store…and since reasoning backward from such a conclusion will occur to many traders, maybe it is time to think that we are beginning to make a bottom?