

ECONOMICS: US PERSPECTIVES—JANUARY 22, 2010

Much More to Come from US Inventory Cycle, Even After Big Boost to Fourth-Quarter GDP

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A sharp and early turn in the inventory cycle has raised estimates for fourth-quarter GDP, while prompting questions about whether the pace of the rebound is sustainable. Our research suggests that the inventory rebuilding process is just beginning, and the economic recovery will benefit in 2010 and beyond.

Consensus estimates for US economic growth have risen dramatically in recent weeks, with some analysts now predicting an annualized gain of 5% to 6% in real GDP for the fourth quarter of 2009. The change in sentiment is striking. Not long ago, our estimate for fourth-quarter growth of 4% to 4.5% ranked at the top of analysts' growth estimates, and now we are in line with or slightly below the consensus.

The shift began after business inventory data for November were released on January 14. In November, business inventories grew 0.4%, twice as much as forecast, while the figure for the build in inventory positions for October was increased by over \$2 billion (**Display 1**).

At the start of the fourth quarter, most analysts had predicted a slowing in the rate of inventory liquidation. But in light of the October data, which showed a small nominal increase, views on the size of the liquidation started to be scaled back and

new figures triggered even larger changes in estimates.

Indeed, the upward revision to October inventory build combined with incremental nominal gains in November, have even led some analysts to estimate that business inventories grew in the fourth quarter, adding as much as four or five percentage points to the quarterly gain in real GDP. With such a large contribution from the inventory component in one period, forecasts of the incremental lift from stock building are being reduced. According to this view, if companies significantly added to their inventories in the fourth quarter, they will not need to add as much during 2010, and some analysts are therefore lowering their quarterly estimates for real GDP growth.

Did Companies Add to Inventories?

We disagree with this analysis and its conclusions, even though there is no doubt that the inventory component added substantially to fourth-quarter

Display 1
Inventory Cycle Turns in Fourth Quarter After Record Liquidation



Source: Census Bureau and Haver Analytics

economic growth. Based on our analysis of the sources of inventory investment in the fourth quarter, and the historical role inventories have played during economic recoveries and expansions, we believe inventory investment will continue make an important contribution to growth in 2010 and beyond.

Importantly, even though the preliminary data for October and November show a rise in nominal business inventories, there is still some debate over whether the rise was driven by price changes or volume increases. According to our analysis, wholesale inventories of food and farm

products accounted for three-quarters of the \$9 billion increase in manufacturing and trade inventory positions for October and November.

Moreover, most of the increases in wholesale food and farm product inventories appear to have been driven by higher prices as opposed to volume increases. Indeed, producer price data show an 8% increase in foodstuff and feedstuff prices over the two-month period, indicating that there was probably no real inventory building in the farm area. This means that in nonfarm inventories, there was most likely very little inventory building and possibly a slight contraction during the last three months of 2009.

This point helps illuminate the bigger area of controversy, regarding the future path of inventory investment in 2010 and beyond. Indeed, it is important to note that although we expect fourth-quarter GDP data scheduled for release on January 29 to show a relatively large contribution from the inventory component, businesses have not yet started adding to stock positions.

Two Stages to Inventory Cycles

History shows that there are two stages to inventory cycles. In the first stage, businesses stop reducing stock positions. This tends to have a large positive impact on GDP growth, especially in the current environment, when businesses are shifting from near-record inventory liquidation in the third quarter of 2009 to either stable or modest contraction in the fourth quarter. Preliminary data for the fourth quarter suggest that we are nearing the end of the liquidation stage of the inventory cycle,

although companies have not yet started to rebuild their inventory positions **(Display 2)**.

In the second stage, firms begin making incremental additions to stock positions. The length and scale of this stage is a function of the GDP growth cycle and its duration. Not surprisingly, long economic growth cycles tend to have larger cumulative lifts to manufacturing production from inventory investment than shorter ones.

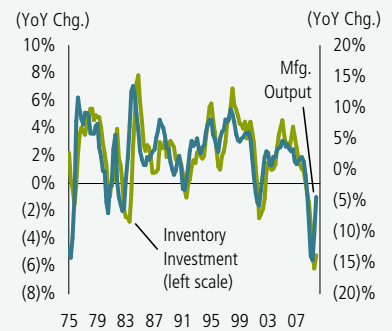
Manufacturing Benefits Yet to Come

Of the past four economic growth cycles, the two longest cycles—1983 to 1990, and 1991 to 2001—were characterized by much larger cumulative inventory contributions than the shorter cycles of 1975–1980 and 2001–2007 **(Display 3)**. But the rate of real GDP growth is also an important factor in this process. During the most recent expansion, which was 15 months longer than the expansion that began in 1975, inventory investment made a smaller contribution to manufacturing growth—three percentage points less—due to a relatively weak growth trend.

Looking back at the last four expansions, the cumulative lift from inventory investment to manufacturing output has ranged from a low of 8.3% to a high of 23%. Since firms have yet to even start the inventory building process, the potential boost from inventory investment in 2010 and beyond is still ahead of us. Thus, in our view, the fourth-quarter inventory lift to GDP is not a one-time event, rather it marks the start of a rebuilding process that may play out over several years to come.

Display 2
Long Way to Go for Inventory Rebuilding

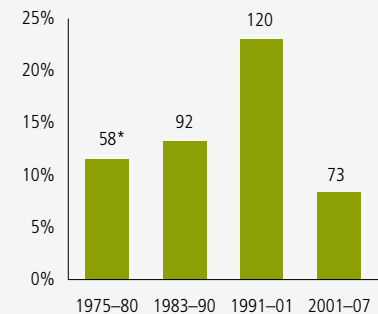
Manufacturing Output vs. Inventory Investment



Source: Bureau of Economic Analysis, Federal Reserve Board and Haver Analytics

Display 3
Inventory Rebuilding Often Adds Momentum to Manufacturing Output

Inventory Investment Contribution to US Manufacturing Output During Economic Expansions



*Months of expansion

Source: Bureau of Economic Analysis, Federal Reserve Board and AllianceBernstein

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