

ECONOMICS: US PERSPECTIVES—JULY 23, 2010

Profits and Politics to Shape Growth Trends After Sluggish Recovery in Second Quarter

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Moderate GDP growth amid uncertainty over policy changes complicates the economic outlook for the remainder of 2010. But we think strong gains in corporate operating profits offer the best guide for the economy’s basic trend, as long as regulatory and policy issues are cleared up as soon as possible.

Deciphering the Outlook at Midyear

US economic performance in the first half of 2010 has left analysts, investors and policymakers with a confusing set of statistics and many unanswered questions. It’s widely assumed now that real GDP growth in the second quarter fell short of the reported 2.7% gain for the first quarter. Yet many indicators—covering the goods, services and structures sectors of the macroeconomy—have improved in recent months, while companies have posted huge sales and profit gains compared with levels a year ago.

These conflicting trends raise two important questions: First, how did the US economic growth rate slow in the second quarter amid an acceleration of growth in key GDP components? Second, how are US companies reporting strong revenue and earnings growth (domestic and total) when real and nominal GDP numbers show moderate growth (**Display 1**)?

To decipher these anomalies, several factors and issues related to GDP calcula-

tions must be kept in mind. It’s important to note that consensus analyst GDP forecasts for the second quarter are still estimates. The government will issue its initial GDP estimate on Friday, July 30. Although analysts and government statisticians use many of the same sources of economic data, there are some differences that could materially affect estimates and lead to changes in final GDP data—especially at turning points in the economic cycle.

Beware of Early GDP Estimates

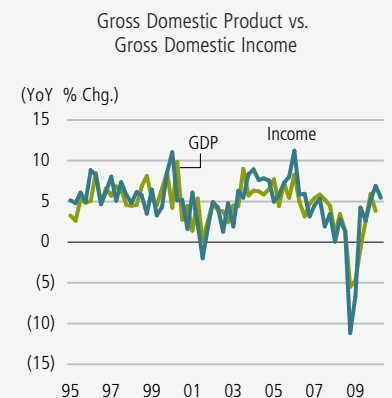
Government statisticians face several challenges when compiling GDP data. They must fit the economic data on consumption, investment, net exports and government spending into the context of certain broader macro output measures. In addition, the government figures aim to align the product and income side of GDP accounts as closely as possible (**Display 2**). Both of these tasks require many assumptions to be made in segments of the GDP data that lack complete information. Economists and analysts also lack

Display 1
Business Sales Growing Faster than GDP



Source: Bureau of Economic Analysis, Haver Analytics and US Census Bureau

Display 2
Income Growth Exceeds GDP Gains



Source: Bureau of Economic Analysis and Haver Analytics

information on some GDP inputs, particularly regarding government spending and inventory components, which could create significant disparities between early estimates and actual GDP numbers.

Initial estimates of GDP—even those made by the government—are based on partial data. Many data series will be repeatedly revised before final GDP figures are reported. These revisions are often more significant after a recession. History suggests that such adjustments are common during the early stages of an economic recovery, when initial estimates are usually revised upward by a substantial amount.

Company Reports Offer GDP Insight

We can get some insight on the likely direction and scale of these revisions by monitoring corporate sales and earnings reports and comparing them with government economic series. This is not a perfect barometer of economic trends, as we must rely heavily on large, multinational companies that may not be representative of the entire economy. However, company reports help address some of the weaknesses of the government series. Most official economic series are based on voluntary company surveys. While this doesn't necessarily compromise their reliability or accuracy, it does mean that initial snapshots could be well off the mark from final readings.

Moreover, we have learned that fewer companies are responding to the vital manufacturing and inventory series in recent years. This drop-off in reporting may be a result of record layoffs, which have left many companies with fewer staff to handle such surveys. It's impossible to say whether other economic series have also been affected by a similar decline in reporting. But the decline in responses to these surveys may significantly affect the reliability of early GDP estimates.

Despite these uncertainties, there are still ways to gain a better perspective on

underlying economic conditions. For example, we are focusing more closely on "hard" data like tax receipts and company earnings because, in our view, the income side of GDP accounts currently offers a more accurate picture of the economy, as explained in last week's commentary. History shows that in time, the product side (GDP) will be revised to be more closely aligned with the income data.

Two Keys to Growth Outlook

Looking beyond the economy's performance in the second quarter, we believe there are two fundamental keys to the outlook for the rest of the year: profits and politics.

So far, about a third of S&P 500 companies have reported second-quarter earnings, and most have beaten analyst expectations. Roughly 80% of companies have exceeded earnings expectations, while earnings have advanced by 38%.

If the remaining companies report in line with estimates, overall earnings for the second quarter will have risen by 35%—well above the 27% growth anticipated by analysts and exceeding our aggregate estimate of 30%. Strong earnings gains are being driven by rising revenue, not just cost cuts. Aggregate revenue growth excluding financial companies is running close to 12%, well above analysts' forecasts of 8% to 9%.

The large earnings gain in the second quarter will add to the record levels of cash that US companies have on their books. Many companies have already increased capital spending plans, but we believe there is ample capacity for much more.

However, for companies to have the confidence and conviction to boost investment, clarity is needed on the political and regulatory fronts. At this sensitive moment in the US economic recovery, we believe it is important for Washington to help bolster confidence and

promote growth, and avoid allowing election politics to create more uncertainty.

US companies are very flexible and tend to adapt their plans and investments based on changes to policies and rules. Certainty and transparency regarding rules and policies are crucial in order for companies and investors to decide how to spend or allocate capital.

The good news is that the US Federal government has completed action on two important issues—healthcare and financial regulatory reform. Although these changes in legislation may not be pro-growth or pro-business, at least there is some clarity on the new rules and policies.

Clarity Needed on Taxation Issues

Yet there is still plenty of ambiguity in the air, particularly in relation to taxation issues. Investors are waiting for clarification regarding the top marginal tax rates on dividends, capital gains and income, which are set to revert to relatively high levels in 2011 if no legislative action is taken. According to some press reports, some Democratic senators are considering extending the Bush tax credits by at least a year or two to help the economic recovery gain strength and breadth. In our view, such a policy would be a powerful catalyst toward promoting increased risk-taking by investors and companies, which would greatly bolster momentum for GDP growth in the coming quarters.

Even if Congress decides to make small marginal changes in tax rates, this could help stimulate growth simply by removing the uncertainty and confusion that exists today.

Although the data on economic growth is complicated, we think there are enough powerful forces in the system to support a solid growth outlook. Following the release of preliminary second-quarter GDP figures next week, we will issue a fresh GDP forecast for the remainder of 2010 and 2011. ■

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