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Economics Group

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GDP: Forward Momentum Continues, Profits Slow to Trend

GDP at 2.0 percent reflects a sharp inventory adjustment due to the outlook uncertainties of last summer. Yet, real final sales were solid, suggesting good forward momentum. Growth—no double dip—remains the theme.

GDP: Broad-Based Gains Support the Growth Story

Sustained growth—neither boom nor bust—remains the theme for this economy. Real GDP rose at a 2.0 percent pace in the third quarter and is up 1.5 percent from a year ago. The gains in the third quarter reflected improvement in consumer spending, business investment—equipment and structures and even residential investment. As a result, real domestic final sales are up 2.4 percent over a year ago. U.S. GDP has now exceeded the pre-recession peak.

Consumer spending rose 2.3 percent in the third quarter with improvement in spending on durables and services, and is in contrast to the first half of the year when weak spending reflected higher prices, specifically for gasoline and groceries. Real disposable income remains under pressure, however, such that the lack of real purchasing power, combined with concerns about jobs, continues to put a damper on overall consumer spending.

Inventories: Big Drag on Third Quarter GDP

Private inventories subtracted 1.55 percentage points in the third quarter—clearly the biggest drag on third quarter GDP (middle graph). During the July-September period, business leaders were clearly concerned about the direction of both the European and U.S. economies. As a result, nonfarm inventories were cut and subtracted 1.48 percentage points from the third quarter GDP number.

Going forward, the outlook for the economy is far more positive and therefore it appears that production will have to pick up to meet the solid pace of real final sales since inventories are very lean. This is good news for the economy going into the fourth quarter and the first half of 2012.

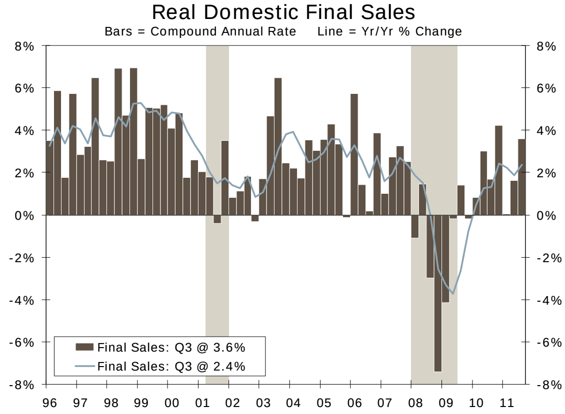
Corporate Profits: Slower Growth Consistent with Expansion Phase of the Business Cycle

Profits are very cyclical as evidenced in the bottom graph. This cycle has been even more pronounced given the very high and sustained productivity numbers we have witnessed for several quarters. Profits with inventory valuation and capital consumption adjustments were up 7.9 percent over a year ago. Corporate cash flow is up 9.6 percent over the same period. Domestic profits were up $33.5 billion with almost even gains between financial and nonfinancial firms. Net foreign profits were up $6.4 billion.

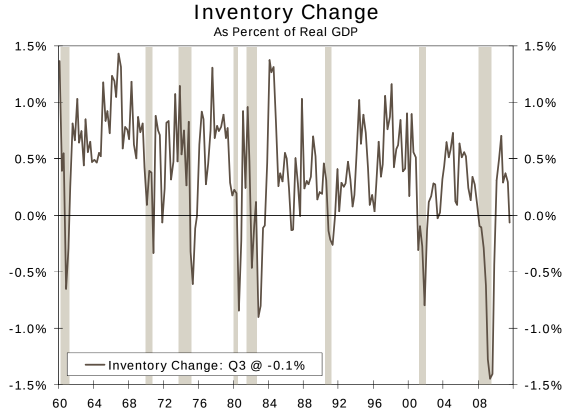
This review suggests that profit growth is both well-balanced and significant enough to maintain business investment and hiring momentum going forward. We find no case for a double-dip recession.

Our challenge will be the post-election environment of 2013 when many of the budget cuts and tax increases will go into effect. For 2012, our expectation is for 2 percent growth, but the range of possible outcomes for 2013 is very wide.

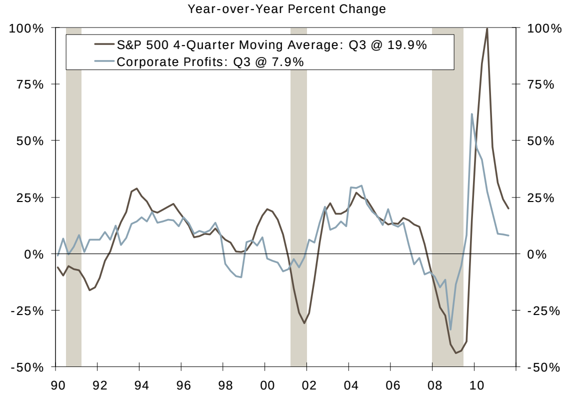
Real Domestic Final Sales



Inventory Change



Corporate Profits vs. S&P 500 Operating Earnings



Source: U.S. Department of Commerce, S&P and Wells Fargo Securities, LLC

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