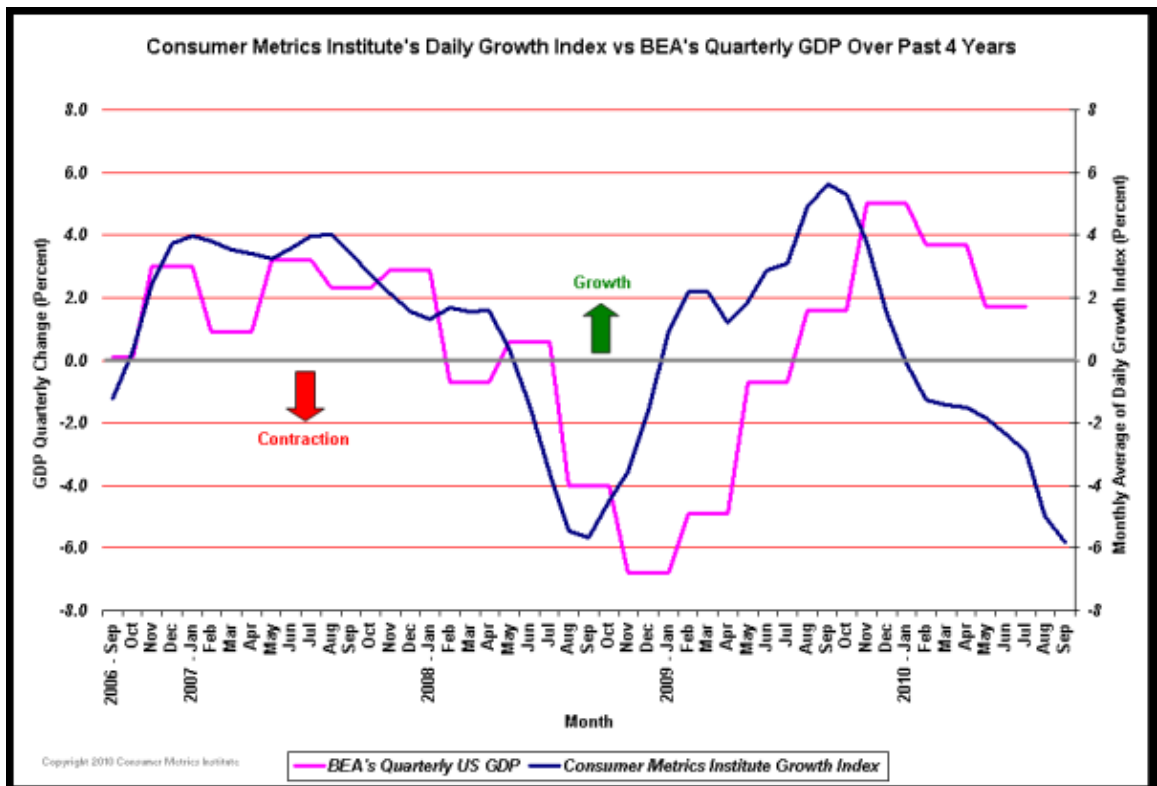


Consumer Metrics Institute Members News

September 26, 2010: The Diverging GDP

Prior to each revision to the GDP we are asked for insights into the likely course of those corrections from the Bureau of Economic Analysis ("BEA") of the U.S. Department of Commerce. Most of the questions we have received recently center on the increasing divergence of our Daily Growth Index from the BEA's GDP over the past couple of quarters:



To understand the causes of this divergence we need to look a little more closely at what the GDP tries to measure. The classic definition of the GDP can be summarized in the following equation:

$$\text{GDP} = \text{private consumption} + \text{gross investment} + \text{government spending} + (\text{exports} - \text{imports})$$

or, as it is commonly expressed in algebraic shorthand:

$$\text{GDP} = \text{C} + \text{I} + \text{G} + (\text{X}-\text{M})$$

where "C" (consumer demand) represents about 70% of the entire U.S. economy. With that equation in mind, we offer the following observations:

-- It is important to remember that at the Consumer Metrics Institute we measure only a portion of the "C" in the above equation. In fact, we have intentionally chosen to track a particularly

volatile subset of "C" in order to gain signal strength and lead time. Regular visitors to our site know our standard disclaimer: "we capture the discretionary durable goods transactions of internet shopping consumers." We don't track the core non-discretionary items that represent perhaps 90% of take-home pay: groceries, gasoline, utilities, non-discretionary medical expenses and current housing. In a deleveraging world, you can add personal savings and/or debt retirement to that list -- thus even further marginalizing our data. But -- and this is a really big "but" -- what we measure is by far the largest driving force behind economic growth and new jobs. Furthermore, the demographics of our shoppers makes them (as empirically observed) early trend setters for consumer durable goods, further enhancing our lead times. All of the above tells us that we should lead the BEA's "C" while having an amplified signal that may or may not offset the impact of "I", "G", "X" and "M" when the final calculation of GDP is performed.

-- We think that the BEA's methodologies for imputing "C" are seriously flawed. Their 1937 based focus on factories places their data far downstream from where the real economic action is -- probably 4 or 5 months. We understand why a factory focus was chosen in 1937 (given FDR's constituency and 1937 jobs demographics), but the economy is much more than just factories in 2010. Additionally, the BEA uses a questionnaire approach, which leads to survivor and large firm biases -- not to mention lags and revisions when the data does finally come in. And finally their numbers are "annualized" growth that is then seasonally adjusted; while our numbers are strictly year-over-year growth, which require no seasonal adjustments.

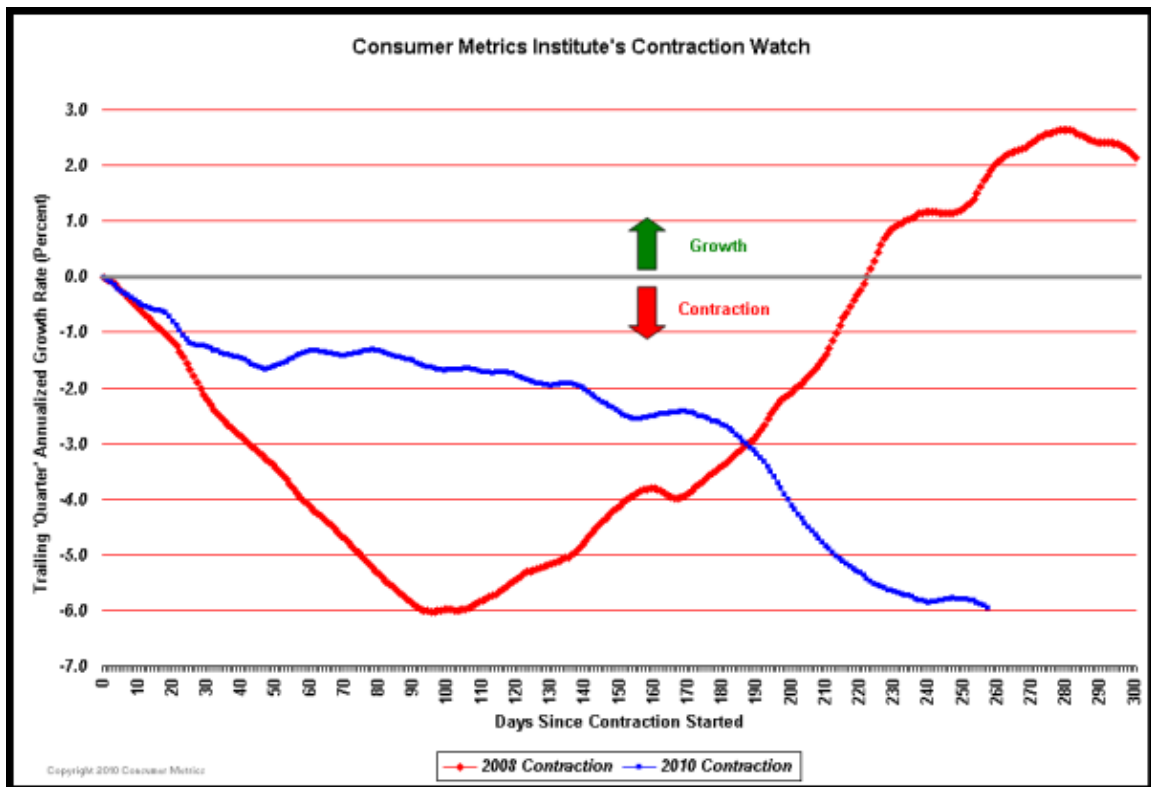
-- Another problem with using factory data to impute "C" is that the BEA feels compelled to somehow reconcile the downstream data source to upstream demand by tracking inventories as they slosh up and down. Doubly unfortunate is the fact that the BEA's inventory data is very, very late arriving -- and it is by far the largest source of post-2nd revision adjustments to the GDP. So the GDP gets bounced all over the place as inventory building/depleting cycles take place. One of these days the inventory builds of the past 3 quarters will come home to roost, depressing the reported GDP figures below raw consumer demand.

-- In an economy where household deleveraging has become commonplace, the relative impact of "C" on the GDP should naturally shrink. John Maynard Keynes would have us believe that at such times we simply print new money and crank up "G" to offset the drop in "C" -- resulting in U.S. roadsides that are cluttered with "American Recovery and Reinvestment Act" signs. If "G" soars by \$787 billion there will have to be some decoupling of the final GDP value from "C."

-- And finally, "(X-M)" could significantly boost GDP if the U.S. Treasury's efforts to devalue the dollar gain traction, thus causing net exports to grow. Unfortunately, the biggest portions of "M" are either valued in dollars or in currencies defacto pegged to the dollar, and efforts to devalue to dollar don't actually help that part of the equation as much as one might suspect. And since most other central banks want their currency devalued for the same reason, there is no reason to suspect that the U.S. alone will manage to pull it off. Add to that the dollar's role as defacto world reserve currency and safe harbor during times of global economic distress, further hampering Washington's best intentions. That said, "(X-M)" has actually improved over the past several quarters, adding to the divergence of the GDP from our Daily Growth Index.

Looking again at the equations above, we can understand that the portion of "C" that we measure should decouple from the reported GDP when consumers deleverage, "G" soars, inventories build or a weakening dollar causes exports to grow -- all of which have been happening over the past few quarters.

Our message for the past six months has been that the current "dip" in consumer demand is not following a classic "V" shaped pattern. We have used the words "lingering" and "prolonged" to describe it, particularly when comparing it to the "Great Recession of 2008," which the National Bureau of Economic Research now informs us ended in June of 2009. Our key question concerns the future course of the blue line in our "Contraction Watch":



If the blue line has actually bottomed (and we guess not until the U.S. midterm elections sort themselves out), should we expect it to follow the upward pattern of the (red) 2008 event? Or is the plateau that we see in the left hand portion of the blue line above a sign of a new "normal" level for an extended deleveraging consumer economy? The question is really about whether what we are seeing in the above chart is a short term aberration in consumer behavior or part of a much longer term profound change in consumer attitudes. Are consumers now much more cynical? Will that cynicism change during the next quarter? Is a return to the economy of 2005 likely anytime soon?

The above chart is an attempt to gain an early signal about possible answers to those questions. If the 2010 contraction event bounces similar to the 2008 event, life may well return to the old "normal." If not, welcome to the American version of 1990's Japan.