Consumer Metrics Institute News

January 27, 2012: Headline 4Q-2011 GDP Growth of 2.75% Masks Mixed Signals

In their "Advance" estimate of the fourth quarter 2011 GDP, the Bureau of Economic Analysis (BEA) found that the annualized rate of economic growth had risen to 2.75%, up slightly less than one percent from their "final" estimate of 1.81% for the third quarter. However the details within the report actually contain a set of seriously mixed signals, with the entire gain concentrated in consumer goods and a huge swing in inventory levels. Those two line items represented an aggregate change of +4.30% relative to the growth rates reported for the third quarter. All of the other major line items were either static or deteriorated significantly, with the growth rates for consumer services, fixed investments and government all down sharply. Additionally, the prior two quarters of reprieve from the negative impact of foreign trade reversed -- with foreign trade now removing -0.11% from the headline number after contributing +0.43% last quarter. And the annualized growth rate of the BEA's "real final sales of domestic product" dropped by over 2% to 0.81%, hardly a ringing endorsement of economic recovery.

Among the notable items in the report**:**

-- The annualized growth rate for consumer expenditures for goods was sharply higher at 1.34%, up over one percent from the 0.33% rate reported for the third quarter of 2011. This is the second consecutive quarterly improvement in that line item, and it is consistent with the upswing in on-line demand for consumer goods that we have been following daily at the Consumer Metrics Institute since late in the second quarter of 2011.

-- On the other hand, consumer services plummeted -- losing 0.80% as the growth rate fell to 0.10%. This is likely a sign of both dropping demand and eroding prices within the consumer services sector. This drop in the consumption of consumer services offsets the bulk of the increase in spending on consumer goods, with the aggregate contribution to the headline number ending up at only +0.21%.

-- The growth rate of private fixed investments also dropped significantly to 0.41%, over 1% lower than the 1.52% annualized rate reported for the third quarter.

-- The growth rate of inventories represented the true "wild card" in the report, swinging from a third quarter contraction rate of -1.35% to a newly reported growth rate of +1.94% -- a change of nearly +3.3% in its contribution to the headline number. This apparently wild swing could be the result of either real changes in inventory levels or phantom changes as commodity prices firmed inventory valuations after dropping dramatically during the third quarter. If the changes are real, it is likely that manufacturers were rebuilding inventories after being overly cautious during the third quarter, following their classic pattern of a lagging over-correction. In that scenario we should expect this line item to revert to long term trend lines during the first half of 2012, lowering the headline numbers at that time. However, if the numbers are the phantom result of changes in commodity pricing (particularly oil) impacting inventory valuations even as physical levels remain largely unchanged, then the headline number is largely meaningless and we can expect the quality of the GDP numbers to continue to be held hostage by the BEA's price deflaters.

-- Another major swing in the numbers concerned total expenditures by governments at all levels, which is now contracting at a -0.93% annualized rate (a significant weakening from the -0.02% rate during the third quarter) -- a rate that continues a string of five consecutive quarters of contraction. It also reflects a change to annualized contraction at all levels of government (Federal, state and local) -- and most notably in Federal defense spending.

-- The annualized growth rate of exports was unchanged at +0.64%.

-- Imports are now removing -0.75% from the growth rate of the overall economy, a significant deterioration from the -0.21% rate reported for the third quarter. This is probably the result of both firming commodity prices and a reversal of any one-time effects from the Sendai Tsunami.

-- The annualized growth rate of "real final sales of domestic product" plunged from +3.16% during the third quarter to only 0.81% in the fourth -- mostly as a consequence of the (possibly phantom) growth in inventories.

-- Working backwards from the data tables, the effective "deflater" used by the BEA to offset the impact of inflation was an annualized 0.39%, much lower than the 2.57% rate used for the third quarter. As a reminder, a lower "deflater" will cause the "real" numbers to increase. In this particular case, however, the 0.39% rate used by the BEA is significantly higher than those provided by their sister agencies for the fourth quarter (particularly the -2.13% annualized change in the Bureau of Labor Statistic's CPI-U during the quarter).

-- Real per-capita disposable income was unchanged from the third quarter.

The Numbers

As a quick reminder, the classic definition of the GDP can be summarized with the following equation:

GDP = private consumption + gross private investment + government spending + (exports â   imports)

or, as it is commonly expressed in algebraic shorthand**:**

GDP = C + I + G + (X-M)

In the new report the values for that equation (total dollars, percentage of the total GDP, and contribution to the final percentage growth number) are as follows**:**

GDP Components Table

	Total GDP	=	C	+	I	+	G	+	(X-M)
Annual $ (trillions)	$15.3	=	$10.9	+	$2.0	+	$3.0	+	$-0.6
% of GDP	100.0%	=	71.0%	+	13.1%	+	19.7%	+	-3.8%
Contribution to GDP Growth %	2.75%	=	1.44%	+	2.35%	+	-0.93%	+	-0.11%

The quarter-to-quarter changes in the contributions that various components make to the overall GDP can be best understood from the table below, which breaks out the component contributions in more detail and over time. In the table we have split the "C" component into goods and services, split the "I" component into fixed investment and inventories, separated exports from imports, added a line for the BEA's "Real Finals Sales of Domestic Product" and listed the quarters in columns with the most current to the left**:**

Quarterly Changes in % Contributions to GDP

	4Q-2011	3Q-2011	2Q-2011	1Q-2011	4Q-2010	3Q-2010	2Q-2010	1Q-2010	4Q-2009	3Q-2009	2Q-2009	1Q-2
Total GDP Growth	2.75%	1.81%	1.34%	0.36%	2.36%	2.50%	3.79%	3.94%	3.81%	1.69%	-0.69%	-6.6
Consumer Goods	1.34%	0.33%	-0.38%	1.10%	1.87%	1.09%	0.87%	1.45%	0.12%	1.70%	-0.52%	0.0
Consumer Services	0.10%	0.90%	0.87%	0.36%	0.61%	0.75%	1.18%	0.47%	0.21%	-0.04%	-0.76%	-1.0
Fixed Investment	0.41%	1.52%	1.07%	0.15%	0.88%	0.28%	2.12%	0.15%	-0.42%	0.13%	-2.26%	-5.0
Inventories	1.94%	-1.35%	-0.28%	0.32%	-1.79%	0.86%	0.79%	3.10%	3.93%	0.21%	-0.58%	-2.6
Government	-0.93%	-0.02%	-0.18%	-1.23%	-0.58%	0.20%	0.77%	-0.26%	-0.18%	0.28%	1.21%	-0.3
Exports	0.64%	0.64%	0.48%	1.01%	0.98%	1.21%	1.19%	0.86%	2.51%	1.49%	-0.02%	-3.8
Imports	-0.75%	-0.21%	-0.24%	-1.35%	0.39%	-1.89%	-3.13%	-1.83%	-2.36%	-2.08%	2.24%	6.2
Real Final Sales	0.81%	3.16%	1.62%	0.04%	4.15%	1.64%	3.00%	0.84%	-0.12%	1.48%	-0.11%	-4.0

Summary

Although the headline number of 2.75% certainly looks better than the prior quarter's 1.81% (and much closer to the growth rates of 3%-4% we might expect 11 quarters into a "recovery"), it turns out that the vast bulk of the improvement came from increasing inventory valuations -- a line item which by itself added nearly 3.3% to the headline number relative to the third quarter, over three times the aggregate headline improvement. Other observations include**:**

-- Consumer spending on goods surged, but was largely offset as consumer spending on services sagged. The aggregate improvement of 0.21% in consumer spending was accomplished even as "real" per capita disposable income was flat, indicating that some of that improvement (particularly since it was focused on goods) may simply be retail sales brought forward as a consequence of deep holiday discounting on the part of retailers.

-- The growth rate for fixed private investments dropped by well over a percent, to an anemic 0.41% annualized rate. Even as businesses grew their inventories they were moderating the growth of their capital investments.

-- Governments at all levels contracted their expenditures. State and local governments spent less on both operating expenses and capital improvements, while the flood of Federal fiscal spending has clearly ebbed. Perhaps the most alarming line item (or perhaps cheering, depending on your point of view) was the -0.73% annualized contraction rate in national defense spending. Even given the state of politics in a Presidential election year, it is hard to imagine that trend reversing over the next few quarters -- especially when ongoing military draw-downs and the inertia of Federal budgets are taken into consideration.

-- Imports reverted to historical form, probably as a result of both firming commodity prices and diminishing impacts from the Japanese tsunami. There is no reason to expect that part of the GDP equation to do anything but weaken the headline number in the quarters ahead.

-- If the highly positive swing in the inventory number is real, it is certainly not sustainable -- and when combined with actual consumer spending the numbers themselves would be prima facie evidence that manufacturers over-corrected in anticipation of huge holiday spending. Such an over-correction should lead to reversals in the coming quarters. On the other hand, if the swing is an artifact of firming commodity prices it is just a further indication that the headline number is hopelessly noisy -- subject to erratic phantom movements as the BEA's "deflaters" struggle to track pricing changes.

Despite the improved headline data, we're not convinced that there is much meaningful positive information in the latest GDP report. We believe that the improvements in consumer spending on goods is likely only a natural form of consumer self-medication for the malaise of extended "frugality fatigue" -- in this case enticed by massive retailer discounting during the fourth quarter.

More importantly, those sales may have only pulled spending forward from the coming quarter. There has been no improvement in real per capita disposable income that could warrant any increase in consumer spending, and the fourth quarter splurge on goods is likely coming from a draw-down in savings, a partially offsetting decrease in spending on services and extra "pocket money" from lower at-pump gasoline prices. At a macro level those funding sources have been augmented by an enormous expansion of student loans and (for a non-trivial portion of all households) unprecedented rent-free living as a consequence of vastly extended foreclosure proceedings. With the exception of the rent-free and student loan components (for which there simply are no horizons or painless end-games), all of the probable sources for the increased consumer spending will probably revert to historical norms during 2012.

And lastly, the volatility of the inventory parts of the BEA's equation continue to distort the headline number enough to render it useless as a source of genuine economic information. In the best of times the inventory data provided by the BEA is late and incomplete, but it is necessitated by the need within the BEA's equations to reconcile the production based manufacturing portions of their equation to the consumption based consumer portions. Because of that it is both partly plugged (at least in the monthly and quarterly updates) and highly susceptible to fluctuations in pricing levels.

In short, this report is disturbing because of how the headline number masks real and troubling weakness in the more substantive details.

Hopefully anyone trying to engineer the economy is basing their tinkering on better information than that provided by the BEA. In fact, it is likely that much of the negative consequences of the recent economic event can be attributed to precisely the poor quality and timeliness of the economic and monetary information available to those whose hubris drives them to such tinkering.