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Economic Update

THOUGHTS FROM OUR ECONOMICS TEAM

JULY 26, 2012

US GDP in Perspective - This Time *IS* Different

The US economy grew at a 1.5% annual rate in the second quarter (broadly in line with expectations), following a 2% growth rate in Q1 and a 4.1% growth rate in Q42011. Consumer spending growth slowed in Q2 relative to Q1 (mainly autos), business investment decelerated and government spending detracted from growth for the eighth consecutive quarter (state & local government "austerity").

Big picture: US economic output is now just 1.7% above the 2007 pre-recession peak, 18 quarters since that peak (***See Figure 1 below***). This is extraordinarily weak economic performance by any measure. ***At this stage in every post-war recovery, US output was up 10-20% relative to pre-crisis levels*** with one exception: 1953, where output was only up 9.4%. Such slow growth is a symptom of our more general "Great Restructuring".

Good news? Housing ("residential construction") contributed positively to economic growth for the third consecutive quarter, comprising 0.3 percentage points of the 1.5% top line growth rate. ***In every post-war recovery, housing led the way—with the notable exception of the current recovery.*** The positive contribution in recent quarters bodes well for future growth and suggests that a recession is not on the near-term horizon.

Impact on Interest Rates: Uncommonly low interest rates reflect a macroeconomic backdrop characterized by frail growth. In particular, we use two components of the report to shape our interest rate views: nominal GDP growth and the GDP price deflator. Today's report showed NGDP growth in Q2 at just 3.1% and the GDP price deflator advancing at 1.6%. Neither datum indicates impending upward pressure on interest rates.

Impact on the Fed: With this perspective, one can understand why the Fed chooses to maintain what policymakers refer to as "very accommodative monetary policy." Will they do more at next week's meeting (July 31-August 1)? This report will not deter them from pursuing additional easing. The average pace of economic growth so far in 2012 is below the Fed's 1-9-2.3% forecast for 2012. Inflation is also running below the Fed's target. However, based on "chatter" this week, the odds of further action point to a September FOMC meeting (when the Fed releases new economic projections) move rather than next week's meeting. Our long-standing view remains: "quantitative easing" will not solve this Great Restructuring.

Figure 1 Recessions in the Post War Period: GDP Growth This Time (2007) IS Different