Payden&Rygel

Economic Update

THOUGHTS FROM OUR ECONOMICS TEAM

JUNE 26, 2014

CAN WE JUST IGNORE IT?

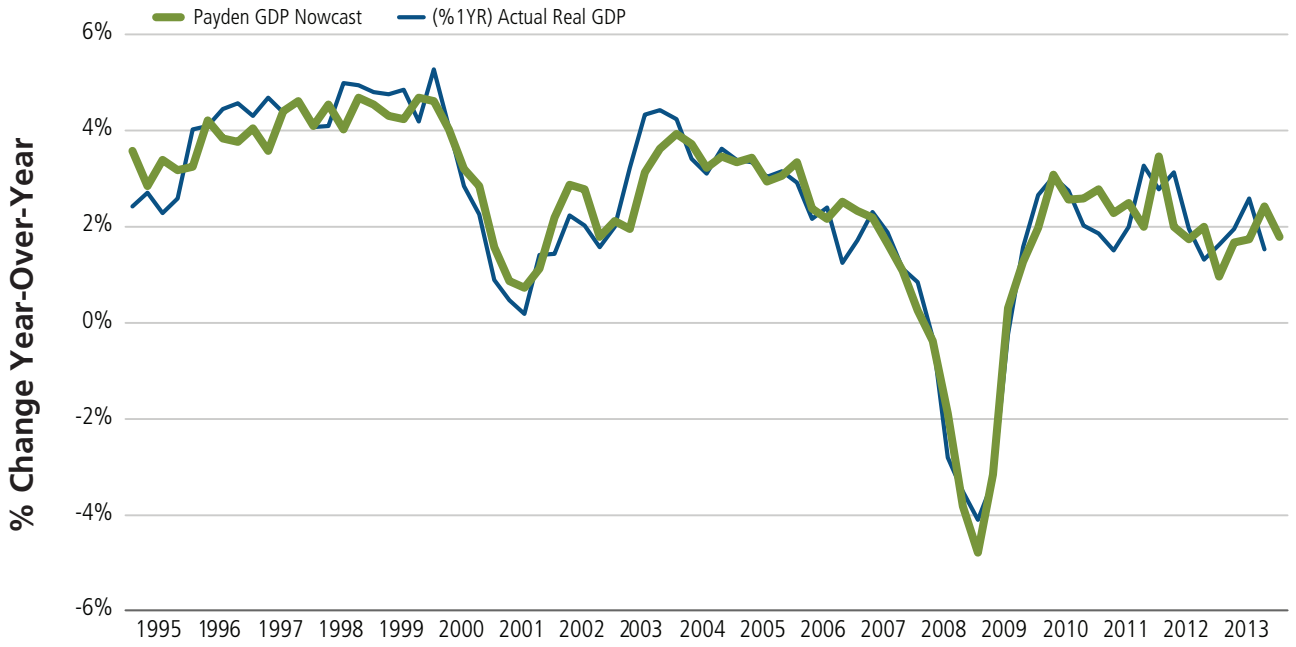
Rare indeed is it that the third revision to a quarterly gross domestic product (data point) draws any attention. However, on Wednesday, data from the Bureau of Economic Analysis showed the US economy contracted at an annualized rate of -2.9% in the first quarter of 2014, which constitutes a three percentage point swing from the initial print of +0.1%. A contraction of this magnitude has never occurred during an economic expansion, but we do not think the US is on the point of a recession.

First, what happened? Downward revisions to consumer spending drove an already weak report into deeply negative territory. In addition to lackluster consumer spending, the underlying frailty of US output in the first quarter was mostly the result of anemic business investment, which subtracted -2% from growth and contracted at an annualized rate of 10%.

Despite all this, we think the awful Q1 GDP report is probably an outlier and, for purposes of discerning whether the US economy has stalled or not, investors should ignore the report. A variety of real time indicators of economic activity (business surveys, industrial production, nonfarm payrolls, etc.) suggest that the US economy, while not rapidly accelerating, is also not in a recession. Indeed, our GDP "nowcast" shows the US to be averaging year-on-year growth closer to 2% using data through May (see Figure 1).

For the Fed, though, it still appears as if their 2014 GDP forecasts are too rosy—as we've pointed out all year. In order to reach even the bottom of the FOMC's revised range of GDP growth for the year, GDP would have to accelerate to nearly 4% in Q2, Q3 and Q4 (see Figure 2). The last time US GDP exceeded 4% for three consecutive quarters was 2003. While we do expect Q2 GDP to bounce back, we wonder just how much of a bounce it will be – around 3% is a reasonable "guess" at this point given the data we've seen for Q2 so far. However, we think the 4% hurdle required is quite high. The way the math works, even under a modest pickup scenario back to 3% growth for the balance of the year, 2014 GDP growth will look a lot more like 2013 GDP growth (i.e., 2% or a maybe even a bit less) than many forecasters had hoped. Since the 2014 growth optimism fueled forecasts for higher long-term interest rates at the start of the year, the revised growth reality should not be ignored by investors.

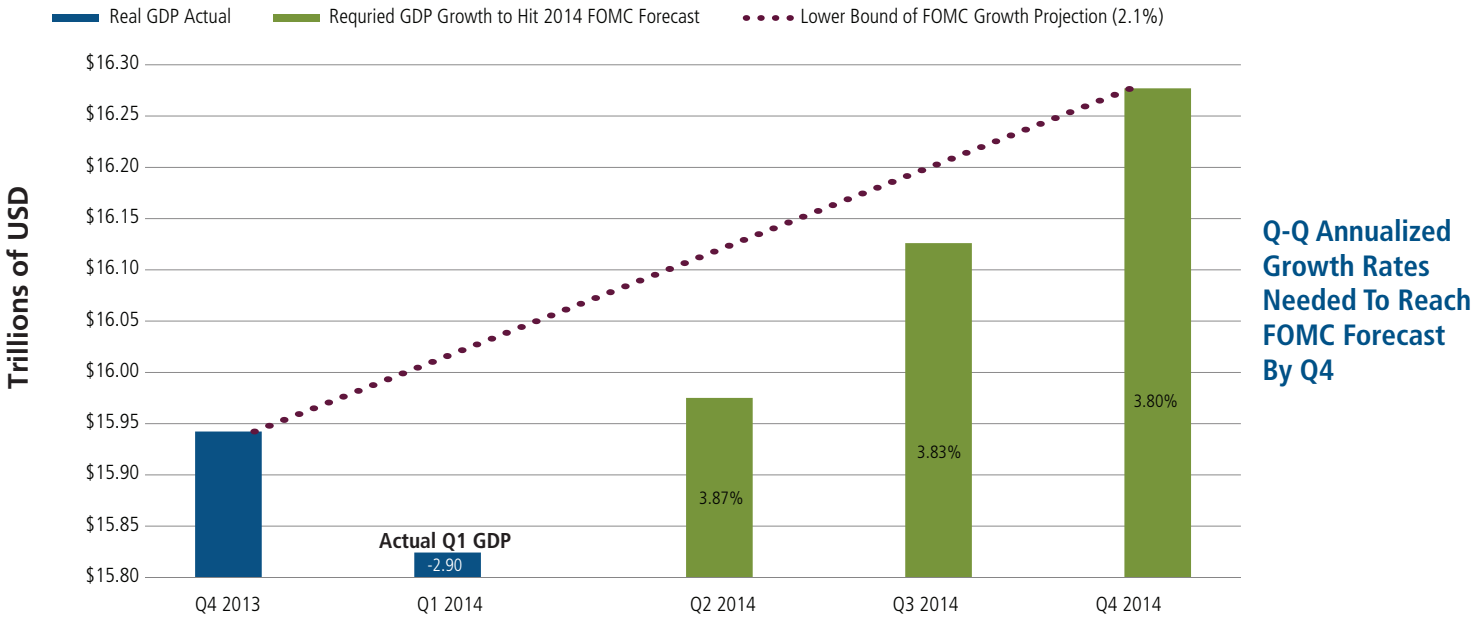
OUR NOWCAST, BASED ON HIGHER FREQUENCY DATA, SHOWS THE US GROWING AT A ROUGHLY 2% PACE



Source: BEA, BLS, Chicago Fed, Philly Fed, Federal serve, ISM, NFIB, Payden Calculations

With annual benchmark revisions to GDP due in July, we may yet learn more about the US economy's growth trajectory than we know now. Perhaps the most important lesson from this surprising first quarter GDP print comes from the Bank of England's chief economist, Andy Haldane, who remarked, "data on the economy is riddled with uncertainties and beset by revisions." It is hard enough to forecast the past, let alone the future.

IN ORDER TO HIT THE FOMC'S GROWTH FORECAST, US GDP GROWTH WILL HAVE TO AVERAGE 3.8% Q-Q ANNUALIZED OVER THE REMAINDER OF 2014—STILL QUITE A HIGH BAR



Source: Bureau of Economic Analysis, Payden Calculations