



GDP Observatory

October 23, 2009

Recovery will take hold in 3Q09

- Fiscal stimulus provided a boost to consumer spending
- The decline of non-residential and residential investment will ease
- Significant economic slack will cause recovery to be slow

Consumer spending will drive economic growth

The U.S. economy is expected to embark down the path of recovery as we anticipate a quarterly annualized growth rate of 4.1% in 3Q09 following four consecutive months of contraction.

Personal consumption expenditures are poised to lead the expansion. The Cash for Clunkers program drove up auto sales to average 11.5M in 3Q09, compared to 9.6M in 2Q09, significantly boosting consumption of durable goods. While the effects of this stimulus program were only transitory, spending on non-durable goods also rose, which could be an indication that demand is resuming even amid ongoing job losses.

In contrast, non-residential investment will continue to decline, albeit at a slower pace. On a positive note, industrial production of high tech goods rose 2.8% in 3Q09, indicating that investment in equipment and software, which makes up 70% of the total, may increase modestly. Nevertheless, the structures component is expected to continue to decline sharply due to deteriorating fundamentals in the commercial real estate market and limited access to credit.

Residential investment will also continue to adjust downward for the fifteenth consecutive month as the market remains weak, but the pace will slow significantly. Housing starts increased as improvement in the housing market boosted builders' confidence, but total construction spending declined.

Expansion in both exports and imports illustrate that demand is picking up both at home and abroad. In fact, exports are expected to grow at a faster rate than imports, which will turn the trade dynamics to favor economic growth in the third quarter.

Recovery will be slow going forward

While economic expansion has taken hold, activity is still far from that of previous years and growth is expected to be slow. The labor market is forecasted to remain weak as job destruction continues into 2010 and the prospect of a jobless recovery is likely. As a result, consumption will continue to be constrained by low household wealth, the high savings rate and tight credit markets. Furthermore, non-residential investment will continue to be plagued by weak demand, limited access to credit and deterioration in the commercial real estate market. Nevertheless, net exports could continue to be supportive as stronger growth in some emerging economies could increase foreign demand for U.S. goods beyond domestic demand for imports.

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3Q09 GDP Releases

Advance: **October 29**

Preliminary: November 24

Final: December 22

Leading Indicators

12-month % change

	Sep	Aug	Jul	2Q09
PCE (real)		0.3	-0.7	-1.7
Retail sales	-5.7	-5.8	-8.5	-9.5
Retail sales ex. autos & gasoline	-4.9	-6.3	-8.6	-7.6
Capital goods new orders*		-21.1	-22.2	-23.2
New orders, nonmanuf. ISM (index)	54.2	49.9	48.1	46.7
Housing starts	-28.2	-30.9	-36.4	-46.9
Residential construction	8.5	9.5	11.9	11.2
Business inventories (\$ bn)		-19.3	-15.1	-18.1
Manufacturing inventories (\$ bn)		-39.4	-46.0	-53.0
Federal public spending	17.2	-7.4	26.2	20.0
Goods exports (real)		-19.5	-18.0	-20.1
Goods imports (real)		-18.0	-18.2	-21.4

* Nondefense excluding aircraft

Gross Domestic Product

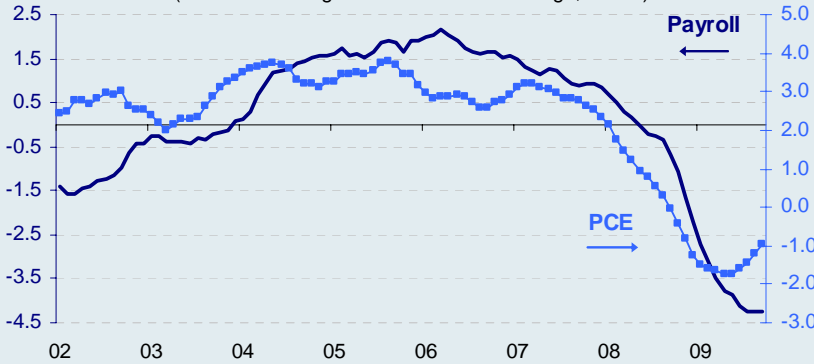
Quarterly annualized rate, sa forecasts in bold

	3Q09	2Q09	1Q09	4Q08	3Q08
GDP	4.1	-0.7	-6.4	-5.4	-2.7
Personal spending	2.3	-0.9	0.6	-3.1	-3.5
Nonresidential investment	-8.8	-9.6	-39.2	-19.4	-6.1
Residential investment	-7.8	-23.2	-38.2	-23.2	-15.9
Inventories (\$ bn)	-85.3	-160.2	-113.9	-37.4	-29.7
Public spending	3.2	6.7	-2.6	1.2	4.8
Exports	10.7	-4.1	-29.9	-19.5	-3.6
Imports	5.7	-14.7	-36.4	-16.7	-2.2
Deflator (YoY % change)	0.9	1.5	2.0	1.9	2.5

Trends

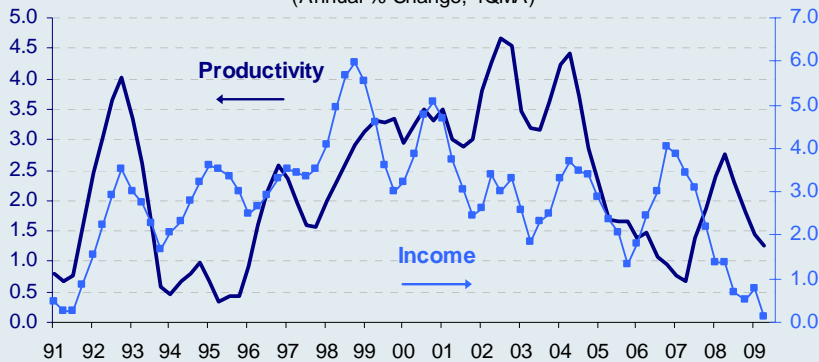
Nonfarm Payroll & Personal Consump. Expenditures

(Annual % Change & Real Annual % Change, 6MMA)



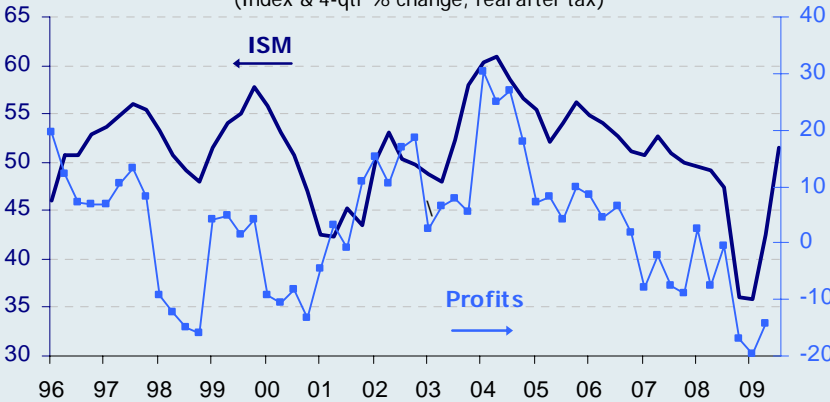
Nonfarm Productivity & Real Disposable Income

(Annual % Change, 4QMA)



ISM & Corporate Profits

(Index & 4-qtr % change, real after tax)



Cash Flow & Non-Residential Investment

(Real Annual % Change, 4QMA % Real Annual % Change)



Personal Consumption Expenditures

The decline in PCE has eased in recent months, indicating that demand has stabilized due to recent fiscal stimuli and improvement in the economic outlook. Most visibly, the Cash for Clunkers program boosted durable goods spending in the third quarter, but the benefits were limited to the duration of the program. Nevertheless, retail sales excluding autos rose in the third quarter, indicating that demand could be picking-up, although it remains at low levels. Another positive note is the stabilization of home prices, which will help to support a household's real estate wealth.

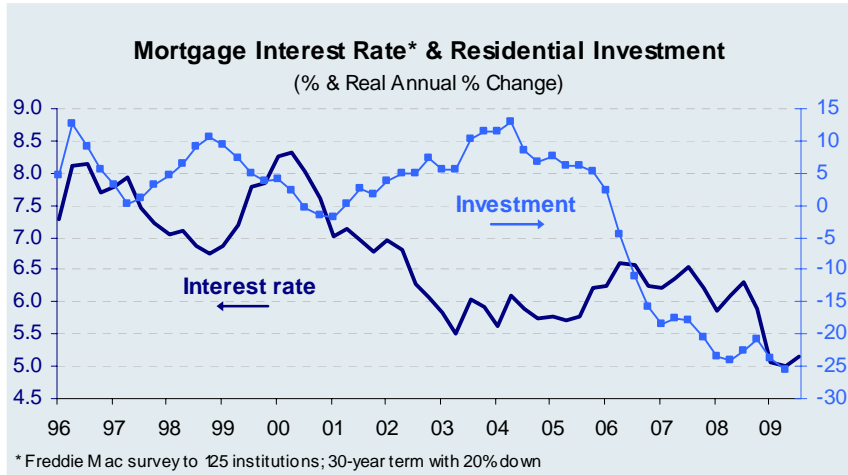
PCE is expected to face many challenges along the path to recovery. Job destruction is forecasted to continue into 2010 and the unemployment rate could creep up further past the current 9.8% to a high of 10.1%. As a consequence of the weak labor market, income growth is expected to remain subdued. Furthermore, consumers are reducing their debt and access to credit is limited for those who seek it. In 2009, consumer credit outstanding has already dropped \$88.1B through July. The combination of these factors will hold personal spending at low levels for some time.

Non-Residential Investment

The decline in non-residential investment (NRI) is expected to slow in the near future. Increases in industrial production of high tech goods and above benchmark levels of the ISM indicate that the worst of the adjustment for NRI may have passed.

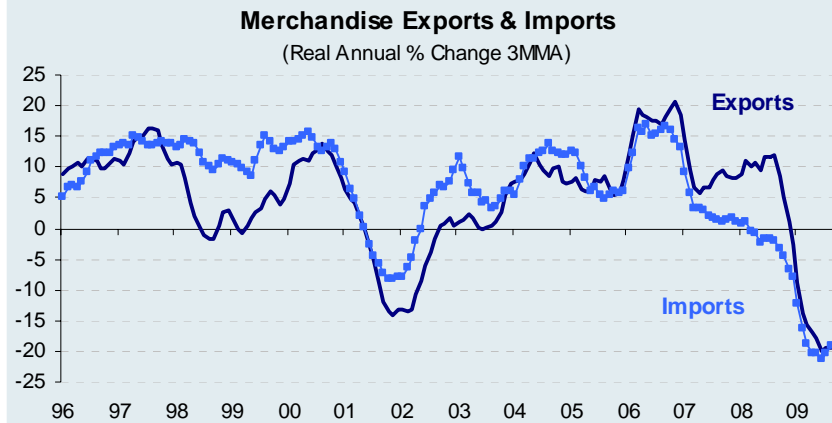
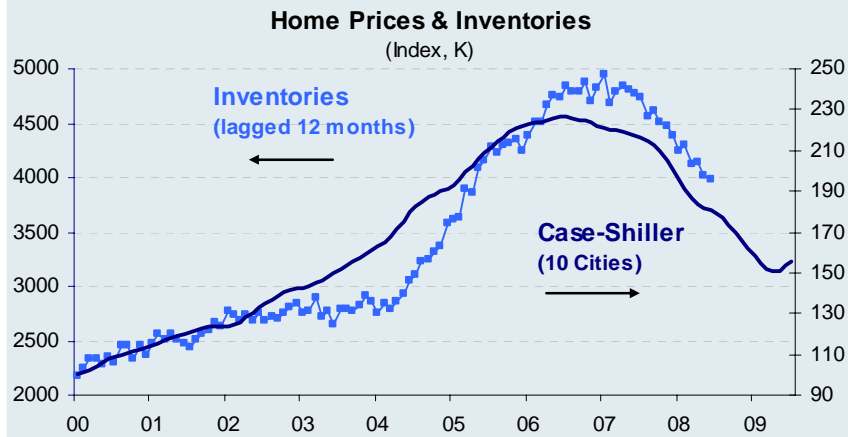
Further positive signs are that corporate profits and cash flows are beginning to recover and business confidence, as reflected in the ISM, is improving. Nevertheless, they all remain at low levels, which indicates that investment will remain subdued.

On the downside, corporations will continue to face weak demand, even as recovery takes hold. Furthermore, they are operating with significant excess capacity, which will be utilized before new investments are made. Lastly, credit markets will continue to hinder corporate spending as lending remains tight. Given these factors, non-residential investment is expected to decline further, albeit at a slower pace, in the upcoming quarters.



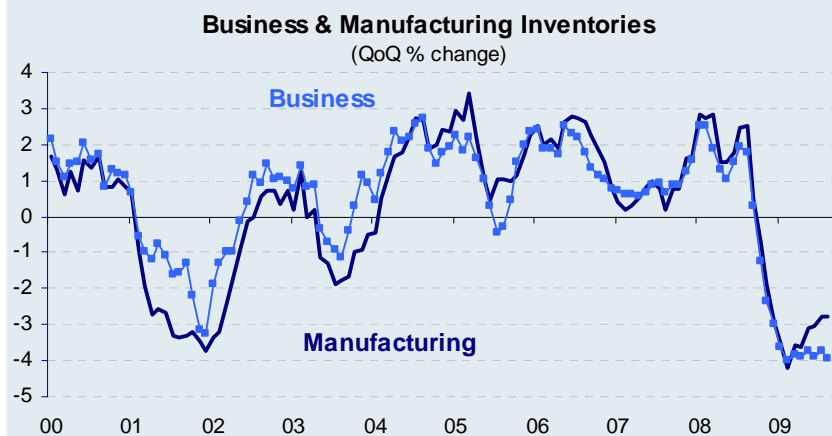
Residential Investment

Housing starts have begun to pick-up due to improvement in the housing market and stabilization of home prices, which appear to have reached the bottom of the adjustment. While this data is positive, levels remain extremely low and demand for new homes will continue to be weak. As a result, the decline in residential investment is expected to slow in the upcoming quarters and overall investment will remain low.



Net Exports

Net exports are expected to remain supportive of economic growth. In recent months, the year-over-year decline in both exports and imports has eased, reflecting stabilization in demand both at home and abroad. Furthermore, stronger growth in emerging markets is expected to support faster expansion of exports relative to imports, which is the premise of our baseline scenario.



Private Inventories

Inventories, which have been falling since 3Q08, are still in the process of adjusting downward. Nevertheless, the quarterly rate of change, while still negative, has stabilized, indicating that the decline in inventories could be close to an end. As a result, we expect the change in inventories to ease moving forward, thus contributing positively to GDP.