

# Weekly Economic Commentary

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### Highlights

The current expansion has lagged the average post-WWII recovery.

Government spending has been a sizable contributor to the weakness of this recovery, as have housing and business investment in structures.

While some of the factors that have weighed on the recovery are lifting, others (notably rising interest rates) are poised to take their place and we continue to expect modest growth of near 2.0% in 2013.

Please see the LPL Financial Research Weekly Calendar on page 3

## Measuring Economic Expansion

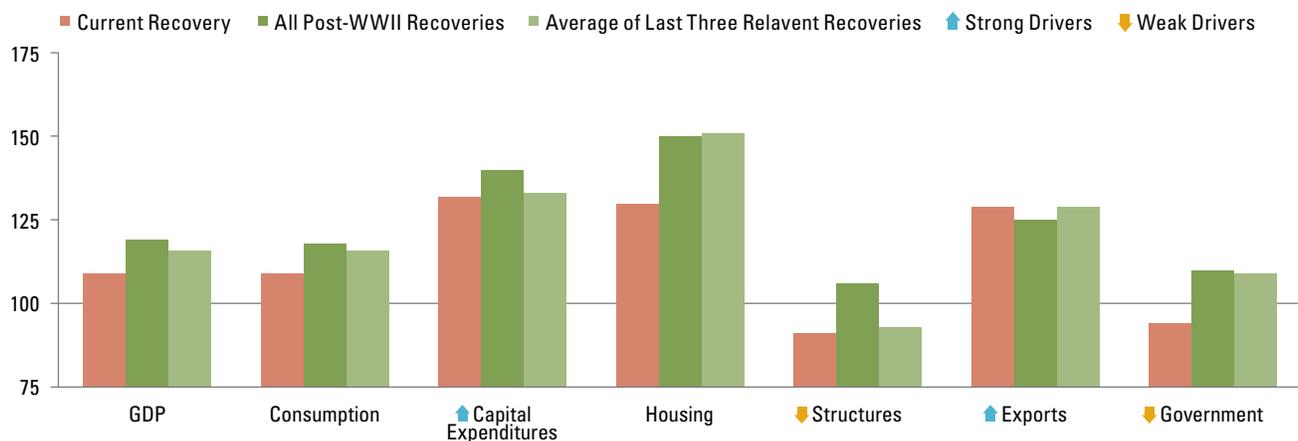
The U.S. economy is now in the fifth year of the 12th economic recovery (or expansion) since the end of World War II. It is already the sixth-longest expansion and would have to last another year to become the fifth longest, as discussed in last week's *Weekly Economic Commentary: Revisiting the Recovery*. This week, we will compare the performance of gross domestic product (GDP)—the broadest measure of economic activity—and its components (consumer spending, business capital spending, government spending, etc.) in the current recovery to previous economic recoveries.

### Where We Stand vs. Prior Recoveries

The Great Recession of 2007–2009 ended in the second quarter of 2009, and the economy has been growing for 16 quarters now. Of the other 11 economic expansions since the end of WWII, just five lasted at least four years—the recoveries that began in 1961, 1975, 1982, 1991, and 2001.

By the end of their fourth year in the five expansions that lasted 16 quarters or more (or “comparable recoveries”), real GDP, on average, had increased by a cumulative 19% from the end of (or trough) the prior recession. In the current expansion, the economy has grown by just 9% over the last four years (from \$14.4 trillion in Q209 to \$15.6 trillion in Q213) [Figure 1].

### 1 Government Spending and Business Spending on Structures Have Held Back the Recovery Trough Quarter = 100



Source: Bureau of Economic Analysis, LPL Financial Research 08/12/13



Please see the April 29, 2013 *Weekly Economic Commentary: The ABCs of GDP* for more details on the composition and drivers of GDP growth.

## 2 Government Spending and Business Spending on Structures Have Been Weak Spots in This Recovery Trough Quarter = 100



Source: Bureau of Economic Analysis, LPL Financial Research 08/12/13

## The Pace of GDP

Consumer spending, which accounts for more than two-thirds of GDP, has matched the performance of overall GDP in this expansion, growing 9% from the trough versus an average 18% gain from the trough in the other five post-WWII comparable recoveries. With the exception of exports, all the other major components of GDP—business capital spending, housing, business spending on structures (office parks, malls, factories, etc.), exports and government spending—have badly underperformed the average post-WWII recovery. Why has the current recovery been so lackluster even after such a severe recession?

Several factors along with uncertainty over legislative and regulatory policy in Washington have contributed to weak growth, not only in consumption, but in all the sectors of the economy over the past four years. These factors include strained balance sheets, only modest gains in the labor market, banks' unwillingness to lend after billions of losses in the housing bust, and a weak external environment (recession in Europe, slowdown in China, and emerging markets).

While the current expansion has lagged comparable expansions in almost every category of GDP, it may not be an "apples-to-apples" comparison. As we noted in last week's *Weekly Economic Commentary*, the U.S. economy has changed significantly since the end of the inflationary 1970s. The last 30-plus years has seen the transformation of the U.S. economy from a domestically focused manufacturing economy to a more export-heavy, service-based economy. In general, this economic structure is less prone to inventory swings that drove the shorter boom-bust cycles of the past, and has led to longer expansions. On average, the last three expansions—the ones that began in 1982, 1991, and 2001—lasted 95 months, or roughly eight years. Using those three expansions as the standard, at 49 months (16 quarters) the current economic expansion is at its midpoint, but it has been far less robust.

Using just the last three economic expansions for comparison, the pace of GDP growth in the past four years still lags the average. GDP grew by 16% over the first four years of the last three expansions, and even by that standard the current recovery (9%) is not up to par. Still, in every major category—except exports, where the current recovery matches the prior three—the current expansion falls short, in some cases far short, of the past three recoveries, especially in government spending, housing, and business investment in structures.

## Taking the Pulse of Government Spending

Government spending in all post-WWII expansions has generally not kept pace with overall growth in GDP. Four years into the average post-WWII expansion, government spending (federal, state, and local) has increased, by 10%, about half of the increase in overall GDP (20%) [Figure 2]. In the past 30 years, government spending in the first four years of expansion has increased,



## LPL Financial Research Weekly Calendar

	 <b>U.S. Data</b>	 <b>Fed</b>	 <b>Global Notables</b>
2013			
12 Aug	<ul style="list-style-type: none"> <li>Monthly Treasury Statement (Jul)</li> </ul>		<ul style="list-style-type: none"> <li>Japan: Machine Orders (Jun)</li> </ul>
13 Aug	<ul style="list-style-type: none"> <li><b>NFIB Small Business Sentiment Index (Jul)</b></li> <li><b>Retail Sales (Jul)</b></li> <li>Business Inventories (Jun)</li> </ul>	<ul style="list-style-type: none"> <li> Lockhart</li> </ul>	<ul style="list-style-type: none"> <li>Eurozone: Industrial Production (Jun)</li> <li><b>Germany: ZEW Survey (Aug)</b></li> <li>Japan: Minutes of July 10–11 Bank of Japan Meeting Released</li> </ul>
14 Aug	<ul style="list-style-type: none"> <li>PPI (Jul)</li> </ul>	<ul style="list-style-type: none"> <li> Bullard*</li> </ul>	<ul style="list-style-type: none"> <li><b>Eurozone: GDP (Q2)</b></li> <li>UK: Minutes of August 1 Bank of England Meeting Released</li> </ul>
15 Aug	<ul style="list-style-type: none"> <li>Initial Claims (8/10)</li> <li><b>Empire State Manufacturing Index (Aug)</b></li> <li>CPI (Jul)</li> <li>Industrial Production (Jul)</li> <li>Capacity Utilization (Jul)</li> <li><b>NAHB Homebuilder Sentiment (Aug)</b></li> <li><b>Philadelphia Fed Index (Aug)</b></li> </ul>		
16 Aug	<ul style="list-style-type: none"> <li>Housing Starts (Jul)</li> <li>Consumer Sentiment (1H Aug)</li> </ul>		<ul style="list-style-type: none"> <li>Eurozone: Trade Balance (Jun)</li> <li>Saturday 8/17 China: Property Prices (Jul)</li> </ul>

 Hawks: Fed officials who favor the low inflation side of the Fed's dual mandate of low inflation and full employment

 Doves: Fed officials who favor the full employment side of the Fed's dual mandate

\* Voting members of the Federal Open Market Committee (FOMC)

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on average, by just 9%, lagging the overall pace of economic activity but still adding to growth. However, in the current expansion, government spending has decreased by 6%, with state and local government spending taking the biggest hit (down 8% from the second quarter of 2009). At the federal level, overall spending is down 5% from the second quarter of 2009, with an 8% cut to defense spending more than offsetting a 4% increase in non-defense spending.

Spending at the state and local level is now stabilizing, after more than five years of spending cuts. At the federal level, the impact of the sequester, the fiscal cliff, and defense cuts were still reverberating through the economy as the second half of 2013 began. On balance, government spending should be less of a drag on growth in the next four years than it was in the first four of the recovery, when government spending added to growth in only three of 16 quarters.

## Taking the Pulse of the Housing Market

Although it got a late start, housing—at the epicenter of the Great Recession—has outperformed the overall economy over the past four years (as it typically does during expansions), but underperformed relative to its performance in past expansions. Housing (as measured by investment in new residential structures) has increased by 30% over the past four years, far above the 9% gain in GDP in that span. But the 30% gain pales in comparison



The recent rise in mortgage rates is a concern, but will likely only slow, not stop, the ongoing recovery in housing, which is being driven, in part, by cash buyers and pent-up demand.

to the 50% average gain in housing in the first four years of all post-WWII recoveries, and also falls far short of the 51% average gain in housing during the past three expansions (1982, 1991, and 2001). The hangover from the housing bust (large amounts of unsold inventory, difficulty in obtaining financing, poor consumer credit profiles, and a lackluster labor market) helps explain housing's underwhelming performance in this recovery.

Looking ahead, our view remains that housing is in the early stages of a long recovery, aided by pent-up demand, near record-low inventories, near record-high housing affordability, a steadily improving labor market, and banks' increased willingness to lend to borrowers. The recent rise in mortgage rates is a concern, but will likely only slow, not stop, the ongoing recovery in housing, which is being driven, in part, by cash buyers and pent-up demand.

### Taking the Pulse of Business Investment in New Structures

On average, business investment in new structures (shopping malls, office buildings and office parks, factories, etc.) over the first four years of all post-WWII expansions rose 6%, lagging the pace of the average recovery in GDP (19%) [Figure 2]. Why does business investment in structures lag overall growth? In part, because these are typically very large projects with long lead times and require outsized commitments of capital, so businesses want to make sure the expansion is well entrenched before committing resources. As a result, this segment of GDP tends to lag during the early part of expansions and then picks up steam as the expansion matures. We would expect the same pattern to repeat in the current expansion.

In the three expansions since 1980, business investment on structures actually dropped by 7% over the first 16 quarters of the expansion, lagging the average of all post-WWII expansions (a 6% gain over four years). But the current expansion has seen business investment in structures fall by 9% over the past four years, an even worse performance than in the past three expansions (a 7% decrease). Business uncertainty around the health and longevity of the expansion, the turmoil in Europe and slowdown in China, as well as the legislative and regulatory backdrop, overwhelmed the positive impact of lower financing rates and years of pent-up demand. We expect business investment in structures to pick up steam and become a bigger contributor to growth in the second half of the expansion, aided by somewhat less legislative and regulatory concern and more confidence in the economy.

### Expansion Lagging Average Post-WWII Recovery

Although it is four years old, the current economic expansion has not felt like a real expansion to many consumers and businesses. Indeed, the data suggest that in virtually every segment of the economy, the current expansion has lagged the average post-WWII expansion and the three expansions since 1980, which are more comparable. While some of the factors that have weighed on the expansion are lifting, others, notably rising interest rates, are poised to take their place and we continue to expect modest (near 2.0%) growth in 2013. ■



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**IMPORTANT DISCLOSURES**

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory.

The Federal Open Market Committee (FOMC), a committee within the Federal Reserve System, is charged under the United States law with overseeing the nation's open market operations (i.e., the Fed's buying and selling of United States Treasury securities).

Quantitative easing is a government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.

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