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Improving Payrolls Leads to Upward GDP Revisions

Based on the improving trend in the U.S. consumer sector, the Argus Economics Department has modestly increased its GDP estimates for 4Q11 to 3.1%. Our new forecast assumes improved growth within the Consumer sector and solid growth in Technology spending. These are expected to offset curtailed growth in government spending. We have also modestly increased our forecasts for 2012. Our quarterly estimates range from 2.3% to 2.9%, and average 2.7% — still below the "normal" U.S. GDP growth-rate trend of 3.0%). Our current estimates do not call for a recession through 2012.

3Q GDP Growth Downwardly Revised

The Commerce Department, in its final revision, announced that 3Q GDP increased 1.8%, down from its previous estimate of 2.0%. The bulk of the revision was driven by a reduction in consumer spending. Key trends included:

- Real Personal Consumption Expenditures, the most-important component of GDP, grew 1.9% in 3Q, despite the decline in healthcare spending. This rate contrasted with a weak 0.5% gain in 2Q.
- Drilling down into PCE, spending on durable goods increased an upwardly revised 5.7%, in contrast to a decrease of 5.3% in 2Q.
- Consumer spending on services was dialed back to 1.9% from a previous 3Q estimate of 2.9%.
- Technology spending also advanced. Equipment & Software jumped 16.2%, compared with an increase of 6.3%.
- Even real estate moved forward, with a gain of 1.2% (though down from 4.2%).

Even with the downward revision, the 3Q growth rate indicates a pick-up from the first and second quarters, when the U.S. economy advanced at an average rate of 0.8% (please see GDP Table on Page 3). The economy remains historically weak (see Chart 1 on Page 2).

Let's take a closer look at the underlying trends. First the Consumer. During 3Q, Personal Consumption Expenditures accounted for 70.9% of GDP and grew 1.9%. The good news included a 5.7% increase in Durable Goods. We also note recent improvements in Consumer Confidence, Retail Sales and Personal Income (see Chart 2)

The next category, Investment, showed a slowdown — to 3.0% growth in 3Q versus 6.0% growth in 2Q. The main culprit was a draw-down in inventories. We think the European debt problems and U.S. credit downgrade may have had an impact on corporate confidence. Still, spending on Equipment & Software increased at a 16.2% rate. Further, low interest rates encouraged investment in Structures, which gained 14.4%. We think the recent pick-up in the ISM Index, as well as consistent growth in Industrial Production and Capacity Utilization, points to continued growth in the Investment Sector (Chart 3)

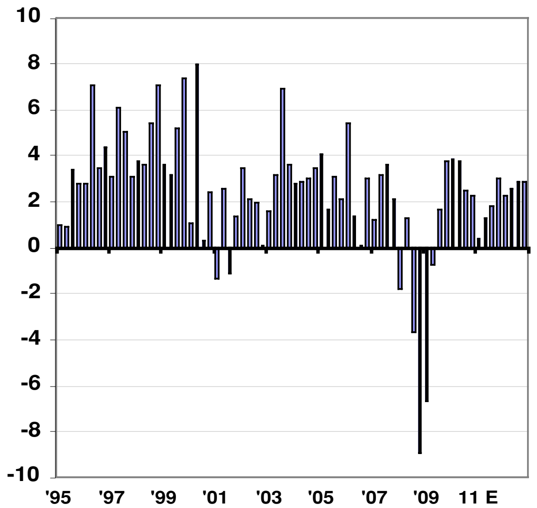
The weak dollar also had an impact on the economy. During 3Q, U.S. exports of goods rose 4.9% and exports of services increased 4.0%. Imports of goods and services increased just 1.3%. The recent stable trend to the dollar could slow export growth and reduce import growth over the next 1-2 quarters.

Government spending again had a muted impact during 3Q. Government spending increased only 2.0%. State & Local spending declined 1.6%.

(continued on back page)

TABLE 1

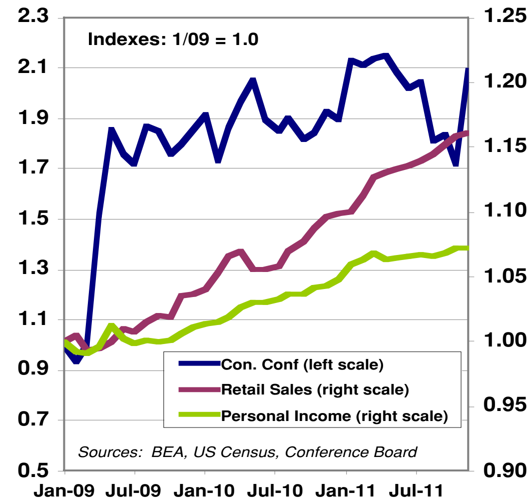
REAL GDP



We have recently been increasing our GDP estimates, based on a stabilizing consumer sector.

TABLE 2

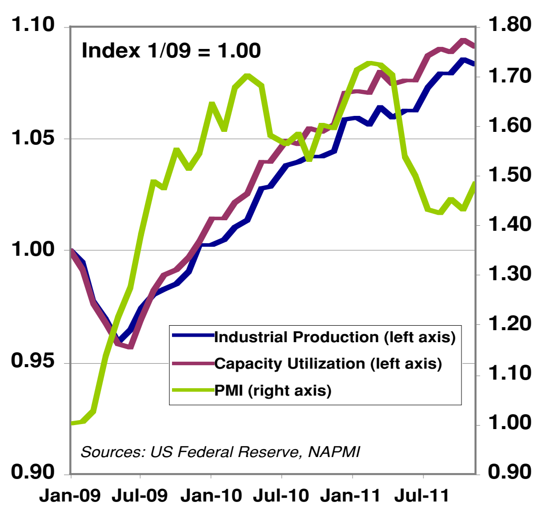
CONSUMER TRENDS



Consumer confidence has rebounded after the S&P U.S. credit-rating downgrade; spending has continued to grow.

TABLE 3

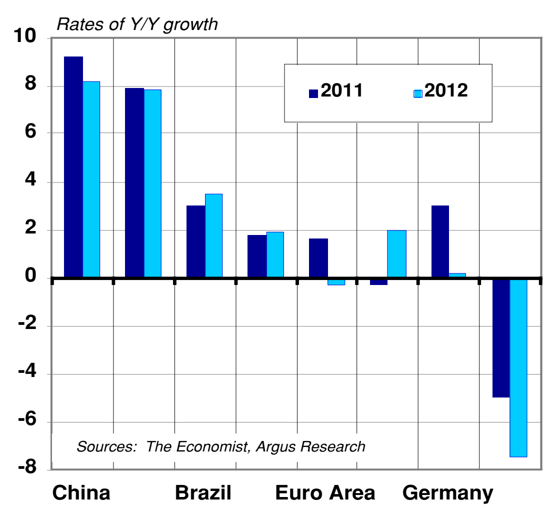
INDUSTRIAL SECTOR METRICS



Industrial trends appear positive, though growth may slow a bit in 1H12 if the dollar remains strong.

TABLE 4

GLOBAL GDP FORECAST



Global economic-growth forecasts are mixed. Europe is expected to be weak, while the Pacific Rim rebounds (driven by China).

GDP FORECAST

Revised as of December 30, 2011

	2009 A				2010				2011 E				2012 E			
	I	II	III	IV	I	II	III	IV	I	II	III	IV	I	II	III	IV
Real Gross Domestic Product	-6.7	-0.7	1.7	3.8	3.9	3.8	2.5	2.3	0.4	1.3	1.8	3.1	2.3	2.7	2.9	2.9
Annual:				-0.5				3.1				1.7				2.7
Personal Consumption	0.6	-0.9	2.2	1.9	1.9	2.8	2.8	3.9	2.4	0.5	1.9	2.4	1.2	1.6	1.7	2.5
Goods	2.5	-3.1	7.2	2.9	5.7	3.4	5.1	8.9	5.3	-1.9	1.8	2.6	1.7	1.5	1.8	1.8
Durables	3.9	-5.6	20.4	0.4	8.8	7.8	8.8	17.2	11.8	-5.3	5.7	3.8	3.2	3.1	3.1	3.1
Non-Durables	1.9	-1.9	0.0	5.6	4.2	1.9	3.0	4.3	1.6	0.2	-0.6	1.9	0.8	0.4	1.0	1.0
Services	-0.3	0.2	0.8	1.0	0.1	2.5	1.6	1.3	0.8	1.9	1.9	2.3	1.0	1.6	1.6	2.9
Gross Domestic Investment	-50.5	-23.7	-7.0	66.1	29.1	26.8	9.0	-5.3	4.5	6.0	3.0	3.5	1.5	4.0	3.5	4.5
Fixed Investment	-39.0	-12.5	-14.4	20.2	3.3	22.8	2.4	7.4	2.0	8.6	13.0	3.0	0.9	4.1	3.5	4.6
Non-Residential	-39.2	-9.6	-8.5	6.7	7.8	21.9	11.8	8.6	3.0	9.7	15.8	3.3	1.1	4.3	4.3	5.6
Structures	-43.6	-17.3	-18.4	-18.1	-17.8	7.4	4.2	10.6	-14.4	22.6	14.4	3.4	0.4	1.2	1.2	1.2
Equip. & Software	-36.4	-4.9	1.5	19.0	20.4	23.2	14.2	8.0	8.7	6.3	16.2	3.3	1.3	5.2	5.2	6.8
Residential	-38.2	-23.2	18.9	3.7	-12.3	22.8	-27.7	2.5	-2.5	4.2	1.2	1.7	0.3	2.9	0.0	0.0
Change in Pvt. Inventories ($BIL)	-113.9	-160.2	-139.2	-19.7	44.1	68.8	92.3	38.3	49.1	39.1	-2.0	0.0	10.0	10.0	10.0	10.0
Net Exports																
Exports	-29.9	-4.1	8.4	-2.5	11.4	10.0	10.0	7.8	7.9	3.6	4.7	0.9	1.0	-0.3	-0.3	1.8
Goods	-36.9	-6.3	17.5	23.1	14.0	11.8	9.0	9.2	10.6	2.5	4.9	0.6	1.1	-0.7	-0.7	0.9
Services	-13.6	0.2	24.6	34.1	5.8	6.1	12.5	4.7	1.7	6.2	4.0	1.6	0.8	0.8	0.8	3.8
Imports	-36.4	-14.7	5.6	2.7	11.2	21.7	12.3	-2.3	8.3	1.4	1.3	2.1	0.2	-8.8	-8.8	-3.7
Goods	-41.0	-16.5	21.2	16.1	12.0	26.0	12.4	-0.5	9.6	1.5	0.5	2.6	0.3	-9.4	-9.4	-4.4
Services	-11.5	-7.5	25.1	20.6	7.8	3.2	11.6	-10.4	2.2	0.4	4.9	-0.3	-0.5	-5.4	-5.4	0.0
Gov't Purch.of Goods & Svcs.	-2.6	6.7	3.2	-1.3	-1.6	3.8	1.0	-2.8	-5.9	-0.9	-0.1	0.8	1.3	0.8	0.6	0.3
Federal	-4.3	11.4	7.9	0.1	1.8	8.8	3.1	-3.0	-9.4	1.9	2.0	2.7	2.3	1.9	1.5	0.7
National Defense	-5.1	14.0	8.4	-3.6	0.4	6.0	5.7	-5.9	-12.6	7.0	5.0	0.3	1.0	1.7	1.1	0.0
Non-Defense	-2.4	6.1	7.0	8.3	5.0	14.6	-1.8	3.0	-2.7	-7.6	-3.8	7.9	5.0	2.2	2.2	2.2
State & Local	-1.6	3.9	-0.6	-2.2	-3.8	0.4	-0.5	-2.7	-3.3	-2.8	-1.6	-0.6	0.5	0.0	0.0	0.0
Addendum:																
GDP Price Deflator (implicit)	1.0	0.3	0.7	-0.3	1.1	1.6	1.6	1.9	1.8	2.0	2.1	2.1	1.8	2.0	2.0	2.0

(continued from page 1)

Looking Ahead: Boosting Our Outlook

Based on the stable-to-improving trends in the Consumer and Industrial sectors, we have modestly increased our estimates for 4Q11 and 2012. We are now expecting the economy to advance an average 2.7%. Here are our key assumptions:

- We look for an expanding jobs environment to allow for modest growth in Personal Consumption Expenditures, though not at a robust pace. This component of GPD accounts for almost 71% of the economy (including the offsetting impact of imports). Our estimates call for growth of 2% on average through 2012.
- As companies slowly begin to rehire, we anticipate that spending on Equipment & Software, which drives productivity, will grow at a rate of 5%-8%.
- The low inventory-to-sales ratio implies companies will resume investing in inventories, and that the Industrial sector will continue to grow.
- The $320 billion U.S. housing industry has been flat to higher in recent quarters, and we expect stability (if not 1%-2% growth) into next year.
- Though the dollar is currently strengthening amid the crisis fears in Europe, we anticipate that dismal financial condition of the U.S. government should reverse the trend in 2H 12, sending the greenback lower and making U.S. goods, including commodities, more attractively priced in global markets (see Chart 4).
- Federal government spending rose at a 2.0% pace in 3Q, after having declined for two of the previous three quarters. Given that 2012 is a Presidential election year, we anticipate low-single-digit growth.
- State & Local government spending declined 1.6% in 3Q, and has fallen in seven of the past eight quarters.

Positive Signals

We conclude that recession can be avoided. Here are some of the factors we are following:

- Federal Reserve activity. The Fed is moving forward with its Operation Twist program, selling short-term paper and buying $400 billion in long-term Treasuries — this in an attempt to keep long-term interest rates low and spur investment. Proceeds from sales of mortgage-related securities are being reinvested in MBS, helping to keep mortgage rates low. The housing market remains the weakest factor in U.S. GDP. We estimate that the housing industry will remain under pressure for the next three years.
- Unemployment Claims. A year ago, claims averaged 453,000 per week and were rising. However, claims recently have been below 400,000. While the current level of claims is still higher than we would like to see, we think it is consistent with jobs growth, on average, of 75,000-125,000 per month.
- Retail sales. The preliminary retail store sales tally for the Thanksgiving weekend showed a 16.4% surge to a record $52.4 billion. Store traffic, including internet touches, jumped 6.6% to 226 million, also a record.

Risks of Recession

At the same time, there are risks that our forecasts may be too optimistic.

While we don't normally pay much attention to consumer confidence surveys (we prefer the hard data from the government on sales, or better yet the same-store sales figures from the companies themselves), the surveys of business leaders are important because businesses have the ability to create jobs. Recently, the ISM Index has been hovering at the break-even level between growth and recession. If the jobs base starts to shrink, the odds of a recession become higher.

The political climate in Washington is another factor that could derail economic growth. The Congressional Super Committee of budget-cutters punted their responsibility, missing a chance to take decisive action to tackle government debt. As a matter of fact, given an almost-no-growth economy, we think the government's focus should be on creating jobs in the near term, not on reducing spending growth three-to-five years down the road.

The debate in Washington also has additional implications for the economy. The S&P credit-rating downgrade hasn't yet led to higher interest rates for the U.S. government or for most corporations. But the downgrade has raised questions and sapped confidence from purchasing managers and consumers in the market for big-ticket items. This confidence must be restored to lift economic growth rates back to normal levels.