Economy Outperforms Expectations But…

A Surprising First Quarter

The first quarter of 2013 is shaping up to be stronger than early expectations despite what appears to be some weakening in March. Real gross domestic product is expected to grow in a range of 2% to 2.5%. This is far better than the 0.4% increase registered during the fourth quarter of 2012 and far stronger than the 1% projections entering 2013. Despite uncertainties from Washington regarding the federal budget and the enactment of higher taxes, consumers and businesses combined to "shake off" these "headwinds" and increase their spending during January and February.

Fueling consumer spending gains was the huge increase in consumer income in last year's fourth quarter as companies paid bonuses and dividends to beat the expected increase in tax rates in 2013. Importantly, job creation continued the expanded gains in the fourth quarter of last year. While March's preliminary employment report was disappointing (only 88,000 new jobs), first quarter job creation was impressive. From November, 2012 through February of this year, average monthly job creation was in excess of 200,000, including over 200,000 jobs created in January and February of this year. This compares to an average monthly job gain of approximately 160,000 for the previous four month period, July to October, 2012. Increased hiring on top of the increase in fourth quarter income led to increased consumer spending. In January and February of this year, personal consumption expenditures increased at an annualized rate of over 3%. In the fourth quarter of last year, the comparable statistic was 2.0%. It is important to note that consumer spending in this year's first quarter has also been largely fueled by the surge in the stock market (up by more than 11%, as measured by the Dow Jones Industrial Average, in the first quarter) and a steady recovery in housing prices (up by more than 11% in the past year). Combined with the reduction in consumer household debt, particularly credit card debt, consumer balance sheets are the healthiest since before the recession.

Despite lackluster earnings growth, the business sector has also surprised analysts with increased activity that began in last year's fourth quarter. Despite some weakening in March, industrial orders, production and importantly, backlogs, have increased in the first quarter. The services sector also experienced expansion in the first quarter.

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Looking Ahead

While events in the first quarter were surprisingly positive, new developments cause us to be cautious regarding the rest of the year. Continued strength in the auto and construction sectors, particularly housing, are expected to lead the economy in the spring and summer aided importantly by continued low interest rates from the Federal Reserve. In addition, business capital spending appears to be holding at elevated levels as companies replace labor with capital equipment to escape rising healthcare costs and increase productivity. But March data is indicating the U.S. economy is showing signs of at least a pause in the accelerated growth of the past four months. It could slow significantly during the next few months as federal spending cuts begin to take hold. The Congressional Budget Office projects that $1.2 trillion in federal spending cuts could lead to approximately 750,000 job losses in 2013 alone. The first quarter surge in consumer spending has taken down consumer savings rates to their lowest levels since before the recession. Under the best of circumstances the consumer is expected to re-liquefy in the second quarter. This will leave employers with the dilemma of whether to hire and spend further or wait for end demand to become clearer in the second half of this year. In addition, corporate profits remain challenged by unrecovered costs and weak overseas earnings. The large cutbacks in federal spending are unlikely to be completely offset by expansion in the private sector, thus leaving a depressant to overall GDP growth this year. Finally, the world economy, including the U.S., is experiencing deepening weakness in exports as Europe continues in recession. This export weakness is hurting key U.S. export markets in Asia, the Middle East and Latin America. Thus, U.S. economic growth for the remainder of this year will have to continue to be shouldered by personal consumption and business capital investment. We continue to use a full year GDP growth rate of approximately 2% for the U.S. given a slowdown from first quarter economic activity and the negative impacts of continuing federal spending cutbacks. Our outlook is also influenced by uncertainty regarding federal budget negotiations in the current quarter which could also have further negative ramifications if not settled.