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WEALTH MANAGEMENT

GDP Growth Decelerates in Second Quarter – is the Economy Weakening?

A Statistically Weak Second Quarter

The second quarter of 2013 is now expected to show slower economic growth below the revised 1.8 percent reported in the first quarter. The latter was a dramatic downward revision from the 2.4 percent growth rate previously reported. Continuing the trends seen since the end of the recession, strength in one quarter has led to retrenchment in a subsequent one and this year's second quarter at first glance appears to follow the same script. After surging out of last year's fourth quarter, economic growth momentum carried through January and February before weakening in March. That weakness continued through April and much of May before signs of economic strength began appearing just before the Memorial Day holiday. Belying the impact of sequestration, consumer spending increased, particularly for leisure time activities and auto and housing-related items. After a slow start, second quarter retail sales, excluding spending on groceries and at the gas pump, increased at an annualized rate of approximately 7 percent, well above the 2 percent growth rate in the first quarter. As the second quarter ended, domestic auto sales increased to an annual sales rate of 16 million units. This is the highest level since December, 2007.

Feeding the increase in consumer spending has been a material improvement in job creation during the second quarter. After growing by an average of approximately 180,000 jobs per month in the second half of 2012, monthly job creation increased to approximately 200,000 in the second quarter and first half of 2013. While the mix of new jobs is largely in lower wage services and increasingly part time employment, nonetheless they resulted in more paychecks to more workers. Those paychecks are increasingly being spent. Also fueling consumer spending has been a large improvement in consumer sentiment in the second quarter. After beginning the second quarter with a reading of 69 in April, the Conference Board Survey of Consumer Confidence rose to a reading of over 81 in June. This was the highest reading in this survey since 2007 and reflected the increased level of consumer confidence coming from a rising stock market (the Dow Jones Industrial Average rose by nearly 14 percent in the first half of 2013); rising home values (The Case-Shiller Home Price Index increased from a level of 146 in the first quarter to over 152 in the beginning of the second quarter); and the increase in employment.

While increased jobs and consumer spending boosted the predominant services sector in the economy, weak foreign economies and continued conservative business spending domestically, resulted in weakness in the manufacturing sector in the second quarter. The ISM Index of Manufacturing Activity fell from a reading of 54.2 in February to a low of 49.0 in May before improving to 50.9 in June. The improved June reading reflects improved levels of orders, shipments and backlogs from the May lows. Initial readings from regional manufacturing surveys in July point to continued improvement in the manufacturing sector going into the third quarter. In addition, surveys of corporate managements indicate an increase in capital spending in the second half of this year and into next as the pressure to meet increasing domestic demand with increased productivity and cost savings force capital budgets to be spent.

Offsetting the positives in the consumer and services sectors of the economy are negative contributions to GDP from the government sector as a result of previous budget cutbacks and the current impact of sequestration; negative net exports as a result of continued recession in Europe and significantly slower growth in emerging market economies; and diminished inventory investment by American business reflecting the slowdown in activity coming out of the first quarter. These factors we believe will result in second quarter GDP growth of 1 to 1.5 percent.

Outlook

However, the data coming out of the second quarter points to stronger economic growth in the second half of this year. At this time, we expect second half GDP growth of approximately 2 to 2.5 percent and we continue to project full year 2013 GDP growth of approximately 2 percent. This growth is expected to be led by continued gains in personal spending and auto and housing sales. We also believe business capital investment will be stronger in the second half than the first. Offsetting these positives are expected negative contributions from government and net exports. The economic outlook for the remainder of this year and next are importantly dependent on the following developments: the reduction and elimination of the Fed's monetary stimulus program and the resulting rise in interest rates; the current spike in energy prices due to unrest in the Middle East; and the outcome of upcoming federal fiscal issues regarding the federal budget and debt ceiling. Despite comments to the contrary, a stronger economy will allow the Fed to pare back its monetary stimulus. A further rise in energy prices from current levels could force consumers and businesses to reduce overall spending. A failure to reach agreement on a new federal budget with funding and an increase in the debt ceiling for next year will revive the uncertainty and concerns among consumers and businesses about the economy going forward. At this time, we are optimistic these developments will not derail the current economic improvement. However, we are not complacent and are watching these events closely and are prepared to adjust our outlook as these circumstances unfold.