

# Scout Investments

## Global Economic and Market Outlook

### Slumping Towards Mediocrity

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#### 2011 Outlook

**GDP GROWTH:**  
1.8%

**UNEMPLOYMENT:**  
9.0%

**INFLATION:**  
1.75%

**FED FUNDS RATE:**  
0.35%

GDP growth is low. From an historical perspective, the average annual growth rate (after inflation) of the U.S. economy has been 3.2 percent (since the end of WWII). We have written ad nauseam about our theme “Long, Hard Slog.” We first developed this theme in the fourth quarter of 2007. We have further developed this concept and maintain the view that due to de-leveraging activities, the U.S. economy could grow at a lackluster rate.

Last Friday, we were surprised by the magnitude of the annual Gross Domestic Product (GDP) “readjustments” which came out of Washington. Once per year, the Bureau of Economic Analysis (BEA) adjusts quarterly GDP growth rates for the previous three years. The revisions this year were particularly large. Listed below are the announced growth rates, both before and after adjustments.

	<u>Growth Before Adjustment</u>	<u>Growth After Adjustment</u>
2008	-2.7%	-3.3%
2009	+0.3%	-0.5%
2010 (Q1)	+3.7%	+3.9%
2010 (Q2)	+1.7%	+3.8%
2010 (Q3)	+2.6%	+2.5%
2010 (Q4)	+3.1%	+2.3%
All of 2010	+2.8%	+3.1%
2011 (Q1)	+1.9%	+0.4%
2011 (Q2)		+1.3%

There are a number of observations. **First, the magnitude of the changes is large.** Going back to the first quarter of 2010, the average adjustment per quarter was 0.9 percent! In an environment where the economy has been growing by an annualized rate of 2.4 percent (rate of growth since Q1 2010), an average adjustment of 0.9 percent seems extremely large.

**Second, not shown in the numbers above, the recession (Q3 2008 – Q2 2009) was much more vicious than previously thought.** Per the adjusted data, the economy shrunk by an annualized rate of 5.0 percent as compared to the previous estimate of 4.1 percent.

**Third, the economic recovery (and now expansion) phase of this cycle has been slightly less robust than previously thought.** Since the end of the recession, the economy has grown by an average annual growth rate of 2.5 percent (as compared to the previous data, which showed average growth of 2.6 percent). At the end of the day, this is not a major adjustment.

**Fourth, what should be viewed as a major adjustment, is the *momentum* of economic activity – on balance the economy is showing strong signs of growth deceleration.** During the last 12 months, the economy has grown by 1.6 percent. Previously, we thought the economy had been growing by 2.5 percent (Q3 2010 – Q1 2011). So, the economy is growing at a rate of 0.9 percent less during the last number of quarters than previously thought. On the surface, this adjustment strongly suggests that the risks of the economy slipping into a recession, due to an external shock, are much higher than previously thought. At the least, this adjustment helps explain why the labor market has been so weak; productivity appears to be growing by roughly 1.8 percent which is more than enough “organic” growth at a business level to keep people from hiring new employees.

## Inside Baseball

Understanding these revisions is particularly important. It appears the economy is growing slightly above “stall speed.” As was stated above, the risks of slipping into a recession are higher, due specifically to the momentum in economic growth, which is weakening.

GDP growth is a combination of Consumption, Investment, Government Activity, Inventory Adjustments and Net Imports. Stated in an algebraic method,  $GDP+C+I+G+IA+X$ . In our opinion, the two more “organic,” or domestic economy-oriented segments of this equation are consumption and investment. These areas of the economy represent consumer spending and the majority of capital spending in the private sector (non-government). This is the part of the economy which affects the majority of corporate profits, employment trends and personal income. Let’s call this area GPDAX– or GDP less government, imports and inventory changes. This calculation represents true domestic “core” growth.

Since the beginning of 2010, the following is the “before revisions” and “after revisions” of this data stream:

	<u>Growth Before Adjustments</u>	<u>Growth After Adjustments</u>
2010 (Q1)	3.0%	2.9%
2010 (Q2)	4.7%	5.4%
2010 (Q3)	2.7%	3.3%
2010 (Q4)	4.7%	4.3%
All of 2010	3.8%	4.0%
2011 (Q1)	2.7%	2.7%
2011 (Q2)		1.7%

Per the data above, it becomes clear that the weakness in the outright changes which occurred to the GDP headline data was driven by “non-organic” items (government spending, inventory adjustments and net exports). From an “organic” domestic arena, it becomes clearer that the U.S. “core” economy growth data was not changed dramatically.

What is also obvious is that the U.S. economy – no matter if one looks only at the “trend” in GDP or the “trend” in GPDAX – is slowing. During the last two quarters, GPDAX slowed from a growth rate of 4.0 percent in 2010 to 2.2 percent this year. So, the actual SLOWING of growth is not just in non-core items. The slowing is occurring in the “core” of economic activity.

### Action Items

As can be seen from data earlier in this report, the U.S. economy grew by 0.9 percent on an annualized basis after inflation. As we are now in the eighth calendar quarter since the end of recession (and traditionally, the U.S. economic growth rate tends to *decelerate* at this stage of the business cycle), we see little hope that U.S. GDP growth will average more than 2.5 percent for the second half of 2011. With this in mind, **we are lowering our outlook for full-year GDP to 1.8 percent.**

In addition, we are **lowering our outlook for growth of fixed investment spending from 10 percent to 8 percent, and our outlook for consumption expenditure growth from 2.3 percent to 2.1 percent.** We will be addressing our interest rate outlook in the near future, but we see few reasons, due specifically to economic momentum, for interest rates to rise significantly any time soon.

### Final Word

Growth in the U.S. economy is decelerating. Do the numbers released last Friday from the BEA mean much? The absolute numbers themselves are interesting. However, **we believe the real message is economic deceleration.** Are we heading towards a recession? We attempted to answer this question recently – we do not foresee a true recession during the remainder of this year; however, we do believe the risks of a recession to start during the next 12-to-18 months have risen.

The U.S. economic growth rate, due to many reasons, is truly “slumping towards mediocrity.”



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