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MACROCOSM

Q2 Marked the Bottom

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Seemingly unthinkable so recently, the economy managed to pull back from the abyss.

Update to strategic view

US MACRO: Today's GDP release paints the picture of an economy going through a bottoming process in Q2 2009. Given the other positive indicators that we continue to monitor, this likely will end up marking the trough of the recession.

[see Investment Strategy Dashboard]

The huge revisions to gross domestic product Q3 2008, Q4 2008 and Q1 2009 incorporated in today's second quarter release is a reminder that early estimates from these enormous data aggregates should by no means be viewed as inviolable. That said, the data showing a better than expected 1% decline in real GDP in Q2 2009 is nonetheless an encouraging sign that the economy was in a bottoming process, and that the quarter likely will mark the trough of this recession. And in the context of the extreme pessimism that was so prevalent within the last nine months, with a near consensus that the economy was in the grip of an unbreakable vicious cycle that would bring about a return of the Great Depression (see "Vicious Cycle Visions" November 10, 2008), today's data should be seen as nothing short of remarkable.

Across the bulk of data categories, a sharp deceleration in the pace of contraction was under way in Q2 2009. With capital investment continuing to bear the brunt of the economic shock of the past few quarters as we noted earlier today (see "Still Waiting for that 'New Era'" July 31, 2009), there were several positive indications in the second quarter. The decline in nonresidential fixed investment slowed from a 39.2% annualized rate to 8.9%, with equipment and software expenditures falling 9.0%, compared to 36.4% in Q1. Having dragged GDP growth down by 5.29% in Q1, nonresidential fixed investment made a negative contribution of just 0.94% in Q2. Equipment and software was a negative factor of 0.59%, after pulling growth down by 3.01% in Q1. Even the decline in residential investment slowed from 38.2% to 29.3%.

Imports of goods were down at a 15.1% rate, but that was after dropping by 41.0% in Q1. In a sign that the *global* economy is also in a bottoming process, exports fell 7.0% in Q2, after declining at a 29.9% pace in Q1. Net exports made a positive contribution of 1.38% to GDP.

One negative in the data is that real personal consumption expenditures fell by 1.2% after showing a marginal 0.6% gain in Q1. But that still is a marked improvement from declines at greater than a 3.0% rate in both Q1 2009 and Q4 2008. Excluding changes in private

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inventories, which subtracted 0.83% from growth compared to 2.36% in Q1, real final sales were down by only 0.2%. Final sales fell by 4.1% in Q1 and by 4.7% in Q4 2008.

This apparent bottoming in GDP is consistent with other indicators we have been tracking which suggest that, with relief from the chaos and fear that was so prevalent during the worst of the credit market crisis, a healing process has been at work. The other indicators include a sharp reversal from the most intense risk abhorrence on record. Symbolizing a contraction in credit spreads across the board, after peaking at nearly 2200 bp last December, and with a reading still around 1700 bp at the end of the first quarter, the Merrill High Yield Index spread has narrowed to 933 bp, just moderately above levels seen prior to the outbreak of the worst of the credit crisis last September. Also, on a 4-week moving average basis, initial jobless claims are now about 15% below their peak in early April. As we have noted, the peak in jobless claims has historically been a perfect coincident indicator of recession troughs (see, first, "Stress Test for T-Bonds" May 8, 2009). In addition, we are now more than 70% through what is far and away the best earnings season in more than two years -- on an unweighted basis, the average S&P 500 stock reporting this month has beaten expectations by almost 30% (see "Surprise, Surprise" July 23, 2009). Even before that, consensus forward earnings have turned, now almost 9% above their early May trough. The annualized month-on-month rate of earnings revisions is running at almost 50%, after hitting a negative rate of nearly 60% coincident with the stock market's bottom in early March.

BOTTOM LINE: Today's GDP release paints the picture of an economy going through a bottoming process in Q2 2009. Given the other positive indicators that we continue to monitor, this likely will end up marking the trough of the recession.