

Growth Metrics: Strong Consumption, but Weak Production and Labor

Markets and economists are still evaluating the fourth quarter GDP improvement and how strongly it will extend into 2011. We think the fourth quarter burst was mostly a rebound from the double dip sentiment during the mid-2010 soft patch rather than a structural acceleration. It represents a welcome recovery in the growth environment but not a normal expansion. Strong consumption coinciding with record transfer payments and fiscal deficits doesn't provide a sustainable basis for strong GDP – there has to be increasing investment, production and private sector labor income. We think this will require a major change in core economic policies toward less reliance on shaky balance sheets at Treasury, the Fed, Fannie, Freddie and FHA.

- We expect 3.5% real GDP growth in the fourth quarter after 2.6% in the third and 1.7% in the second. This would bring 2010 growth to 2.9% (fourth over fourth), rising to 3.5% in 2011. In the first quarter of 2011, we expect 4% growth, running out of steam once auto production catches up to sales.
- The table below shows several back-of-envelop barometers of 2010 GDP through the fourth quarter. The bottom row shows the dichotomy in the economy – strong consumption, but much slower growth for production, employment and hours worked.

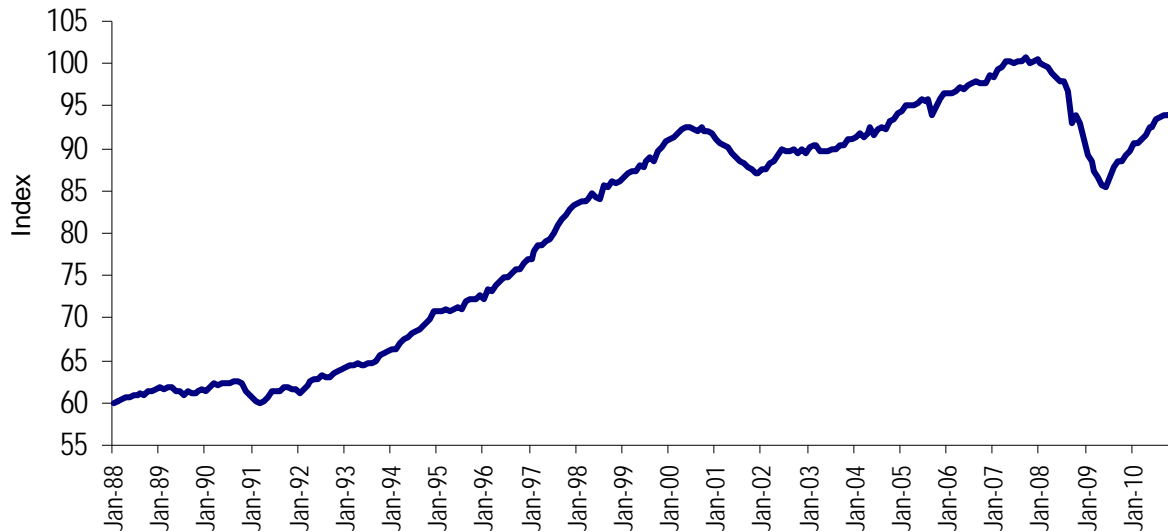
Some GDP estimators (annualized, PCE and GDP estimated for Q4 2010)

	IP	Auto Assemblies	Retail Sales	Real PCE	Dom Auto Sales	Payrolls	Agg Hours Worked	Real GDP
2009 Q4	89.1	7.2	350,999.7	9,182.9	8.2	129,639	90.8	
Q/Q AR	6.9%	44.5%	6.0%	0.9%	-14.2%	-1.3%	-1.5%	5.01%
2010 Q1	90.7	7.5	359,101.7	9,225.4	8.4	129,697	91.3	
Q/Q AR	7.2%	16.3%	9.6%	1.9%	9.8%	0.2%	2.4%	3.73%
2010 Q2	92.2	7.6	363,128.7	9,275.7	8.8	130,392	92.0	
Q/Q AR	7.1%	5.1%	4.6%	2.2%	22.8%	2.2%	3.3%	1.72%
2010 Q3	93.7	8.2	366,087.0	9,330.6	8.7	130,344	92.6	
Q/Q AR	6.7%	38.1%	3.3%	2.4%	-5.3%	-0.1%	2.5%	2.56%
2010 Q4	94.3	7.7	378,302.3	9,437.6	9.3	130,620	93.1	
Q/Q AR	2.3%	-22.5%	14.0%	(f) 4.7%	28.1%	0.8%	2.3%	(f) 3.50%

Source: Federal Reserve; BEA; Census Bureau; BLS; Encima Global

- Industrial production strengthened 0.8% in December from downwardly revised November data. However, it is up only 2.3% at an annual rate in the fourth quarter from the third, in part due to low auto production.

Industrial Production (last obs. December 2010)

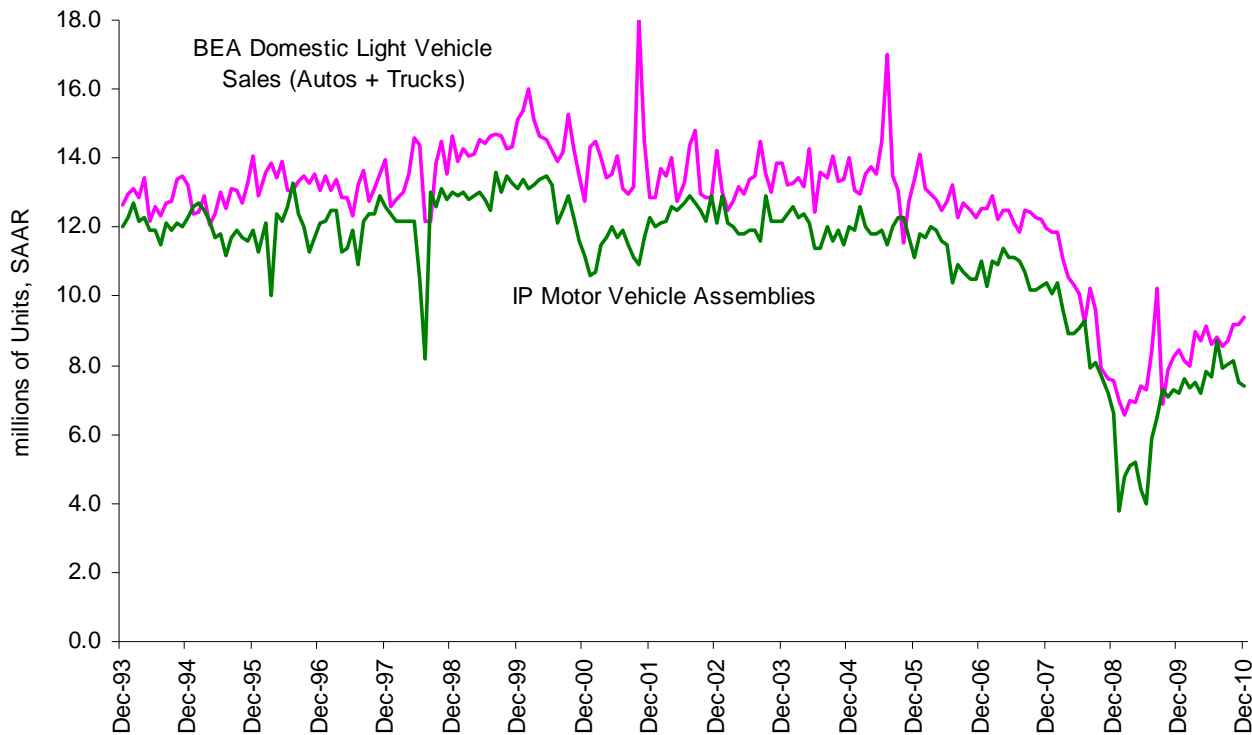


Source: Federal Reserve; Encima Global

- Auto sales were much stronger than production in the fourth quarter. Domestically produced cars sold at a 9.3 million average annual rate in October-December, up 28.1% annualized from the third quarter. In contrast, auto production fell sharply in the fourth quarter from the third to an average 7.7 million annualized rate.

- Looking to Q1 GDP, auto production will be increased substantially from the fourth quarter, adding to industrial production and GDP growth. This is already showing up in strong ISM data, auto company production plans and equity market signals. Autos are roughly 3% of the economy, so by itself will not control first quarter GDP.

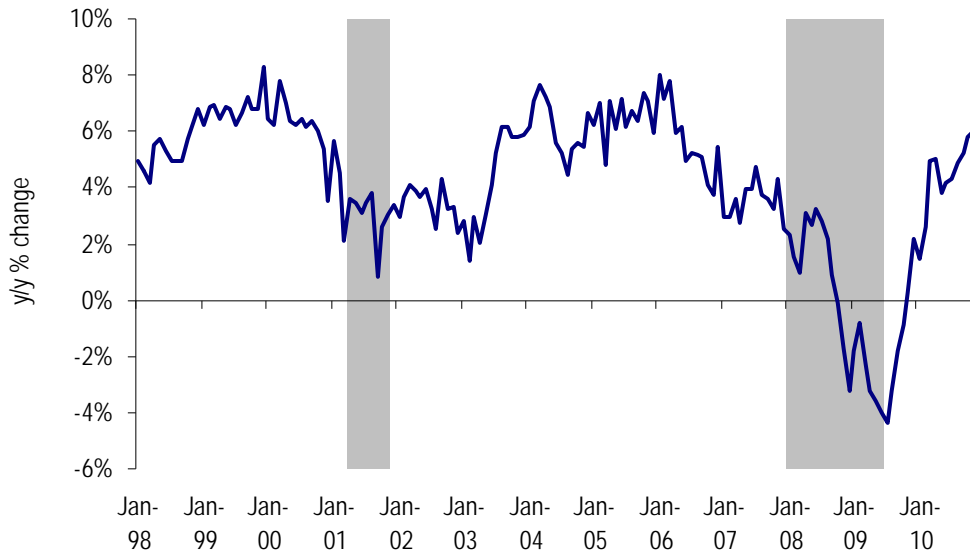
Auto Sales and Production (last obs. December 2010)



Source: Federal Reserve; Encima Global

- In the table, real PCE growth is estimated at 4.7% based on October and November. We think the PCE deflator, which converts nominal consumption into real, is lagging behind true inflation as it did in the 2003-2006 monetary bubble. If so, real GDP may be strong in its preliminary estimates (tracking strong first estimates of real PCE) but then may be systematically revised down as it was for the overstated 2003-2006 period.
- Total retail sales were 0.6% in December from November and up at a 14.0% annual rate in the fourth quarter from the third, in part due to gasoline price increases and strong auto sales. Excluding autos and gasoline, retail sales rose a still-strong 8.6% at a nominal annual rate in the fourth quarter from the third and 6.2% year-over-year in December (graphed below).

Retail Sales ex autos and gas (last obs. December 2010)

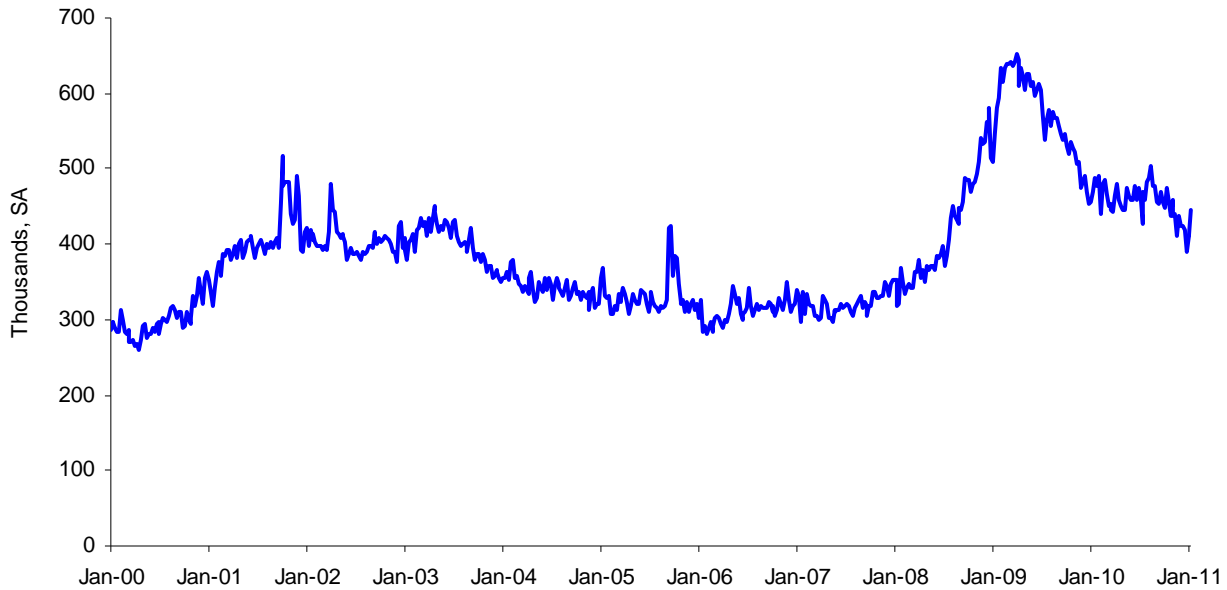


Source: Census Bureau; Encima Global

The extension of the Bush tax cuts and the reduction in the social security tax rate creates a somewhat better tax environment in 2011 than the uncertainty hanging over 2010. However, it came at a high cost in terms of the budget hit, the one-year extension of 99 week unemployment insurance, and the many add-on pieces of complex legislation during the lame-duck. On net, it's a mild plus. It's getting credit for upward revisions to the consensus growth forecasts, but we think the better explanation for current optimism is the mid-year underestimates of the outlook, particularly the Fed Reserve's hyping of the deflation risk.

- On the positive side, we note signs of improvement in the small business environment – strong ADP job growth, a small increase in commercial and industrial loans especially by big banks, a stabilization in NFIB's confidence indicator, the extension of the Bush tax cuts, and declining weekly initial jobless claims (though yesterday's claims jumped by 35,000 to 445,000).

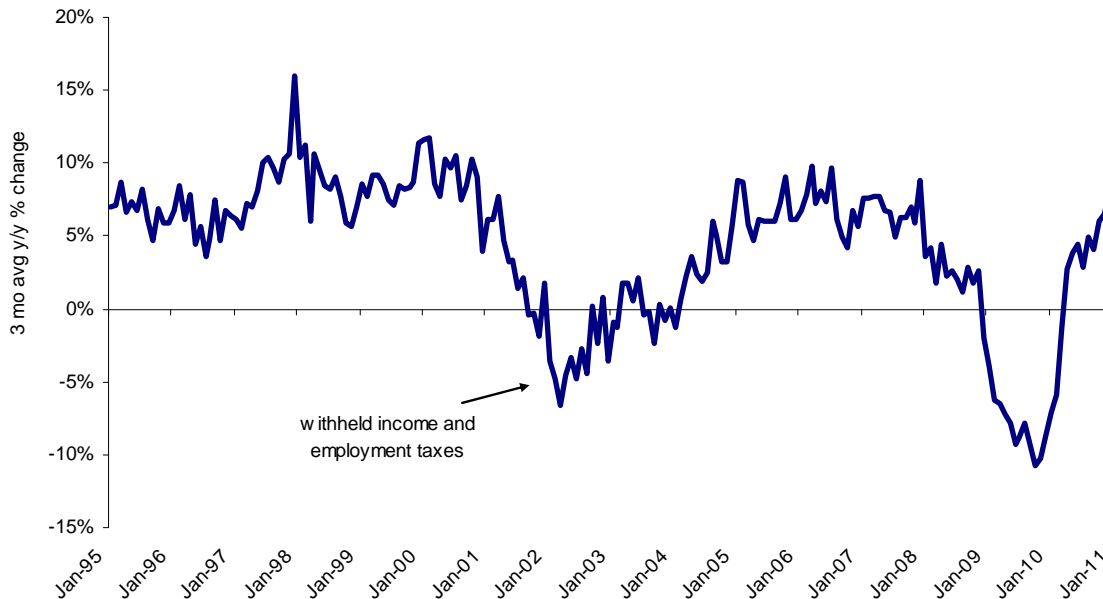
Initial Unemployment Claims (last obs. January 8, 2011)



Source: Bureau of Labor Statistics; Encima Global

- Treasury's withholding tax data is showing a strong 8% gain in the fourth quarter of 2010 from the fourth quarter of 2009.

Withheld Income and employment taxes y/y (last obs. December 2010)

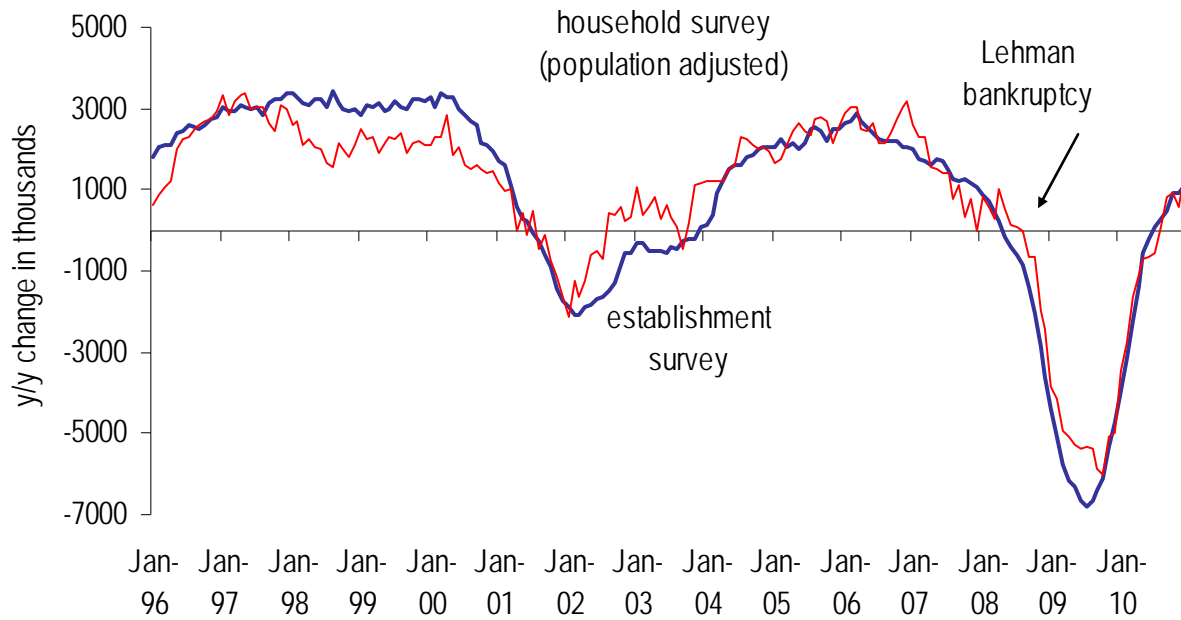


Source: U.S. Treasury; Encima Global

On the negative side, several measures of labor information are pointing to slow growth.

- Aggregate hours, which combines the number of workers and their average hours worked, grew at an annualized 2.3% in the fourth quarter, in line with IP.
- Payrolls grew 103,000 in the December establishment survey raising payroll growth for the fourth quarter to 0.8% on a seasonally adjusted annualized rate. The household survey showed a gain of 297,000 in December, but October and November had declines, leaving jobs down 0.4% at an annual rate in the fourth quarter from the third.

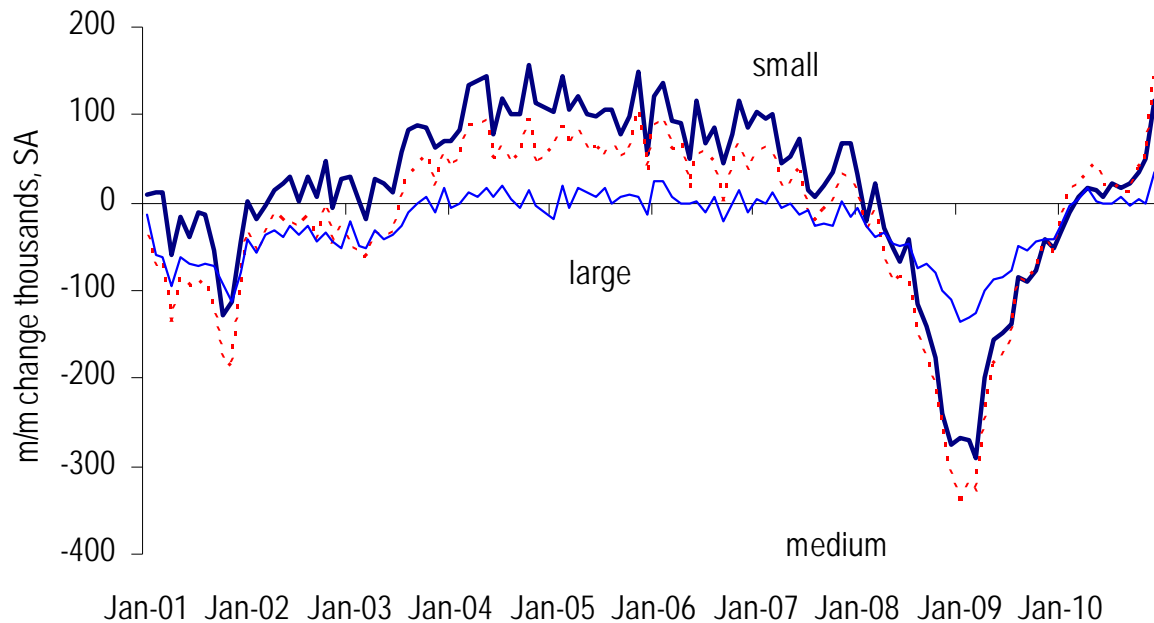
Annual Growth in Employment (last obs. December 2010)



Source: Bureau of Labor Statistics; Encima Global

- ADP data for the month of December coincidentally matched the household data at 297,000, putting fourth quarter annualized growth based on ADP data at only 0.8%.

ADP payroll growth by company size (last obs. December 2010)



Source: ADP; Encima Global

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