One Step Forward, One Step Back

Sometimes it's easy to feel a little like a hamster on a wheel in this business. It seems that we get a great bit of economic news one day only to have the mood dampened by disappointing news the next.

Let's consider some recent news releases. Real GDP grew by 2.2% in the first quarter (for non-economists, that means the economy grew by 2.2%). While any growth at all may seem like something to celebrate at times, this was down from the 3.0% clocked in the 4th quarter of last year.

Breaking down the numbers, we see some interesting developments. Personal consumption expenditures improved slightly, growing at 2.9% for the quarter vs. 2.1% last quarter. Breaking this down further, we see durable goods—i.e. large purchases such as appliances that are typically purchased with credit—enjoyed 15% growth for the quarter. I don't expect this growth rate to continue, mind you, but we'll enjoy it while we can.

Residential construction enjoyed a nice boost as well, increasing by 19.1 percent (though admittedly coming off of a low base).

On the flipside, overall business investment fell by 2.1%, and non-residential construction fell by a full 12%.

But where all of this gets particularly interesting is at the government level. Federal government spending—a fair bit of it *deficit* spending, I might add—has been credited by supporters and detractors alike for helping to keep the economy above water. But with deficit spending becoming a major risk to the long-term stability of the U.S. financial system (and a political hot-potato to boot), we are about to see what happens when that support begins to crumble.

Federal spending and investment decreased by 5.6% in the first quarter, and defense spending fell by fully 12%. At the state and local level, the decrease was more modest at 1.2%, but felt nonetheless.

Keep in mind; these numbers are likely to sink far lower this time next year, once the dust has settled on the presidential election. Whether we have an Obama or Romney administration, the next president will have pressure from Congress, the capital markets, and the American public to rein in spending.

What does all of this mean?

It means a continuation of the status quo, a choppy on-again/off-again recovery interrupted by disappointments here and there.

Looking at the positives, you have a large generation—the Echo Boomers—entering the workforce with decades of productivity and spending ahead of them. You also have a corporate America that is "lean and mean" after years of paying down debt and shedding costs. You also have a low-interest rate environment, which is encouraging risk taking, all else equal.

But the negatives are significant as well. The largest and richest generation in history—the Baby Boomers—continues to pay down debts and save for retirement. The financial sector continues to deleverage itself, which sucks demand out of the system. And the government—at the federal, state and local level—is already too indebted to jolt us into growth mode with more spending.

On balance, it is a recipe for slow and erratic growth, with some great years and some particularly bad years in the mix.

As investors, this means that we need to tread carefully. This is not a time for blind optimism. But there will certainly be great opportunities for those of us that stay nimble and keep our eyes open.

Notes: http://www.bea.gov/newsreleases/national/gdp/gdpnewsrelease.htm

Sincerely,

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