

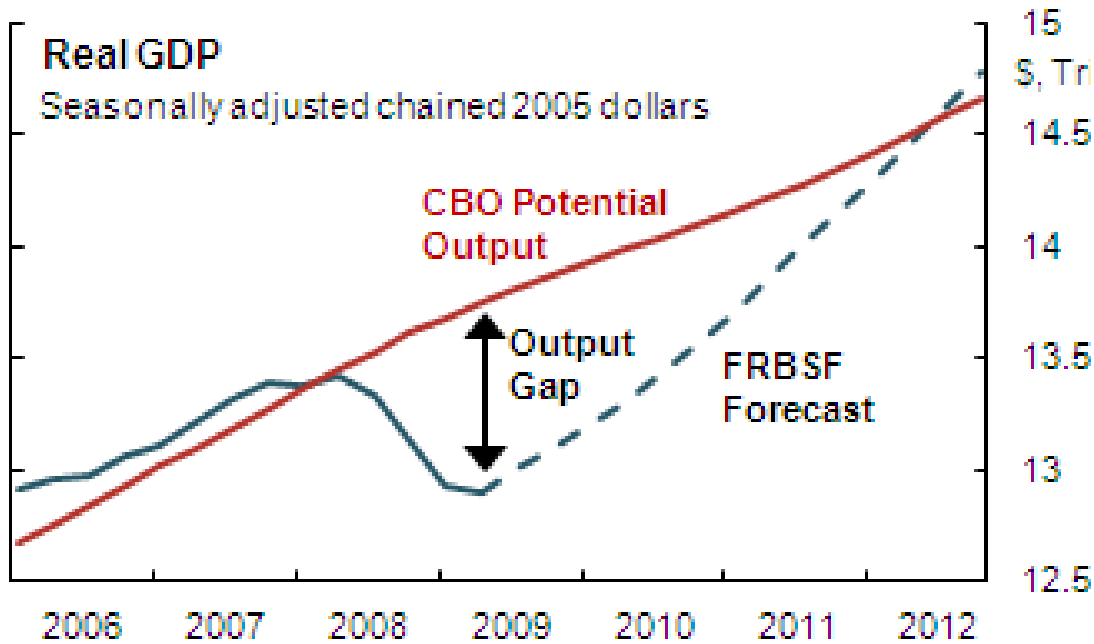
The Week

Tom McManus, Chief Investment Officer

Climbing Back to the Long-Term Trend: Even a Long Journey Begins With a First Step

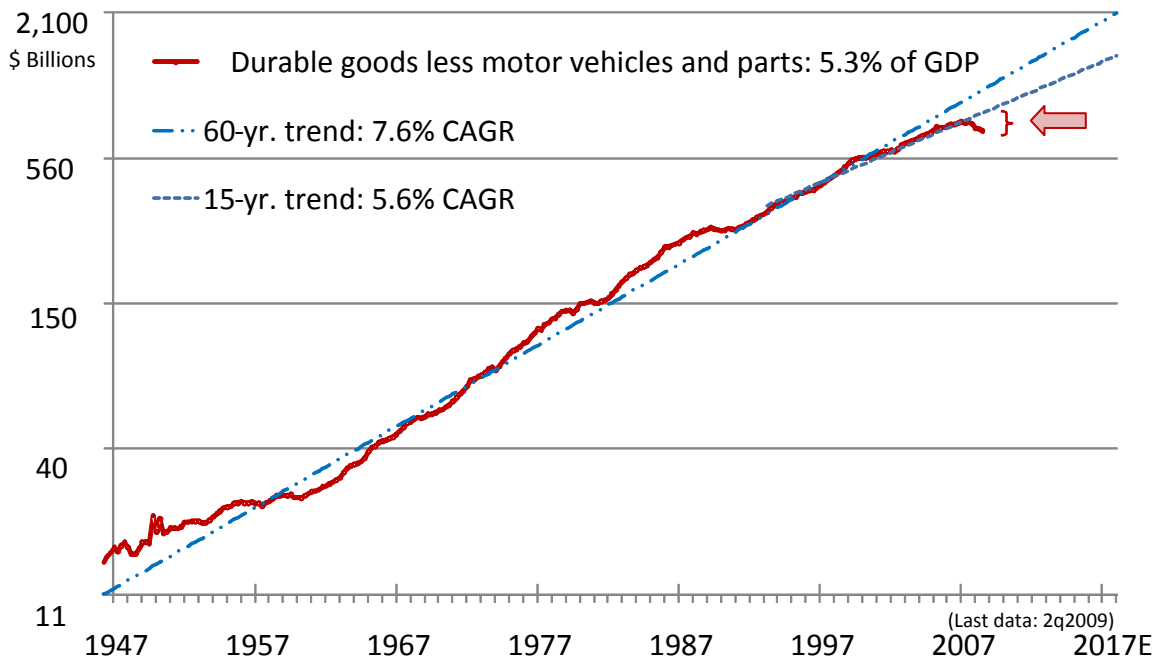
- Thursday's upcoming release of Gross Domestic Product for the third quarter should indicate that this key measure expanded by +3.7% at an annual rate, according to our economists. Typically, GDP is reported on a "real" basis (i.e. after adjustment for inflation).
- The annualized growth rate we anticipate equates to a bounce of almost +1% for the three month period, which recovers almost one-fourth of the cumulative contraction since mid-2008 (see first chart overleaf). But the "output gap" — the difference between actual and potential GDP — is measured against a trend-line which rises +2% to +2.5% /yr. At the current pace, it may take three years to erase the output gap. But even a long journey begins with a single step, and real GDP seems to have hit bottom with the help of extraordinary "lending and spending" by government — here and abroad — to help offset a plunge in lending and spending by the private sector (i.e. business and households).
- Now that GDP has begun to expand again, it will be useful to monitor the various components of that growth to determine how long it might take to recover the losses and to gauge whether the road back may be smooth or bumpy.
- The economists at the San Francisco Federal Reserve (FRBSF) are suggesting it may take until 2012 before the output gap disappears. Potential GDP (the trend line) is determined by the Congressional Budget Office and others based on estimates of population growth, workforce participation and productivity trends. Sharp-eyed readers will note a gradual flattening in the solid trend line after 2008, which should make it easier for us to catch the trend by 2012. Whether we can enjoy faster trend line growth after 2012 depends on our willingness and ability to invest in productivity-generating initiatives today.
- We have noted previously (see "the Week" dated September 21) that US retail sales are apparently reaching a bottom, too, about -10% below their own trend line before inflation adjustment. Almost two-thirds of sales at retail establishments are for necessities such as food, medicine, fuel and the like, while the rest is for items that are more discretionary, such as autos, furniture, electronics and sporting goods. Many of these discretionary items are considered "durable" because they are expected to last 3 years or more.
- Our second chart shows the trend for consumer purchases of durable items before inflation adjustment. We have excluded autos because the Cash for Clunkers program caused a surge in purchases late in the summer. Our previous note discussed the process by which a rebound in stock prices (i.e. wealth) might boost confidence and — combined with pent-up demand — translate into increased spending on discretionary items. If business owners sense that rising demand is sustainable, they may begin to expand their job rolls. We have already seen many businesses try to "spread the pain" of weak demand across their workforces by reducing hours worked rather than initiating further layoffs.
- While there are many components of GDP that are below trend, personal consumption of durable goods is an important measure of demand because so many jobs depend on manufacturing, selling and financing these products. Continued weakness in this area may restrain the rebound in employment, potentially affecting both the growth rate of corporate profits and the price/earnings multiple that investors are willing to assign to future profits.

San Francisco Fed Forecasts GDP Won't Return to Trend Until 2012



Note: CBO is the Congressional Budget Office, which forecasts US potential output (GDP), based on estimates of population, workforce participation and productivity. Source: San Francisco Fed (FRBSF).

Pre-Inflation Adjustment, Durable (ex-Autos) Purchases Now –15% Below Trend!



Note: CAGR is "Compound Annual Growth Rate." Source: Bureau of Economic Analysis.

Investment and Insurance Products: ▶NOT FDIC Insured ▶NO Bank Guarantee ▶MAY Lose Value

Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice. The investment or strategy discussed may not be suitable for all investors. Investors must make their own decisions based on their specific investment objectives and financial circumstances.

Wells Fargo Advisors is the trade name under which Wells Fargo & Company provides brokerage services through two registered broker-dealers: Wells Fargo Advisors, LLC, Member SIPC, and Wells Fargo Advisors Financial Network, LLC, Member SIPC. Each broker-dealer is a separate non-bank affiliate of Wells Fargo & Company.
©2009 Wells Fargo Advisors, LLC. All rights reserved.