



Naroff Economic Advisors
"Linking the Economic Environment to Your Business Strategy"

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INDICATOR: First Quarter GDP

KEY DATA: GDP: +2.2%; Consumption: +2.9%; Government Spending: -3.0%

IN A NUTSHELL: *"It's hard for the economy to accelerate when the government has its foot on the brake."*

WHAT IT MEANS: *The first estimate of how the economy grew during the early part of the year was disappointing.* The consensus was for growth in the 2.5% range but the expansion fell short of that target. First, that amuses me. The idea that economists can get the first number exactly right is laughable, especially when the miss was so small. Basically, there is little difference between a 2.2% and 2.5% growth rate. They both are less than needed. But also keep in mind that the report will be revised and those changes are sometimes large, so chill. *The details of the report were so-so. Consumers hit the vehicle showrooms hard and consumption was strong. The warm weather helped boost home construction. But businesses cut back sharply on their building activity* and that reduced growth by over one-third percentage point. *Investment in software and equipment was also less than stellar.* With nearly \$3 trillion of liquid assets on their books, firms will be spending this year. *There was also a solid increase in exports,* which was nice given the world economic slowdown. *But the real issue was government spending, especially for defense. For the second consecutive quarter, the Pentagon took an axe to its outlays. Federal spending was down for the fourth time in six quarters. With states and local governments also cutting back, the government sector held growth back by over one-half percentage point.* Finally, when you take out the inventory buildup and only consider actual sales of the

goods and services, that key measure, called final sales, rose by a solid 3.2%. In other words, businesses are moving the goods. Prices rose a little faster than in the fourth quarter with consumer costs jumping.

MARKETS AND FED POLICY IMPLICATIONS: *This report came in less than expected but it was hardly a disaster. The major takeaway is that fiscal austerity comes at a price: slower growth.* Think about it this way: If government spending was simply flat, the economy would have grown at a 2.8% rate. Would anyone have been disappointed with that number? ***As usual, the details provide a mixed picture for the second quarter.*** Business investment is likely to rebound as another huge decline in construction is not likely, but the big push from vehicle sales should ebb. One key is government spending. ***Will the enormous defense reductions turn into major increases?*** Have state and local governments completed most of their cut backs? That would turn that sector around. ***But maybe most importantly, will consumers start spending more on services. This component accounts for about 45% of GDP and to get strong growth, households have to pick up the pace.*** My expectation is that the second quarter will be a lot better than the first and I believe it could exceed 3%. But let's wait for the revisions so we have a better handle on what actually was first quarter growth. As for the markets, it is still earnings season and while this was a disappointment, it was not bad. ***As for the Fed, this report plays directly into the hands of those who want to keep rates low for a very long time.***

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