Solid Q3 GDP Headline Masks Underlying Weakness

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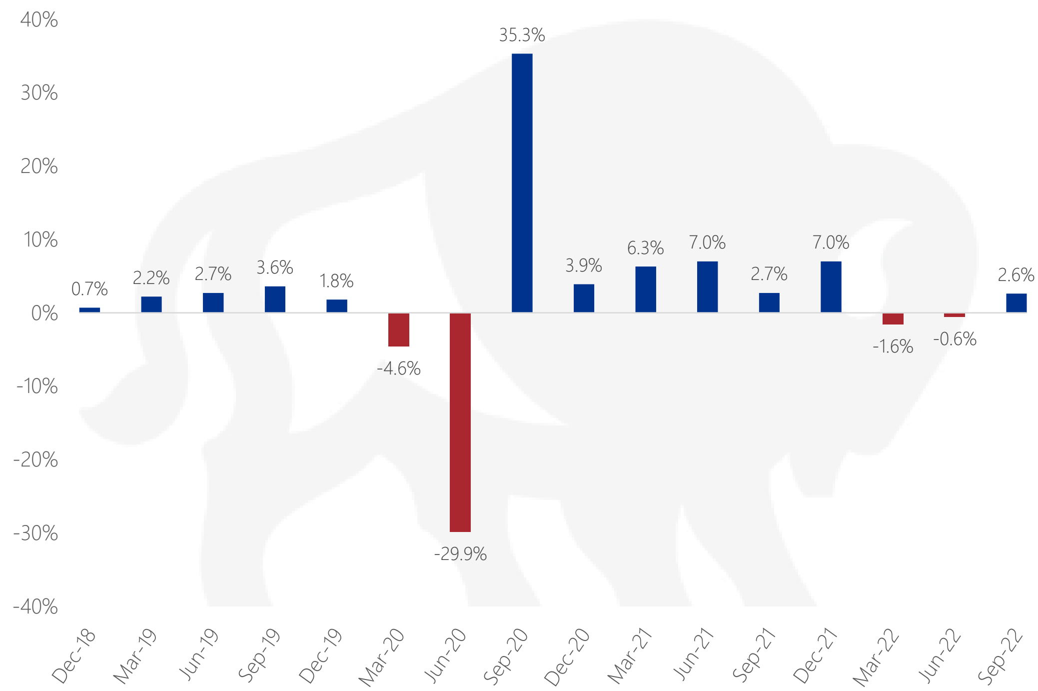
The U.S. economy rebounded sharply in the third quarter, posting a +2.6% GDP gain (quarter-over-quarter, annualized) following two quarters of contraction. Although the headline topped the +2.4% median forecast, the underlying numbers indicate a more fragile economy going forward.

Exports rose +14.4%, while imports fell -6.9%. This dramatic improvement in the trade balance *added nearly 2.8 percentage points to the overall number.* If this volatile trade number had been simply unchanged, overall GDP would have been negative. Business inventories, another volatile component, subtracted -0.7 percentage points from the headline during the quarter as U.S. companies, suddenly awash in goods, pared back inventories.

U.S. GDP - Quarterly Annualized Percent Change



Source: US Census Bureau

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Personal consumption, by far the biggest historical contributor to U.S. growth, rose +1.4% during the quarter, adding just a percentage point to the overall number. Spending on goods continued to slow while spending on services continued to expand, although at a slower pace. The poor showing by U.S. consumers indicates waning capacity heading into the holiday season.

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One bright spot was business fixed investment, which climbed +3.7%. Within this number, increased spending on equipment more than made up for a sizable drop in structures.

Government spending rose +2.4% and contributed 0.4 to overall GDP. It was the first increase in government spending in six quarters.

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On a year-over-year basis, the U.S. economy grew at a +1.8% pace, matching the previous quarter, but down sharply from the +5.7% annual pace at the end of last year.

On the inflation front, the personal consumption expenditures price index was up +4.2% (quarter-over-quarter, annualized) in the third quarter, well below the +5.3% median forecast and the slowest pace in nearly two years.

GDP growth was positive for the first time this year, but the report (in total) hardly suggests an improving economy. Fed officials should be relatively pleased that growth was positive and the inflation data improved more-than-expected. However, quarterly inflation data is inherently stale; more recent CPI numbers indicate that prices remain far too high. As a result, the Fed remains on track to hike another 75 basis points next week.

Bonds are rallying in early trading, probably believing the lower inflation number will appease the Fed over time.

Market Indications as of 9:32 A.M. Central Time

DOW	Up 541 to 32,380 (HIGH: 36,800)
NASDAQ	Up 12 to 10,983 (HIGH: 16,057)
S&P 500	Up 20 to 3,851 (HIGH: 4,797)
1-Yr T-bill	current yield 4.50%; opening yield 4.50%
2-Yr T-note	current yield 4.34%; opening yield 4.42%
3-Yr T-note	current yield 4.29%; opening yield 4.39%
5-Yr T-note	current yield 4.08%; opening yield 4.19%
10-Yr T-note	current yield 3.92%; opening yield 4.01%
30-Yr T-bond	current yield 4.08%; opening yield 4.14%