MV CAPITAL MANAGEMENT

Weekly Market Flash

Soybeans and Sustainable Growth

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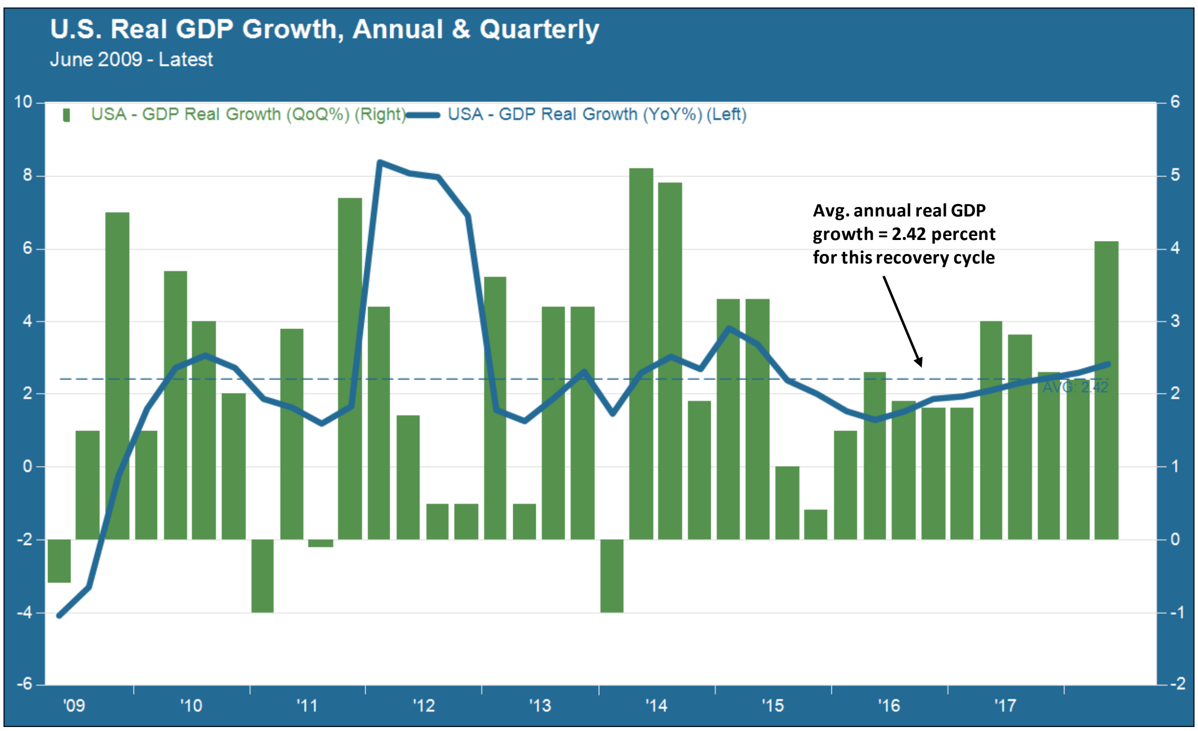
They say numbers don't lie, right? So what to make of the 4.1 percent real growth rate in US gross domestic product (GDP) from the first to the second quarter of the year? We feel quite comfortable in predicting that the narrative of today's news cycle will be anything but unified. Depending on what news source you turn to for a first take on today's Bureau of Economic Analysis release, you may be told that this quarterly number is in fact the dawning of the Age of Aquarius, when peace will guide the planets and love will steer the stars (hi, kids! ask your parents…). Or, alternatively, that 4.1 percent really isn't 4.1 percent at all, but a fictitious sugar high delivered on a transitory pile of soybeans, never to be seen again.

As usual, the reality is somewhere between delusional happy talk and delusional apocalypse-now talk. Here's an actual picture of GDP growth over the full cycle of the economic recovery that began in the middle of 2009. We show both the quarter-to-quarter rate of growth and the somewhat smoother year-on-year growth trend.



Source: MVF Research, FactSet

Something Old, Something New

The best way, in our opinion, to interpret the current trend in GDP growth is to ascribe much of it to factors that have been underway for some time. Consumer spending is by far the largest single component of GDP, accounting for more than 70 percent of the total, and Americans have continued to not disappoint in their purchasing predilections. Fixed private sector investment – both residential and commercial – also reflects continuing confidence by homeowners and businesses alike. The mix will change in any given quarter – nonresidential construction and intellectual property investment were key drivers this quarter while residential investment declined – but the overall trend has stayed positive. This is the "something old" – a continuation of the modest but steady growth that has characterized recent years.

The "something new" shows up in an usual jump in US exports, which grew by 9.3 percent overall and which was dominated by certain categories of goods. Enter the "soybeans" meme. It appears that other countries have been stockpiling various products from the US which they expect to jump in price on account of the new tariff regime. Those bags and bags of soya beans from Iowa really were a second quarter phenomenon, were mostly related to China, and have mostly stopped with the implementation of the first wave of tariffs imposed by Beijing on US products earlier this month.

Something Borrowed

Looking beyond the quirks of any given quarter – and as the above chart shows, these numbers do bounce around considerably – the longer term question is how much of this growth is sustainable. The average annual rate of GDP growth since the second quarter of 2009 has been 2.4 percent. Many economists argue that even that number is too high – remember that for a good chunk of this time much of the growth came courtesy of direct monetary intervention by the Federal Reserve, which is no longer in effect. The fiscal stimulus put in place at the end of last year – windfall tax cuts to US businesses – may have the effect of elevating fixed investment above trend levels for a few more quarters, but that has the longer-term implications of significantly higher deficits and thus borrowing costs. This could be a particularly thorny problem if it converges with a sustained period of higher interest rates as the Fed tries to "normalize" borrowing rates.

Something Blue?

There has not been much in the way of market reaction to today's GDP release – partly because the number was largely in line with consensus estimates and thus already baked into stock prices. Investment sentiment around GDP appears largely dominated by the "something old" theme – different quarter, same trends – while ascribing little in the way of impactful news to either transitory short term phenomena like soya bean exports or the longer term borrowing implications of the fiscal stimulus. This way of looking at what is arguably the economy's lead headline number also assumes that the trade tensions are mostly smoke and mirrors and will not metastasize into an all-out hot war (which view got some support this week with a surprisingly docile outcome of trade talks between the US and the EU).

What has some observers feeling blue, even when most data point to continued growth in the economy and with corporate sales and earnings, is that this recovery cycle is already long by historical standards. We have discussed this in other recent commentaries, usually with the caveat that every cycle is different and that recoveries don't end because they pass some arbitrary calendar milestone. We do not think we are in for some super-long period of above-trend growth. Neither, however, do we see a compelling case for an imminent winding down of this cycle.

Stock prices rise and fall on account of all sorts of influencing factors on any given day. For the time being, at least, the overarching economic narrative does not give us much cause to be feeling blue.

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