NOVEMBER 3, 2003

BUSINESS OUTLOOK

U.S.: The Virtuous Cycle Is Finally Kicking In

As the recovery takes hold, GDP growth may hit levels not seen since 2000

Forecasting the recovery's third-quarter growth rate has begun to resemble a game of "Can You Top This?" Economists are jacking up their projections for real gross domestic product growth to the range of 5% to 6%, with a few bullish souls calling for a 7% annual rate. The Commerce Dept. will report its first look at third-quarter real GDP on Oct. 30. But more important than the top-line number will be how much momentum the economy has. Executives, job seekers, and politicians want to know if the recovery's summer growth spurt is sustainable through 2004.

In a word: Yes. After almost two years of recovery that felt more like recession, the economy is finally entering the virtuous cycle crucial to self-sustaining growth -- that is, when increased demand triggers a pickup in output and jobs, generating more income and profits, which lifts demand even further. True, the 6% or 7% pace of last quarter probably won't be repeated, but solid growth in the neighborhood of 4% for the next couple of quarters seems likely, especially given the powerful boost expected from the need to rebuild inventories.

During the past three years, this virtuous cycle has been elusive. Each time the economy reached the point where demand looked strong enough to justify expanding production, stockpiling goods, and adding workers, an extraordinary shock triggered a new round of uncertainty. First came the terrorist attacks, then the corporate scandals, and then the war. Barring any more shocks, this recovery will finally feel like the real thing.

THE CURRENT MOMENTUM can trace its roots back to the second quarter. Monthly data indicated that businesses and consumers resumed spending midway through the spring after the Iraq war was declared over. Although overall real GDP grew by a moderate 3.3% annual rate in the second quarter, domestic demand accelerated to the fastest quarterly pace in three years.

For the third quarter, Commerce's report will show a further, broad speedup in U.S. demand, highlighted by a surge in consumer spending reminiscent of the late-'90s boom. Data on store sales and vehicle purchases suggest the advance in real consumer outlays could top 6% at an annual rate, after a healthy 3.8% increase in the second quarter.

On the corporate side, trends in orders and shipments suggest that business investment in new equipment grew at a double-digit clip, even faster than the 8.3% pace in the second quarter, which was the best showing in three years. Plus, as mortgage rates stayed near historically low levels, the relentless strength in home demand and new starts means housing also may have grown faster than its 6.6% second-quarter pace.

To be sure, several one-time boosts to growth were at work last quarter. For one, cautious inventory buying contributed to a drop in imports, while exports probably grew for the first time in four quarters. The resulting narrower trade deficit was a big plus for real GDP growth. But that addition will turn into a minus in the fourth quarter, as booming demand brings in more imports at a pace that will swamp the further gains in exports.

Second, households benefited greatly last quarter from the July cut in tax withholding rates and child-credit tax rebates. Real pretax income grew at an annual rate of only about 1.5% last quarter, but aftertax earnings surged about 8%, providing a huge lift to buying power.

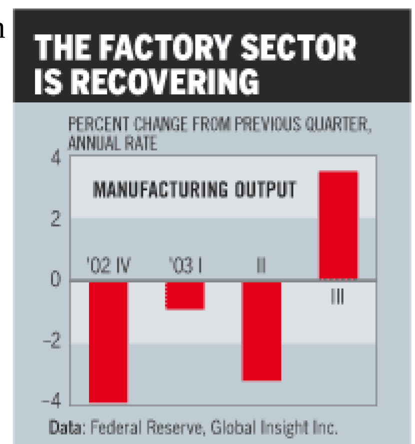
WHAT'S IMPORTANT, THOUGH, is where we go from here. On that score, the supports to both demand and production are rock solid. In fact, the one negative in the third-quarter GDP was actually a big positive for future activity. Business inventories shrank for the second quarter in a row. A large 0.4% drop in August stockpiles, the largest monthly decline in a year and a half, suggests that last quarter's liquidation was even greater than the $17.6 billion decrease in the second quarter. By any measure, inventories are too low to support demand. That sets up a powerful boost to output in coming months, as order rates pick up.

The turnaround in industrial production has already begun. Output was up 0.4% in September on the strength of autos and tech equipment. For the third quarter as a whole, manufacturing output rose at an annual rate of 3.5%, after falling for three straight quarters. And when inventory-rebuilding kicks in, factory output will advance at even faster rates in the coming months.

U.S. manufacturers will have to share some of the new demand with importers, but the turnaround will nevertheless help stanch manufacturing job losses. That's one reason the job picture is improving: Simply halting the decline in factory jobs will boost overall monthly payroll gains substantially. For example, excluding September's factory-job losses, private-sector payrolls would have risen by 101,000. The new strength in demand will broaden the nascent job recovery.

BUT WILL DEMAND REMAIN STRONG? Fundamentals say yes. For households, look for a second round of tax benefits, as 2004 refund checks reflect lower tax rates retroactive to the first half of 2003. In addition, continued stimulus from past mortgage refinancing and increased household net worth, thanks to the rising stock market and home prices, will bolster spending until job growth gets on a more solid track.

Consumers no longer will be the only sector carrying demand. Besides spending more on inventories, businesses will also continue to lift their capital spending, and bigger capital budgets always go hand in hand with new hiring. Companies already show a new willingness to spend, and they clearly have the means. Third-quarter profits, now being reported, look exceptionally good, and it's no longer just because of cost cutting. Top-line revenue gains are starting to drive earnings.



That's why the outlook for fourth-quarter profits and beyond is so positive. Although pricing power remains weak, revenues are growing much faster now, as peppier demand allows businesses to sell more units of their products. Based on the continued slowing in the core consumer price index, which excludes energy and food, through September, more pricing power won't show up until later in 2004. During the past year, core consumer inflation has fallen from 2.2% to 1.2%, while core wholesale inflation has held at essentially zero. Even a little recovery in pricing power next year will give revenues and profits a further lift.

Fatter corporate profits are just one element of the virtuous cycle that is taking hold in the U.S. economy. It has been a long time coming. But finally the positive supports far outweigh the negative drags in the outlook. And while the third-quarter gallop won't last, it finally looks as if real GDP is ready to string together three quarters of growth averaging 4% or better. The economy has not seen growth that strong for that long since mid-2000. And since the rate is fast enough to boost both profits and payrolls in coming months, it's a pace sure to bring cheer to both Wall Street and Main Street.

BY JAMES C. COOPER & KATHLEEN MADIGAN