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Third Quarter Growth Robust

The U.S. economy is booming, in spite of the credit crunch. The 'Advance' estimate of third quarter GDP growth came in at 3.9 percent, higher even than Q2's 3.8 percent and the best performance in the past 6 quarters. The Federal Reserve dropped its fed funds and discount rates another 0.25 percent on the same day, so that the Prime Rate is now 7.5 percent.

In spite of the good growth rate, the Fed's quarter percent rate drop was far too timid for the job at hand. Third quarter foreclosures are up 40 percent over the second quarter in California alone, according to DataQuick Information Services. So interest rates have to come down further to ease the credit problems caused by the Fed's rate increases of the past 2 years.

The Fed's press release said that "economic growth was solid in the third quarter, and strains in financial markets have eased somewhat on balance. However, the pace of economic expansion will likely slow in the near term, partly reflecting the intensification of the housing correction."

Yet the FOMC release added that the upside risks to inflation "roughly" balanced the downside risks to growth. Such wording usually means the Fed is done with any more rate reductions for the present. This is even though the Congressional Budget Office estimates that a possible 2,000,000 subprime loan holders may lose their homes nationwide through 2008!

Six Southern California Counties had 13,314 foreclosures in July, August Sept., versus just 1,960 foreclosures in the third quarter of 2006. They are particularly pervasive in San Bernardino and Riverside counties, the working-class exurbs of Los Angeles and Orange County, and the fastest-growing counties in the state.

But overall, the surge in economic activity has easily outweighed the effects of the credit crunch to date. Business investments and exports led the way, growing 7.9 and 16.2 percent per year, respectively, in Q3. Disposable, or after tax, income grew a whopping 4.4 percent, which seems to be fuelling consumer spending. So-called real final sales—after inflation and inventory expansion are taken out—rose 3.5 percent. And yet inflation, via the GDP price index, rose just 1.6 percent, versus 3.8 percent in the second quarter.

Meanwhile, residential investment (ie, new-home construction) is "nowhere near a historic low", according to the Economic Policy Institute—in fact, it remains close to the post-1979 average of 4.6 percent,. Though housing inventories are at historic highs, new-home construction would have to drop by another one-third—to 3 percent of GDP growth—to approach its historic low last reached in 1991. But new-home construction rose 4.8 percent in Sept., and inventories shrank to an 8.3-month supply.

The GDP price index assesses the costs of all goods and services produced domestically. So where is the inflation with the index so low, and why is the Fed so worried about it? That is the mystery, and why we believe they will in fact continue to lower rates come Dec. 11, the last meeting of the year.