NEW MINERVA REPORT

Growth Returns

The '*advance*' estimate of third quarter economic growth for the US has come in at an unbelievable 7.2%. Despite economists revising up their estimates over the past month or so, the best expectation was only 6%. We have to be a little bit cautious of advance estimates, because the source data on which they are based is incomplete. However, although revisions are likely to be made, you can not get away from the fact that these figures are good. Additionally, the spread of the figures is better than many had expected.

The effects of the tax cuts are clearly seen in the Personal Consumption figures, which show an increase of 6.6%, compared to last quarter's growth of 3.8%. Final sales of computers contributed 0.5% to the GDP figure, and the output of motor vehicles added 1.17%. In some respects this is the bad news; the good news is that the falling US dollar has meant that exports have gone up. Just to remind readers of the mathematics for economic growth:

$$GDP=C+I+G+(X-M)$$

Where X is exports, and M is imports, C is consumer expenditure, I is fixed investment and inventory changes, and G is government consumption. GDP is Gross Domestic Product. So, from this equation, you can see that when growth in exports are greater than growth in imports, this produces a positive input into the GDP figure. The preliminary figures show exports rising by 3.3%, and imports rising by just 0.1%. One other point of note in these figures, that bodes well for the immediate future, is that inventories actually fell over the quarter, which had a negative drag of 0.67% on the GDP figure. The reason why this bodes well is that declining inventories will have to be rebuilt. That will have a positive impact on future economic growth numbers. Finally, bearing in mind the situation in Iraq, one strange figure is that defence spending, which rose by 45.8% in the second quarter, is unchanged in the third quarter.

It's not just the US who are seeing better numbers. In the UK a revision to the second quarter's growth from 0.3% to 0.6%, coupled with third quarter numbers of 0.6%, suddenly makes the Chancellor's growth figures a little more plausible. Rather than 1.1% growth so far this year, we have 1.4%. That means, if the fourth quarter manages the same growth as the preceding two quarters, we have 2% growth for the year which hits the minimum of the Chancellor's 2% to 2.5% band in his Budget. In fact it is the revision of the second quarter figure which has placed the Bank of England in a quandary. The reduced interest rates were seen as an 'insurance' in July because they believed that the housing market was finally quietening down and the economy could sink into malaise. Now the figures showing the malaise have been amended upwards, and the housing market is once again picking up steam on record borrowing. But they mustn't upset the housing market too much with higher rates, or they could kill the golden goose!

HIGHER RATES

The question that will start to surface in the minds of investors is whether all this good economic news will become too good. Will the central banks be forced to put up interest rates to calm the economic numbers down? The Bank of England has already responded by being the first western bank to raise interest rates. But to be fair to them, they were just clawing back a decrease that they made in July, based on erroneous growth figures received from the Government. In the US, in its statement made after the latest Fed meeting where they kept rates on hold, the Federal Reserve committed itself to "maintaining policy accommodation for a considerable period." However, with the impact of the inventory cycle still to come, there will be concerns for the future. In fact in the minutes of their September meeting, the Fed said that there was concern about "committing themselves to a particular policy stance over some pre-established, extended time frame."

There are two things likely to stay the Fed's hand. Firstly, 2004 is a Presidential election year. There is little doubt that the White House is doing all in its powers to ensure that George Bush jnr does not suffer the same fate as his father, and not get a second term because of the economy. (At the moment, he seems to be doing the opposite, he's losing on the war but winning on the economy.) The second is that in the back of the Fed's mind must be the original concerns about deflation and economic stagnation. The current economic growth has come about due to the low interest rates, the tax cuts and the government spending. These are all one off measures. It's a bit like giving a child extra pocket money, once it is spent, that's it. The other side of that coin is that the parent/ government had to borrow that money to give to the child. At some stage this money will have to paid back.

What is the implication of all this to markets? The economic news is good news for markets. With the inventory kicker still to come in the US, there should be some further pick-up in earning numbers, especially companies not involved with the finished goods. As far as rising interest rates are concerned, we looked at past interest rate rises to get a feel of how markets performed

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