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Real GDP: Traditional Business Cycle Patterns Emerge

Real GDP declined at an annualized rate of 6.1 percent in the first quarter and despite the hype, the traditional patterns of a business cycle are emerging. After a sharp decline in demand in the fourth quarter we are now witnessing the inventory correction. Ahead is rising demand and recovery at a slower, but still positive, pace.

GDP: Not a V nor L—Just a Swoosh

U.S. real GDP declined 6.1 percent in the first quarter while real final sales fell 3.4 percent after a decline of 6.2 percent in the fourth quarter, all at an annualized rate. Most importantly, the patterns of individual components of the report are tracking traditional business cycles.

Economic cycles are driven internally by the balance between final sales and inventories. In the prior quarter, final sales plunged while inventories hardly declined. Therefore the sales/inventory balance needed to be corrected. We got the correction this quarter. In today's report the rebalancing began with the decline of inventories of over $100B which subtracted 2.8 percentage points from GDP. Meanwhile, the waterfall collapse of final sales of 6.0 percent in the fourth quarter has given way to a smaller decline of 3.4 percent in the first quarter.

Components Of Growth

Consumer spending was actually up 2.2 percent as households responded to lower gasoline prices and increased federal transfer payments (Social Security and tax refunds). Both durable and nondurable goods spending improved.

Meanwhile, business investment followed its traditional pattern of weakness in the recession. Firms responded to the lack of profits to finance growth as well as reduced expectations of growth going forward. Purchases of equipment and software plunged nearly 34 percent at an annual rate—the sharpest quarterly decline in 50 years. Nonresidential construction fell 44 percent as commercial construction appears to have totally shutdown given economic uncertainty and the credit crunch. Residential construction continued its freefall, down 38 percent after a decline of 23 percent at an annual rate in the fourth quarter.

As for trade, both imports and exports fell as expected. Gross exports fell 30 percent, a by-product of recession in most foreign countries. Imports also fell reflecting U.S. weakness.

Federal spending was the surprise weakness—led down four percent by defense spending. As expected state & local spending fell again, consistent with budget constraints.

Job growth and income growth will be more moderate. Housing and consumer durable spending will be more limited by credit and a more cautious attitude for consumers. Businesses face a higher cost of capital and higher energy and health care costs and taxes. State & local governments face significant budget challenges. Trade and federal spending will move ahead but the implications for interest rates and the dollar are highly uncertain.