

## Economics Group

John E. Silvia, Chief Economist  
[john.silvia@wellsfargo.com](mailto:john.silvia@wellsfargo.com) • (704) 374-7034

# GDP: Modest, Broad-Based Growth; Inflation Above Fed Goal

**Gains in consumer spending and business investment led to a gain in final sales of 3.6 percent, which supports the case for sustained growth going forward. Unfortunately, inflation exceeds the perceived Fed target.**

### GDP Finally Supersedes Pre-Recession Peak

Sustained growth—neither boom nor bust—remains the theme for this economy. Real GDP rose at a 2.5 percent pace in the third quarter and is up 1.6 percent from a year ago. The gains in the third quarter reflected improvement in consumer spending, business investment—equipment and structures, residential investment—and even government spending. U.S. GDP has now exceeded the pre-recession peak.

Consumer spending rose 2.4 percent in the third quarter with improvement in spending on durables, nondurables and services, and is in contrast to the first half of the year when weak spending reflected higher prices, specifically for gasoline and groceries. Real disposable income remains under pressure, however, such that the lack of real purchasing power, combined with concerns about jobs, continues to put a damper on overall consumer spending.

### Business Investment: Positive But Slowing—Typical Expansion

Real business fixed investment rose 13.7 percent in the third quarter and contributed 1.6 percentage points to the overall 2.5 percent gain in GDP. This is consistent with the moderation of the nondefense capital goods orders over the past year. Over the last three months orders have risen 8.4 percent on an annual basis so there is still good forward momentum. The gains in investment were in structures, software, computers, industrial and transport equipment—a very broad-based gain. The supply shock from the Japanese earthquake has passed and we expect positive economic momentum going forward.

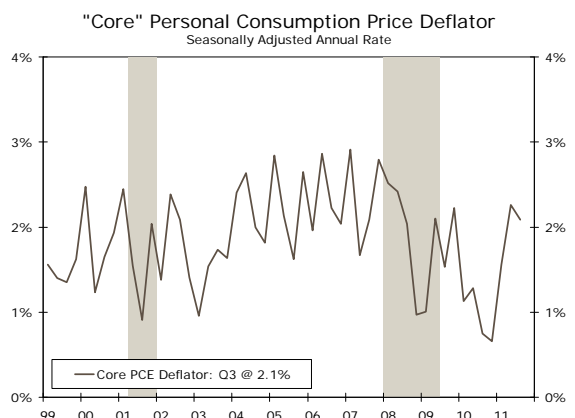
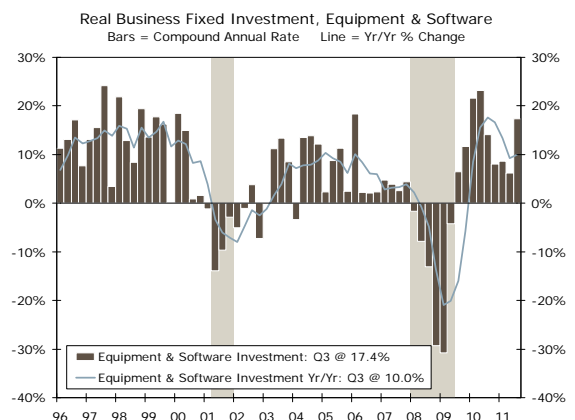
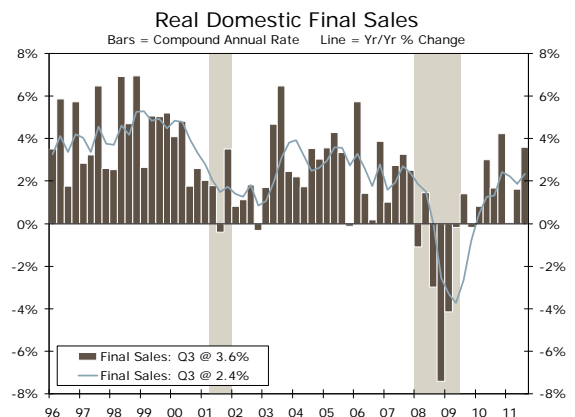
State and local government spending was the one negative hit on the economy, as was expected. The restructuring continues to proceed in this sector as spending needs to match revenues going forward.

### Inflation: Above Perceived Fed Target, Definitely Not Deflation

While real GDP growth at 2.5 percent appears modest, inflation, as measured by the core PCE deflator, now exceeds the perceived 2 percent Fed target. The overall GDP deflator rose 2.5 percent and the core PCE deflator came in at 2.1 percent which is above the Fed's perceived target. The rise in inflation for the overall GDP reflects gains of 4.5 percent in nondurable consumer goods and 4.8 percent in structures. Import prices and residential investment prices were down.

At this point, the Fed appears more concerned about growth than inflation with Governor Yellen and Vice Chairman Dudley talking about the possibility for further monetary accommodation with QE3.

For decision makers, the signal is that the Fed will accept above-target inflation for the time being and retain an easing bias to promote growth. With inflation already rising above the yield on most of the Treasury yield curve, real returns are negative and make Treasuries a difficult choice.



## Wells Fargo Securities, LLC Economics Group

Diane Schumaker-Krieg	Global Head of Research & Economics	(704) 715-8437 (212) 214-5070	diane.schumaker@wellsfargo.com
John E. Silvia, Ph.D.	Chief Economist	(704) 374-7034	john.silvia@wellsfargo.com
Mark Vitner	Senior Economist	(704) 383-5635	mark.vitner@wellsfargo.com
Jay Bryson, Ph.D.	Global Economist	(704) 383-3518	jay.bryson@wellsfargo.com
Scott Anderson, Ph.D.	Senior Economist	(612) 667-9281	scott.a.anderson@wellsfargo.com
Eugenio Aleman, Ph.D.	Senior Economist	(704) 715-0314	eugenio.j.aleman@wellsfargo.com
Sam Bullard	Senior Economist	(704) 383-7372	sam.bullard@wellsfargo.com
Anika Khan	Economist	(704) 715-0575	anika.khan@wellsfargo.com
Azhar Iqbal	Econometrician	(704) 383-6805	azhar.iqbal@wellsfargo.com
Ed Kashmarek	Economist	(612) 667-0479	ed.kashmarek@wellsfargo.com
Tim Quinlan	Economist	(704) 374-4407	tim.quinlan@wellsfargo.com
Michael A. Brown	Economist	(704) 715-0569	michael.a.brown@wellsfargo.com
Joe Seydl	Economic Analyst	(704) 715-1488	joseph.seydl@wellsfargo.com
Sarah Watt	Economic Analyst	(704) 374-7142	sarah.watt@wellsfargo.com
Kaylyn Swankoski	Economic Analyst	(704) 715-0526	kaylyn.swankoski@wellsfargo.com

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