ECONOMIC UPDATE

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Q1 2013 Real GDP: Disappointing Headline, Broader Story Remains The Same

- Real GDP grew at an annualized rate of 2.5 percent during Q1 2013 following growth of 0.4 percent (annualized) in Q4 2012.
- The GDP Price Index rose at an annualized rate of 1.2 percent during Q1.

The U.S. economy grew at an annualized rate of 2.5 percent during 2013's first quarter, better than the 0.4 percent growth logged during Q4 2012 but considerably below expectations for better than 3 percent growth. Perhaps more significantly – though certainly no more uplifting – the longer running story has not changed, as the economy remains mired in the pattern of slow and uneven growth seen since the end of the Great Recession. Since Q3 2009, the start of the recovery, real GDP growth has averaged 2.1 percent (annualized) per quarter, and the swings seen over Q4 2012 and Q1 2013 have not changed that.

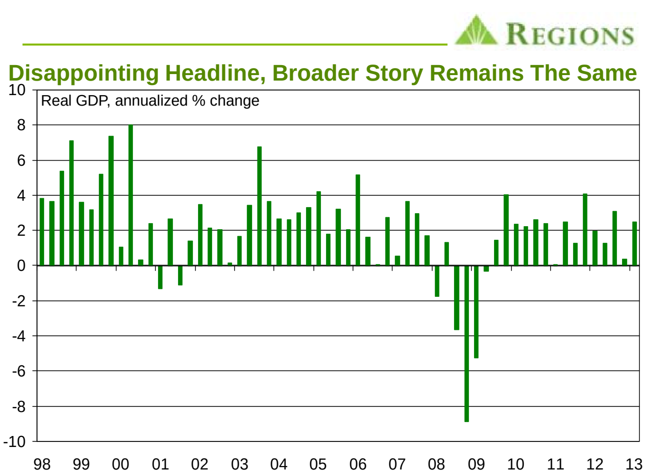
For the record, we'll get the full disclosure paragraph out of the way now. We had looked for growth of 3.5 percent during Q1 which was clearly off the mark. The biggest factor behind our miss is the government sector. After a 22.1 percent annualized decline in Q4 2012, we had looked for a modest bounce back in defense spending in Q1, but instead defense spending declined again, at an annualized rate of 11.5 percent. Nondefense spending declined as we anticipated, but at a faster rate than we expected. Also, imports grew by more than we anticipated. So, while growth in private domestic demand was pretty much as we projected, we were caught out by the magnitude of the drop in government spending.

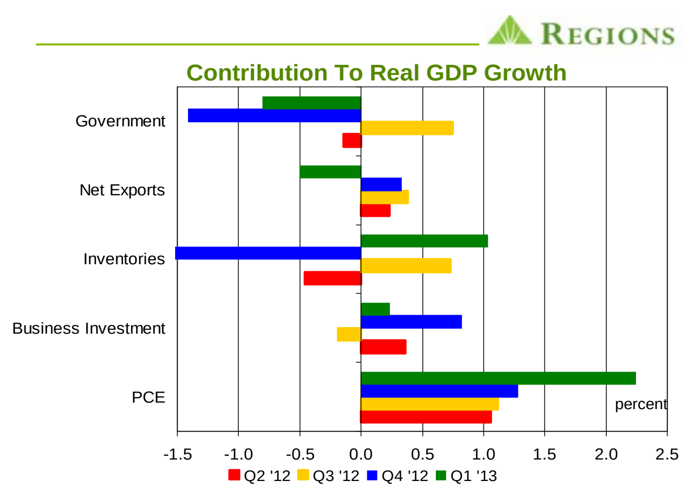
As we did with the Q4 GDP report, we do take some comfort from the performance in private domestic demand during Q1 – and not because that's the part of our forecast that was on the mark. Instead, a second consecutive quarter of better than 3 percent growth in private domestic demand affirms the building momentum in the private sector over the past several months, despite some uneven month-to-month reads on the high frequency data. Personal consumption expenditures grew at an annualized rate of 3.2 percent during Q1, led by motor vehicle sales and a stepped-up rate of spending on household services, though the latter to a large extent reflects higher utilities outlays. Business investment in equipment and software logged a 3.0 percent annualized gain while business spending on structures declined, which was to be expected after an outsized gain of 16.7 percent during 2012's final quarter. Residential investment posted a third consecutive double-digit gain during Q1 as the housing market continues on its road to recovery.

In terms of contributions to, or deductions from, top-line growth, consumer spending added 2.24 percent, business fixed investment added 0.2 percent, and residential investment added 0.31 percent. This raises a useful point about the recovery in the housing market – despite the seemingly impressive rates of growth in residential investment the contributions to top-line growth remain modest. This is a reflection of how far the housing market fell during the downturn and how far away from "normal" we are in terms of the levels of new construction and home sales. The decline in government spending took 0.8 percent off of top-line growth while a larger trade gap took another 0.5 percent off. After deducting 1.5 percent from top-line growth during Q4, private inventory accumulation added 1.0 percent in Q1. While this was in line with expectations, what was not expected was this increase being primarily driven by higher farm inventories, with nonfarm inventories contributing only 0.25 percent to top-line growth.

Disposable personal income declined at an annualized rate of 4.4 percent during Q1. This is a function of higher payroll taxes, lower unemployment insurance payouts, and a sharp decline in dividend income that simply reverses the spike seen during Q4 2012. Total wage and salary earnings grew at an annualized rate of 3.2 percent.

Keep in mind that today's report reflects the BEA's first pass at estimating Q1 GDP and is based on incomplete data, the biggest gaps being trade, inventories, and nonresidential construction. Still, we don't look for pending revisions to change the broader story – we continue to live in a two percent world. Current quarter growth will fall short of that mark, thanks to the impact of higher payroll taxes and the sequestration spending cuts. We continue to maintain, however, that by year-end the U.S. economy will be on the move to a three percent world.





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