ECONOMIC UPDATE
REGIONS
August 27, 2015

Q2 2015 Real GDP: Better Q2 Headline, Details Less Favorable For Q3 Growth

- The BEA's second estimate shows annualized real GDP growth of 3.7 percent in Q2 2015, compared to the initial estimate of 2.3 percent.
- Consumer spending, business fixed investment, government spending, net exports, and inventory accumulation were all revised higher.
- After-tax corporate profits were up 1.3 percent, quarter-over-quarter, but down 1.9 percent year-over-year.

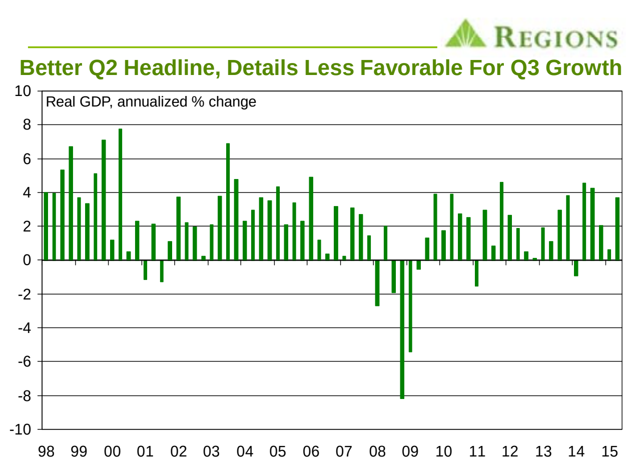
Just imagine the possibilities if the government sold naming rights to the economic data releases. For instance, today's release of the second report on Q2 GDP could have been brought to us by *Overstock.com*, which would have been quite appropriate as the first half of 2015 saw the biggest two-quarter inventory build in the life of the GDP data. Based on more complete source data the BEA now reports real GDP grew at an annualized rate of 3.7 percent in Q2, compared to the initial print of 2.3 percent growth. The pace of inventory accumulation in the nonfarm business sector was revised higher, as was growth in consumer spending, business investment, and government spending, while the trade deficit is now shown to be slightly smaller than first estimated. While the upward revision to the Q2 headline growth number is of course welcome, the underlying details set up a less favorable profile for Q3 growth, most notably the large inventory build. If history is any guide, inventories will be a significant drag on Q3 growth, to the point that, for the Q3 GDP report, *Five Hour Energy* may be an appropriate sponsor as the economy will likely appear to have run out of steam.

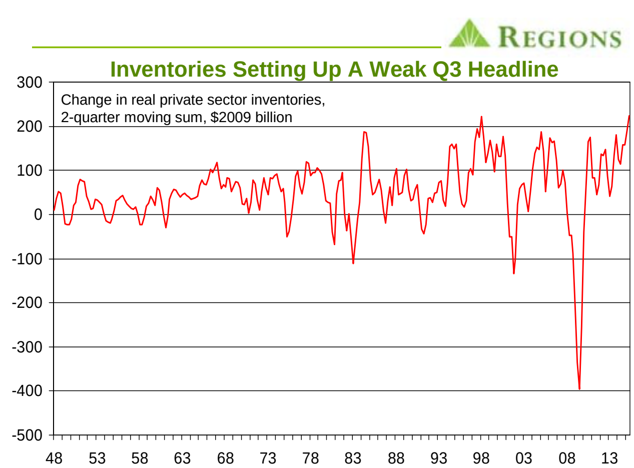
Growth in real consumer spending was revised from 2.9 percent to 3.1 percent, annualized, thus adding 2.11 points to top-line real GDP growth in Q2. Real business spending on equipment, intellectual property products, and structures was revised higher – spending on equipment did decline in Q2 but by far less than had initially been estimated. Residential investment was also revised higher with real investment in both single family and multi-family structures upgraded. Growth in multi-family residential investment is now shown to have advanced at an annual rate of 28.3 percent in Q2 and since Q2 2011 average annualized quarterly growth has topped 34 percent in this segment, though it should be noted the level of multi-family investment is far, far lower than the level of single family investment.

Total government spending is now reported to have grown at an annual rate of 2.6 percent in Q2, compared to the initial estimate of 0.8 percent growth. Spending on the federal government level was revised higher, but it was a sizeable upward revision to state and local spending that drove overall government spending higher. Real exports of U.S. goods grew by 6.5 percent in Q2 after having contracted 11.7 percent in Q1, while real imports of goods into the U.S. grew by 2.7 percent after growing 7.2 percent in Q1 (these are all annual rates). As such, the trade gap fell in Q2 but it should be noted the trade data over most of the first half of 2015 was clouded by the impact of the West Coast port strike.

One question we've already heard is how much today's GDP report will impact the FOMC as they gather in September to discuss the course of monetary policy. We think not a lot – the GDP data are by nature backward looking and the current quarter high frequency data will carry much more weight. Still, between the details of today's report and the flow of higher frequency data for Q3 to date we have a fairly good idea what the contours of Q3 growth will look like. First, it is highly unlikely we will see a repeat of the 4.3 percent (annualized) growth in state and local government spending in Q3, so government will likely be a drag on growth. More significantly, the magnitude of the inventory build seen over 1H 2015 suggests there will be payback in Q3, and as the chart below indicates, that payback could be severe. Based on past episodes of rapid inventory builds, it is not unreasonable to expect a slower pace of inventory accumulation in Q3 will take well over a percentage point from top-line growth. Moreover, with the trade data free of the strike related distortions, weak global growth will weigh on exports of U.S. goods and trade will be a drag on top-line growth.

As we often do, we'll note the underlying trends are more meaningful than any given headline number. As such, we aren't getting too high over today's headline GDP growth number just as we won't get too down over what we expect to be much slower Q3 growth. The reality is, even with today's data, since the end of the 2007-09 recession the U.S. economy has grown at an average rate of 2.2 percent which, to be sure, is more familiar than it is comforting. Despite some sharp swings in the quarterly growth rates we don't look for this to change much.





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