ECONOMIC OUTLOOK

REGIONS

September 2015

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U.S. Economy Off To The Races? Maybe Not Just Yet . . .

What a difference a revision makes. In their first estimate of Q2 GDP, the Bureau of Economic Analysis (BEA) reported the U.S. economy expanded at an annual rate of 2.3 percent. But, the BEA's second estimate showed annualized real GDP growth of 3.7 percent in Q2, a significant upgrade and one that, perhaps predictably, had many analysts proclaiming the U.S. economy was off to the races, a call premised on the revised Q2 growth rate being sustainable over coming quarters. As for us, we found reasons to be encouraged and discouraged at the same time with our longer-term view of the economy's growth outlook not changing all that much. No, really, that makes more sense than it probably seemed when you read that last sentence.

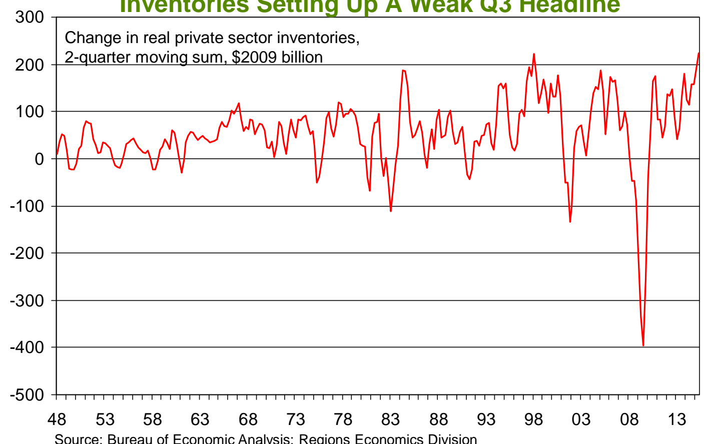
As we regularly point out, the BEA's initial estimate of GDP in any given quarter is based on highly incomplete source data, so that the BEA relies on estimates to fill in what are in some cases substantial gaps in the data. Between the first and second estimates, most (though not all) of these gaps are filled with source data, but at the same time many of the data points that were available in the first estimate are revised. The bottom line is that, for any given quarter, the BEA's initial estimate of GDP is subject to large revisions, as was the case for Q2 2015.

That particular large upward revision was not at all surprising, or at least should not have been. Simply monitoring the regular flow of higher frequency data released after the initial estimate made it plain there would be a sizeable upward revision to the initial print. Yet in the wake of the release of the second estimate, many analysts came away with a much sunnier outlook for the economy over coming quarters, which we found a bit surprising. Still others took the higher headline growth number as validation of what have been long-standing (or, in some cases, perpetual) forecasts of a sustained period of faster growth, which we found more than a bit predictable.

As for our seemingly all over the map reaction, well, that is really a function of our stubborn insistence, by now familiar to our regular readers, on focusing on the details of the report and the longer-running trends, as opposed to merely running with the latest headline number. So, what we found encouraging in the revised Q2 GDP data were the broad based upward revisions in the various components of household and business spending. These revisions show activity in Q2 to be more aligned with what we've seen as steady improvement in the economy's underlying fundamentals, even if that improvement has come at a slower pace than we and nearly everyone else would have preferred.

What we found discouraging were the details on inventory accumulation and government spending, or, more specifically, what these details imply for current quarter growth. For instance, in the BEA's initial estimate of Q2 GDP, real total government spending was reported to have grown at an annual rate of 0.8 percent but the second estimate pegged annualized growth in government spending at 2.6 percent, the fastest such growth since Q2 2010. The largest revision came to combined real state and local government spending, reported to have grown at an annual rate of 4.3 percent in the second estimate compared to the initial estimate of 2.0 percent. If it survives the pending revision to the revision to the Q2 GDP data, that 4.3 percent growth in real state and local government spending would be the fastest growth since Q4 2001, but we find it highly unlikely there will be a repeat performance in Q3. Thus, after adding half a point to top-line real GDP growth in Q2, we see it as very likely state and local government spending will act as a drag on Q3 real GDP growth.

To us, though, what is far and away the biggest downside threat to Q3 real GDP growth is inventory accumulation, or, what we expect to be the relative lack thereof in Q3. Private sector businesses added to inventories at an annual rate of $121.1 billion in Q2, which comes on the heels of an annualized increase of $112.8 billion in Q1. This marks the largest back-to-back inventory build in the life of the quarterly GDP data, which go back to 1947. Even before one commences to digging through that historical data, the seemingly obvious takeaway is a repeat of the inventory build seen over the first two quarters of 2015 would be unlikely in Q3, meaning inventories will be a drag on top-line real GDP growth in the current quarter.



When one actually does go through the historical data to find past episodes of large inventory builds, the seeming obvious takeaway doesn't necessarily become set in stone, but let's just say the data don't exactly offer a lot of encouragement. One thing apparent from the above chart is how volatile inventories

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tend to be, and it is also apparent that large swings in inventories in a given quarter, or two, tend to be quickly reversed in subsequent quarters. In the case of inventory builds as large as that seen over 1H 2015, it is not at all uncommon for inventories to deduct more than a point off of top-line real GDP growth in a subsequent quarter. We look for that to be the case in Q3, with the drag closer to two points than one. Between this, the drag we expect from government spending, and what we expect to be little, if any, help from trade (which also added to Q2 growth) we are at present looking for Q3 annualized real GDP growth to come in below 2.0 percent despite what is shaping up to be another quarter of brisk growth in real consumer spending and improved business investment spending.

There are those, however, who argue the pace of inventory accumulation seen over the first two quarters is part of the new normal of inventory management. The two lines of argument are businesses ramped up inventories in 1H in anticipation of a rapid acceleration in growth of final demand in the year's second half, or, alternatively, a higher level of inventories over time is consistent with the expanding size of the economy. We don't find either one of these arguments to be at all convincing. And, as if by magic coincidence, the people making this case are using it to help justify their calls of sustainable growth in real GDP at or slightly above 3.5 percent. Calls they have, by the way, been making for some time now.

By now you're probably saying to yourself, if not screaming it out loud, could this discussion get any less interesting than a detailed primer on inventory accumulation? Be that as it may, we still think it worthwhile given how inventory accumulation can impact top-line real GDP growth, for better or worse, in any given quarter. One thing to keep in mind is that in GDP accounting, the change in inventories from one quarter to the next goes into the calculation of the level of GDP, but in the calculation of GDP growth what matters is the velocity of the change in inventories. In other words, even if those who argue large inventory builds are now a fact of economic life are correct, any increase in inventories less than $121.1 billion, annualized, in Q3 will be a drag on top-line real GDP growth.

It seems almost a given this will be the case, making it a matter of not whether, but to what degree, inventories will be a drag on Q3 real GDP growth. As noted above, we think this drag will be significant. But, this gets us, even if in a roundabout way, back to our earlier point that the revised Q2 GDP data do not really alter our longer-term view of the economy's prospects, and neither will the Q3 GDP data even if they come in as we expect. The reality is that, even with the revision to Q2 growth, since the end of the deep and painful 2007-09 recession the nature of the recovery/expansion has not really changed all that much, nor do we expect it to any time soon.

Indeed, over the past six years there is no time at which one could reasonably claim the economy was totally in synch. Instead, different sectors of the economy have taken turns at the head of the peloton, to borrow a cycling term, pulling hard to offset other sectors lagging behind. In the early stages of the recovery manufacturing and energy were key drivers, with housing, consumer spending, and government lagging. Over time, the housing market has strengthened and growth in consumer spending has picked up but we are now seeing energy and manufacturing, at least non-auto manufacturing, acting as drags. Moreover, a series of what in and of themselves could be seen as transitory factors – unusually harsh winters, port strikes, and the like – have consistently acted as drags on growth, as have a host of regulatory and policy changes. So, even though there have been some dramatic quarter-to-quarter swings in real GDP growth, the reality remains that since the end of the 2007-09 recession average annualized real GDP growth has been 2.2 percent and it remains unclear whether, let alone when, the economy will break out of a fairly mundane growth range.

We find it more than a bit curious there remain die-hards who continue to argue the economy can suddenly ramp up to sustained real GDP growth of 3.5 percent or more. Particularly in light of what, in recent years, has become a much heavier regulatory burden and what has effectively been the abdication of fiscal policy on the part of those tasked with managing it. To be sure, in our 2015 outlook (published in the January *Monthly Economic Outlook*) we forecast real GDP growth in excess of 3.0 percent for 2015. That call quickly, and unceremoniously, fell by the wayside as the economy limped through the first quarter of the year, barely managing to avoid contracting. But, while we saw better than 3.0 growth as plausible for 2015, we never felt that to be a sustainable pace, and still don't see it as being such.

Will Shaky Global Backdrop Trump Domestic Demand?

Our expectations that a significant drag from inventories would lead to a sharp deceleration in real GDP growth in Q3 were formed well before mid-August, when China's surprise devaluation of the yuan was the catalyst for a wave of turbulence that rocked global financial markets and, as of this writing, has shown few signs of abating. To be sure, an alternative view is equity valuations were higher than warranted and, as such, due for a correction, and China was a convenient scapegoat.

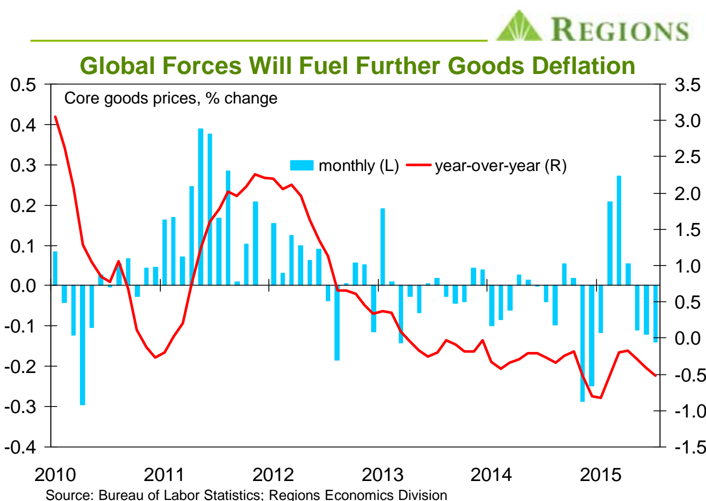
That may well be the case, but the more fundamental issue is that China's economy has clearly slowed more than had been anticipated, which has had a ripple effect through the emerging market economies that rely on China as a prime buyer of raw materials and commodities. At the same time, another leg down in crude oil prices has rocked energy producers, with Canada now in recession, at least technically, the energy sector a clear drag on U.S. growth, and a struggling Russia raising considerable worries – it is not yet clear whether the rest of the world should be encouraged by, or fearful of, news that Russia is working on a "plan" to boost oil prices.

In short, a host of global issues seemingly stack the odds against a meaningful and sustained acceleration in U.S. economic growth, at least for the next few quarters. While the collective force of these global issues is not sufficiently strong to drag the U.S. economy into recession, the impact will nonetheless be felt. And, to be sure, not all of the impacts of weak global growth will be negative for the U.S. economy. For instance, lower energy and commodity prices mean lower prices for U.S. consumers and businesses. If we are correct in our prediction that after mid-September renewed downward pressure on oil prices will lead to

further declines in retail gasoline prices, that will simply add to the cumulative effect of what, over the past ten months, have been significantly lower gasoline prices.

To be sure, we have argued (March 2015 *Monthly Economic Outlook*) the highly touted boost to consumer spending was more than a bit too highly touted, but by this point in time the cumulative impact of the cash freed up by lower retail gasoline prices has given consumers the wherewithal to spend more, save more, or pare down debt, if not some of all three. For some reason, though, there seem to be those analysts who judge the health of U.S. consumers by only spending, as though increasing savings or paying down debt are somehow undesirable, or signs of caution on the part of consumers, a curious conclusion indeed.

It is also important to note that price effects are not limited to gasoline. Prices of goods almost across the board are falling on a year-on-year basis and many prices are now even declining on a month-to-month basis as well, which reflects what, for some time now, has been an appreciating U.S. dollar. For instance, prices for core (i.e., excluding food and energy) goods have fallen (year-on-year) for 28 consecutive months now, a streak we fully expect to be extended in the months ahead. The point here is the same as it is for gasoline prices – lower prices continue to free up cash for consumers to deploy in other manners.



As a side note, the monthly retail sales data have been a favorite prop for those bemoaning the sad state of U.S. consumers based on growth rates, whether month-to-month or year-over-year, that don't look especially inspiring. Indeed, we were taken to task last month by one "analyst" (and, let's just stipulate that in the interest of saving space we did not attach nearly as many quotation marks to that term as in this case are warranted) for being quoted as saying "U.S. consumers are just fine." The "evidence" (ditto) cited was the weak year-over-year growth in retail sales. A fine argument, indeed; logically sound, backed up by the data, and irrefutable. Unless of course one considers such pesky little details such as that retail sales cover sales of goods and are reported on a nominal, i.e., not adjusted for price changes, basis. So, with falling prices, particularly given the extent of declines in retail gasoline prices, of course growth in nominal spending will look weaker than it actually is. One need simply to look at growth in inflation adjusted spending on goods, either in the monthly retail sales data or in the monthly personal income & spending data, to see that growth in real consumer spending is indeed healthier than suggested by the nominal data.

In any event, to the extent weak global growth sustains further appreciation in the U.S. dollar and keeps downward pressure on energy and commodity prices, it will be to the benefit of U.S. consumers and businesses, at least those businesses for which energy and commodities are not outputs but instead inputs to production. One reason we and many others expect the FOMC to move at only a very gradual pace – regardless of when they start – in normalizing the Fed funds rate is we expect disinflationary pressures stemming from weak global growth to continue to work their way through the U.S. economy over coming quarters.

This is not to say there will be no adverse impacts from a weak global growth environment. Ongoing weakness in global demand for crude oil is obviously a negative for producers, including those U.S. producers who have already been through a wave of significant pullbacks in capital expenditures and payrolls. The impacts of these pullbacks have been apparent in the data on capital spending, commercial construction outlays, and nonfarm employment over the past several months; the question going forward is whether or not crude oil prices will fall enough to spark further cutbacks. We cannot rule this out, of course, but should this indeed prove to be the case any subsequent cuts will be nowhere near as severe as the initial round.

Additionally, U.S. exports will suffer from a weak global growth environment, via both price effects and income effects. In other words, demand for U.S. produced goods in countries such as China will suffer from weak domestic growth in those nations. Moreover, to the extent there is further U.S. dollar appreciation, U.S. produced goods will become more expensive in global markets making U.S. firms less competitive. There are, however, many who attach little significance to a potential drop in U.S. exports – first, because exports are a relatively small share of U.S. GDP and, second, because while China is the third largest market for U.S. exports (behind Canada and Mexico), it accounts for just over 7 percent of total U.S. exports, which translates into less than one percent of U.S. GDP. That emerging markets account for smaller shares of U.S. exports lead some to dismiss any weakness there as well. Now, we're no experts, but we've always held that if you take a lot of numbers that, in and of themselves, don't amount to much and add them together, what you end up with is one bigger number that certainly can matter.

There are other channels through which global forces can adversely impact the U.S. economy. One such channel is corporate profits, which are vulnerable to a slowdown in U.S. exports and to an appreciating U.S. dollar. Based on the corporate profits data in the GDP accounts, we see year-over-year declines in foreign profits in four of the past five quarters. In Q2 2015 foreign profits accounted for just 18.97 percent of total corporate profits, the smallest share since Q1 2007. We expect foreign profits to remain under pressure over coming quarters, particularly to the extent there is further U.S. dollar appreciation as the FOMC begins the task of normalizing the Fed funds rate. For those corporations with foreign operations, a stronger U.S. dollar means foreign earnings translate into fewer dollars when firms opt to convert foreign earnings into dollars.

Then again, it isn't as though firms have much incentive to repatriate foreign earnings given the ridiculously high tax penalty they incur for doing so. But, let's pretend for a moment this isn't an issue and say, to the extent firms do repatriate foreign earnings, a stronger U.S. dollar leaves corporations with less cash to deploy in whatever manner they see fit.

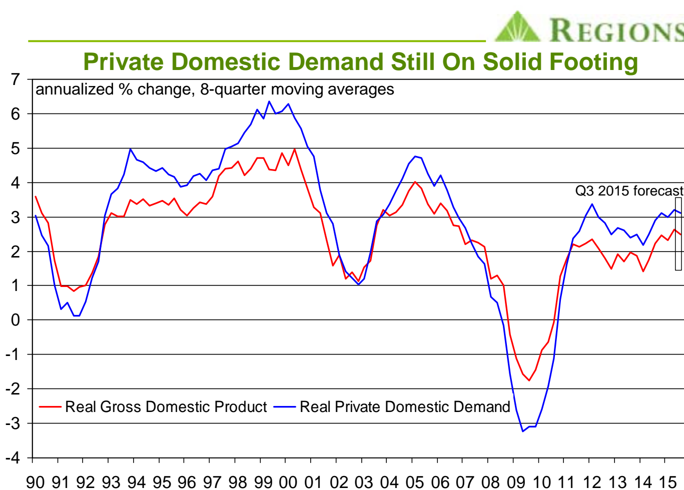
The financial markets, particularly equity markets, open other channels through which global weakness could adversely impact the U.S. economy. To the extent U.S. equity prices remain pressured by concerns over global growth, this could weigh on consumer spending via the wealth effect channel – declining equity prices reduce household net worth which in turn leads households to curtail spending. To date there has been a nontrivial hit to household wealth from lower equity prices and, should this continue, negative wealth effects could kick in. Many brush this aside by noting stock ownership is concentrated amongst upper income households such that any negative wealth effects would be largely confined to spending on "luxury" goods.

We're not so sure we buy this argument, but instead have relied on empirical work to show wealth effects from changes in stock prices are far smaller than wealth effects from changes in house prices. That said, we do nonetheless have concerns that should there continue to be heightened volatility in stock prices, particularly more multi-hundred point daily declines in stock indices, this could take a toll on both business and consumer confidence which, in turn, could lead to curtailed spending in both sectors and thus weigh on real GDP growth.

All in all, we look for the net effect of soft, and uncertain, global growth to be a modest drag on the U.S. economy over coming quarters. Moreover, the FOMC's job becomes even harder as they debate how much weight to attach to these global factors. To the extent the financial markets attach different weights to these global factors and to inflation expectations that have drifted lower, even as the FOMC sticks to the "reasonably confident" party line (see the August 2015 *Monthly Economic Outlook*), there is the potential for heightened volatility in the financial markets when (we assume it is still "when" as opposed to "if") the FOMC pulls the trigger on the initial funds rate hike.

Still, despite our concerns over global economic growth and the potential for ongoing volatility in financial markets, our outlook on the U.S. economy calls for steady, albeit unexciting, growth, the exceptions remaining energy and non-auto manufacturing. We have held to this view for some time now (sure, there was our flirtation with 3.0 percent growth, but, we shall never speak of that again) despite what our growing frustration with what has been considerable volatility in the high frequency economic data – there seems to be very little consistency in a given series from one month to the next or across series in a given month.

One can argue this pattern is consistent with the uneven nature of the ongoing expansion, but the broader point is that, at least to us, has gotten increasingly difficult to form a view of the economy's underlying health, let alone to have any confidence in that view and assess the economy's future course. As a means of drowning out the noise and volatility in much of the top-tier economic data, if not simply protecting our sanity, we've become increasingly reliant on data pertaining to the private sector of the U.S. economy. For instance, we rely heavily on higher frequency data for a more real time glimpse of private sector activity – initial jobless claims, commercial bank loan balances, purchase mortgage applications, and government tax revenue collections (data on income tax withholdings comes daily, the other series come with a weekly frequency). Over the past several months these indicators have consistently been pointing to an improving pace of private sector activity, with growth in bank loans across loan types indicating a broadening of economic activity.



Though they are lagged considerably by time they are released, the GDP data can also be used to construct a gauge of private sector activity. Private domestic demand captures spending in the household and business sectors of the U.S. economy, excluding inventories, government, and net exports. Sure, you can get the data to say whatever you want it to tell you if you manipulate it enough, but, at least to us, the advantage of focusing on private domestic demand is it eliminates two of the primary sources of quarter-to-quarter volatility in top-line real GDP growth – inventories and government. As for trade, it does account for a relatively small share of GDP and tends to be volatile, so also excluding trade offers a cleaner view of the underlying health of the domestic economy. As seen in the above chart, growth in private domestic demand has easily outpaced GDP growth since 2011 (we show 8-quarter moving averages in keeping with our focus on longer-term trends) which, as would be expected, has been the case over time outside of recessions.

Our focus on higher frequency indicators of private sector activity has helped keep us on an even keel despite considerable noise in the more publicized data and, more recently, considerable volatility in the financial markets. Domestic demand is by no means immune to shifting global fortunes but, as of yet, the highest frequency data available suggest the U.S. economy remains on course for steady, but by no means spectacular, growth over coming quarters. And, should that appear to change, we'll have earlier indicators than would be the case were we to rely solely on the monthly or quarterly data. So, for now, the economy may not be off to the races, as some concluded in the wake of the revised Q2 GDP data, but neither is the economy mired in the mud being thrown off by global turmoil, as some now fear will be the case.

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Q1 '15 (a)	Q2 '15 (a)	Q3 '15 (f)	Q4 '15 (f)	Q1 '16 (f)	Q2 '16 (f)	Q3 '16 (f)	Q4 '16 (f)		2013 (a)	2014 (a)	2015 (f)	2016 (f)
0.6	3.7	1.9	2.4	2.3	2.6	2.7	2.6	Real GDP[1]	1.5	2.4	2.4	2.5
1.7	3.1	2.8	2.4	2.6	2.5	2.5	2.3	Real Personal Consumption[1]	1.7	2.7	3.0	2.6
								Business Fixed Investment:				
4.3	3.1	4.4	5.2	5.5	5.5	5.4	5.6	Equipment, Software, & IP[1]	3.5	5.6	4.3	5.1
-7.4	3.2	4.4	4.7	3.7	3.5	3.6	4.0	Structures[1]	1.6	8.1	0.0	3.9
10.1	7.8	10.9	5.6	4.4	7.6	12.4	12.7	Residential Fixed Investment[1]	9.5	1.8	8.6	7.8
-0.1	2.6	0.3	-0.6	-0.7	-0.3	-0.3	-0.3	Government Expenditures[1]	-2.9	-0.6	0.5	-0.2
-541.1	-532.6	-527.9	-528.1	-530.8	-531.9	-532.3	-532.1	Net Exports[2]	-417.5	-442.5	-532.4	-531.8
0.978	1.155	1.156	1.058	1.091	1.134	1.175	1.219	Housing Starts, millions of units[3]	0.928	1.001	1.087	1.155
16.7	17.1	17.5	17.1	16.9	16.8	16.8	16.7	Vehicle Sales, millions of units[3]	15.5	16.4	17.1	16.8
5.6	5.4	5.2	5.2	5.1	5.0	4.9	4.9	Unemployment Rate, %[4]	7.4	6.2	5.3	5.0
2.3	2.2	2.1	2.0	1.9	1.9	1.8	1.8	Non-Farm Employment[5]	1.7	1.9	2.1	1.8
1.0	1.0	1.1	1.6	2.0	1.9	1.8	1.6	GDP Price Index[5]	1.6	1.6	1.2	1.8
0.2	0.2	0.4	0.9	1.9	1.7	1.7	1.8	PCE Deflator[5]	1.4	1.4	0.5	1.8
-0.1	0.0	0.4	1.1	2.4	2.1	2.0	2.1	Consumer Price Index[5]	1.5	1.6	0.4	2.2
1.3	1.3	1.3	1.5	1.7	1.7	1.8	1.8	Core PCE Deflator[5]	1.5	1.5	1.3	1.7
1.7	1.8	2.0	2.1	2.2	2.0	1.9	1.9	Core Consumer Price Index[5]	1.8	1.7	1.9	2.0
0.13	0.13	0.29	0.50	0.54	0.79	1.04	1.29	Fed Funds Target Rate, %[4]	0.13	0.13	0.26	0.91
1.97	2.17	2.36	2.41	2.51	2.72	2.82	2.88	10-Year Treasury Note Yield, %[4]	2.35	2.54	2.23	2.73
3.73	3.83	4.13	4.14	4.18	4.32	4.43	4.50	30-Year Fixed Mortgage, %[4]	3.98	4.17	3.96	4.36
-2.5	-2.2	-2.2	-2.4	-2.4	-2.4	-2.5	-2.5	Current Account, % of GDP	-2.4	-2.3	-2.3	-2.4

a = actual; f = forecast; p = preliminary

Notes:
1 - annualized percentage change
2 - chained 2009 $ billions
3 - annualized rate
4 - quarterly average
5 - year-over-year percentage change

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