First Trust
Monday Morning OUTLOOK
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Looking Past a Weak Q2

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While some economists are reducing their projections for second half growth, we remain confident in a relatively strong rebound from a weak first half. We forecast that real GDP will grow at a 4% to 4.5% average annual rate in Q3 and Q4 2011.

Productivity is strong, monetary policy is loose and fiscal policy is getting no worse. Jobless claims are falling again and auto production is set to surge. In addition, with full expensing allowed for tax purposes this year, record levels of both profits and cash will fuel growth in business investment.

None of this will help Q2 real GDP, which we now expect will come in at roughly 1.3% annualized growth. We think spring growth was held back by three factors.

First, the Japanese earthquake and tsunami wreaked havoc with the global supply chain. Auto and light truck assemblies here in the US fell at a 26% annual rate in Q2.

Second, like last year, the government is still probably having trouble seasonally-adjusting oil prices, meaning oil imports around mid-year will look artificially high and real GDP will look artificially low.

And third, an unusually violent tornado season hit housing hard in the South. Outside of the South, housing starts were actually up in Q2. We expect this trend to spread to the nation as a whole in Q3 and beyond.

Here are the assumptions behind our estimate of 1.3% real GDP growth in the second quarter of 2011.

Consumption: Auto sales are down at a 25% annual rate in Q2. Despite this decline, overall retail sales adjusted for inflation, increased at a 0.3% annual rate. Real purchases of services, a major component of overall consumption, are up through May. Real personal consumption – goods and services combined – probably climbed at a 1% annual rate in Q2, contributing 0.7 points to the real GDP growth rate. (1.0 times the consumption share of GDP, which is 71%, equals 0.7.)

Business Investment: Business investment in equipment and software appears to have grown at a healthy 7% annual pace in Q2. However, commercial construction looks unchanged for the quarter. Combined, these two components of non-residential investment grew at about a 5% rate. In turn, 5% growth in business investment should add about 0.5 points to the real GDP growth rate. (5 times the business investment share of GDP, which is 10%, equals 0.5.)

Home Building: The weather-related weakness in the South caused residential construction to fall by about 4% at an annual rate in the second quarter. This translates into a 0.1 point drag on the real GDP growth rate. (-4 times the home building share of GDP, which is 2%, equals -0.1.) For future quarters, large excess inventories remain. But with the building pace so slow already, housing inventories will continue to decline even as building rebounds.

Government: Real government purchases expanded at about a 1.5% rate in Q2, which should boost the real GDP growth rate by about 0.3 percentage points. (1.5 times the government *purchase* share of GDP, which is 20%, equals 0.3).

Trade: Due to problems seasonally-adjusting oil prices, the government calculated that there was a huge spike in "real" oil imports in the second quarter of 2010. As a result, imports were the biggest drag on real GDP growth for any quarter on record, going back to at least the 1940s. This calculation problem is likely to linger for at least another year. As a result, despite smaller monthly trade deficit figures from the Census Bureau so far in Q2 of 2011, the GDP accounts are likely to show the trade sector was neutral for real growth in Q2.

Inventories: Inventories remain a wild card. At this point, we only have data on inventories through May and *inflation-adjusted* numbers are only available through April. Right now it looks like inventory accumulation slowed slightly from the pace in Q1, probably due to the auto sector. As a result, we estimate that inventories will be a drag of 0.1 point on the real GDP growth rate.

Add 'em all up and you get a 1.3% real GDP growth rate for the second quarter of 2011.

This GDP report – the second consecutive one below 2% real growth – will worry many. But, the data have already begun to turn and the second half is set to accelerate nicely.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
7-19 / 7:30 am	Housing Starts – Jun	0.575 Mil	**0.575 Mil**		0.560 Mil
7-20 / 9:00 am	Existing Home Sales - Jun	4.950 Mil	**4.800 Mil**		4.810 Mil
7-21 / 7:30 am	Initial Claims – Jul 16	410K	**405K**		405K
9:00 am	Philly Fed Survey - Jul	2.0	**1.0**		-7.7
9:00 am	Leading Indicators - Jun	+0.2%	**+0.3%**		+0.8%