# ECONOMIC UPDATE

REGIONS

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## Q1 2016 GDP: A Lousy Q1, But A Little Less Lousy Than We Thought . . .

- Revisions and more complete source data put real GDP growth at an annualized rate of 0.8 in Q1, up from the first estimate of 0.5 percent.
- Before-tax corporate profits scratched out a 0.3 percent increase in Q1, but were down 5.8 percent from Q1 2015.

There was some good news and some bad news in the revisions to the Q1 GDP data. Of course, as is true of life in general, in an economy seeming stuck in a slow-growth rut, "good" and "bad" are relative terms. So, real GDP growth was revised up to 0.8 percent from the BEA's initial estimate of 0.5 percent. The underlying details, however, were a bit disappointing, both on their own merits and in terms of what they imply for current quarter growth. All in all, however, the revisions don't really alter our view of the economy – things are not nearly as dour as implied by the Q1 growth rate, nor are they as solid as what the Q2 growth number is shaping up as.

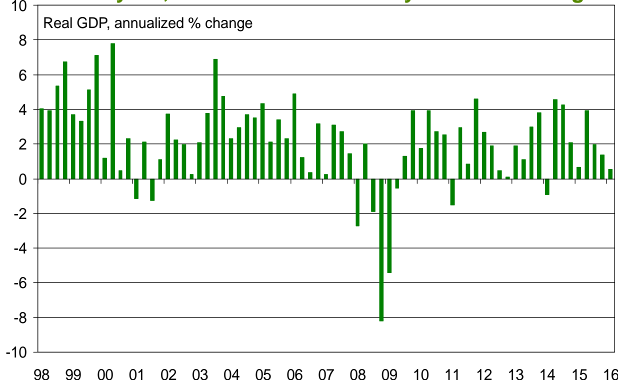
Real consumer spending grew at an annualized rate of 1.9 percent in Q1, unchanged from the initial estimate. If you recall from the April report on retail sales, control retail sales, a direct input into the GDP data, were revised higher for February and March. This led us and other analysts to expect an upward revision to Q1 consumer spending growth. Which did and didn't happen – spending on goods was indeed revised up slightly, but this was basically negated by a downward revision to growth in spending on household services, which is far and away the larger component of consumer spending. It is worth noting that growth in personal income, particularly wage and salary earnings, was revised higher not only for Q1 but also for Q4 2015. While many are puzzled that solid growth in disposable personal income has not led to faster growth in consumer spending, we have repeatedly pointed out consumers are also managing their balance sheets by building up saving and paring down debt. As such, the foundation under consumers is far sturdier than was the case leading up to the 2007-09 recession.

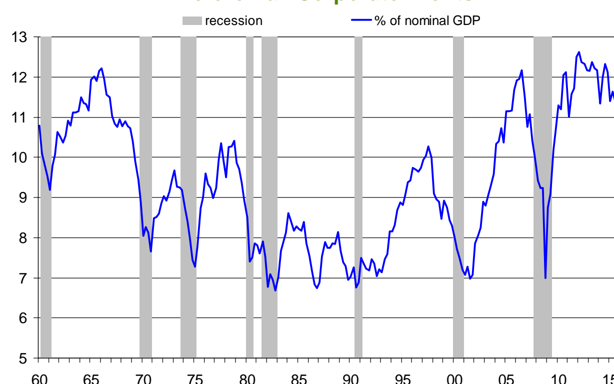
Real exports of U.S. goods are now shown to have slipped by less than had been previously estimated, hence a smaller trade deficit was one factor in the upward revision to top-line real GDP growth. The bigger factor, however, was a faster pace of inventory accumulation than had been incorporated into the first estimate of Q1 GDP. This is its own good news-bad news story – while aiding the Q1 growth number, the faster rate of inventory accumulation means inventories are likely to be more of a drag on current quarter growth. It is true that firms have made progress in working down what had been a sizeable overhang, but today's data show less progress than had been thought to be the case. Finally, residential fixed investment grew faster than initially estimated, thus contributing to the upward revision to top-line GDP growth.

There were some downward revisions to the initial estimates, mainly concentrated in the corporate sector. Real business fixed investment contracted at a faster rate than first estimate, with spending on business equipment and machinery even weaker and spending on intellectual property products contracting mildly, in stark contrast to the first estimate of 1.7 percent growth. Weak business investment spending has many implications for the broader economy, none of them good. We have argued for some time that persistent underinvestment on the part of firms over the course of the present expansion has been a prime factor behind anemic growth in labor productivity. This does not figure to change any time soon, particularly with spending on intellectual property products now on a much lower trajectory.

While some are puzzled that firms continue to add workers but have not been willing to enhance their capital stock, we see a perfectly plausible explanation. In a persistently slow-growth environment with heightened uncertainty – economic and regulatory – firms have opted to add variable costs, i.e., labor, as opposed to fixed costs, i.e., capital. That there has been an ample pool of relatively cheap and readily available labor has added to firms' incentive to do so. One problem, however, is that with labor costs now rising at a faster – though still below normal – rate, firms are seeing mounting pressure on profit margins, as shown in the chart below. In the absence of faster growth in top-line revenue, we see continuing pressure on margins over coming quarters.

Through the normal quarter-to-quarter swings in GDP growth, the trend rate remains just north of 2.0 percent. Clearly, consumer spending and housing are on the most solid footing, but we continue to worry about the prospects for business investment spending.



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