ECONOMIC UPDATE
REGIONS
August 26, 2016

Q2 2016 GDP: The Details Have Changed, The Headline Not So Much

- The BEA's second estimate shows real GDP grew at an annualized rate of 1.1 percent in Q2, compared to the initial estimate of 1.2 percent.
- Adjusted pre-tax corporate profits were down 4.9 percent year-on-year in Q2, the fifth consecutive over-the-year decline.

Revised and more complete source data show real GDP grew at an annual rate of 1.1 percent, down marginally from the BEA's initial estimate of 1.2 percent. Still, while the headline growth number hardly budged, there were numerous and in some cases significant changes in the underlying details. Today's release includes the first look at Q2 corporate profits; pre-tax profits with inventory and capital consumption adjustments were down 1.2 percent compared to Q1 2016 and down by 4.9 percent compared to Q2 2015. Adjusted after-tax profits were down 2.4 percent quarter-to-quarter and down 6.3 percent year-on-year.

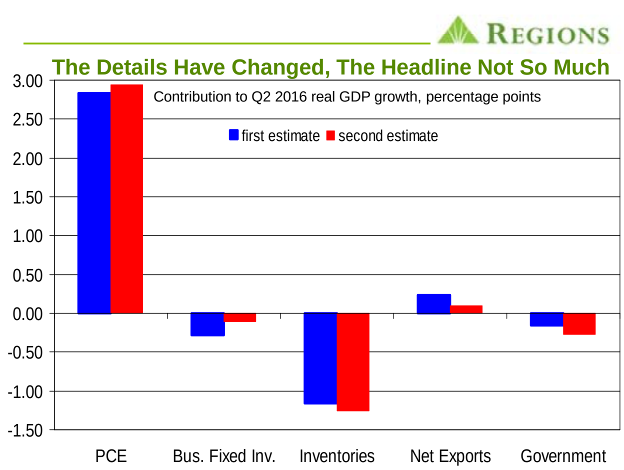
Growth in real consumer spending was revised from an annual rate of 4.2 percent to 4.4 percent. Spending on consumer durable goods and on household services was revised up while spending on nondurable consumer goods was revised down. Growth in real consumer spending added 2.94 percentage points to top-line real GDP growth, more than accounting for the entire increase in real GDP in Q2. At the same time, growth in disposable personal income was also revised higher, though far more significantly than was consumer spending. Real disposable personal income is now reported to have grown at an annual rate of 2.2 percent in Q2 compared to the initial estimate of 1.2 percent. Labor earnings, interest income, and returns on assets were all revised higher. The personal saving rate was revised up to 5.7 percent.

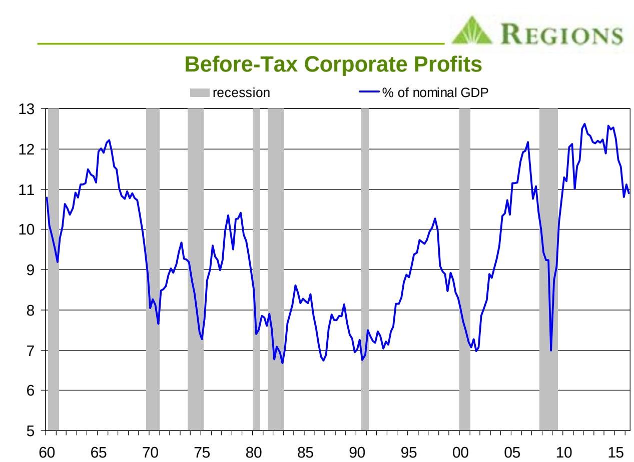
Business fixed investment was revised higher – still a drag on top-line growth but less so than reported in the initial estimate. Still, the entire upward revision to the broader business investment category comes from an upward revision to spending on intellectual property products, a somewhat nebulous category that includes business spending on R&D but also many entertainment related components. Business spending on structures and capital equipment was revised lower, which is more concerning to us. Net exports and government spending were also revised lower in the BEA's second estimate.

The decline in business inventories in Q2 is now reported to be larger than initially estimated. As we've noted before, a decline in inventories is highly unusual during an expansion and the decline seen in Q2 is the culmination of a prolonged effort by businesses to right-size stocks after the first half of 2015 saw the largest two-quarter inventory build in the life of the GDP data. While we see the inventory adjustment as being largely complete, the more relevant question is how firms will manage stocks going forward. It is not uncommon to see large swings in the level of business inventories from one quarter to the next, and these swings tend to have undue influence on top-line real GDP growth. Many analysts are counting on such a swing – higher in this case – in Q3 and, as such, are forecasting a robust rebound in top-line real GDP growth. We do not see such a large bounce in inventories in Q3, as inventory-to-sales ratios remain elevated across the nonfarm business sector and without concrete evidence of a meaningful and sustained pick-up in demand growth, we think firms will keep a tighter rein on inventories. If we are wrong on this point, then Q3 real GDP growth will come in faster than we anticipate.

Another question going forward is the path of corporate profits. As seen in the chart below, corporate profit margins remain elevated by historical standards but are clearly past their cyclical peak. We will note that industry level profit detail are not yet available but the weakness seen in past quarters extended beyond the energy industry. What we do know about Q2 is that foreign profits bounced back sharply from the decline posted in Q1 and now stand 3.6 percent above their-year ago level. Profits in the financial sector rose modestly in Q2 but are still down year-on-year, while profits in the nonfinancial corporate sector fell quarter/quarter and year/year. With profit margins set to compress further over coming quarters, the risks to business investment remain tilted to the downside.

As we noted upon the BEA's initial estimate, the Q2 GDP data do not materially change our view of the U.S. economy. Near-term, consumer spending and housing will be the main drivers, trade and business investment will be the main wild cards and despite the usual quarter-to-quarter swings, trend growth won't stray too far from 2.0 percent.





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