ECONOMIC UPDATE

REGIONS

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Q2 2016 GDP: Consumers Main Driver Of Growth, But Will Need Some Help . . .

- The BEA's initial estimate shows real GDP grew at an annualized rate of 1.2 percent in Q1.
- Consumer spending was the main support for top-line real GDP growth, with inventories and business investment the biggest drags.

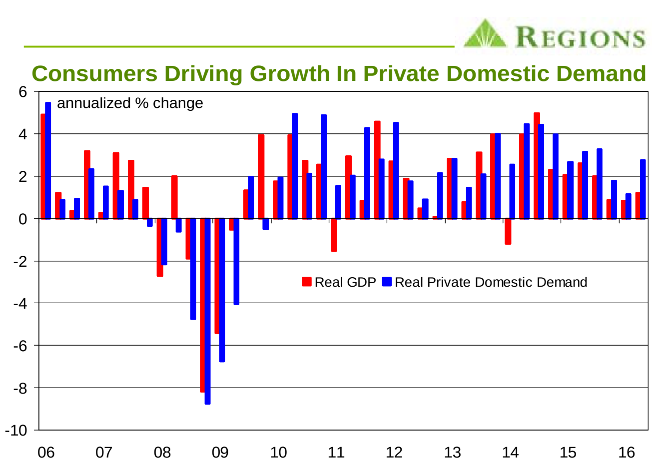
Real GDP increased at an annualized rate of 1.2 percent in Q2, well below expectations. We actually got a clue yesterday that today's report would come in shy of expectations, in the form of a new Census Bureau report that contained estimates of June business inventories. Those data, which showed much slower inventory accumulation in June, were incorporated into today's GDP report, and inventories are a primary reason the Q2 headline number fell so short of expectations. That said, there are other causes for concern, particularly with business investment spending. Consumer spending was the main driver of growth, with an assist from a smaller trade deficit.

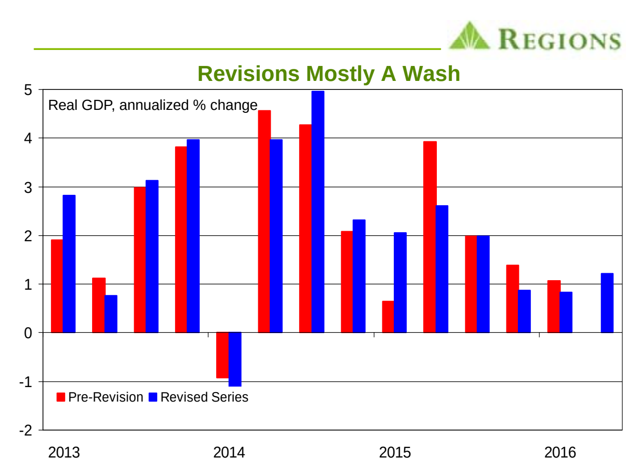
Today's report also incorporated the BEA's annual benchmark revisions to recent historical data, in this case from 2013 through Q1 2016. While the quarter-to-quarter growth pattern looks a bit different, on the whole the revisions are a wash. Prior data showed average annualized real GDP growth of 2.22 percent from Q1 2013 through Q1 2016, the revised data show average growth of 2.24 percent. And, accounting for both the revisions and the soft Q2 print, since the end of the 2007-09 recession average annualized real GDP growth is . . . 2.1 percent. Somehow you just knew that was coming, right?

The bigger question right now, however, is how we should feel about the Q2 data. While we don't feel particularly good about it, neither do we feel as lousy as the headline number may imply, and we certainly feel better than some of the people we've heard screaming on financial talk TV seem to feel. As we routinely point out – whether the headline numbers are "good" or "bad" is that, sure, it matters what the numbers are, but it matters more why the numbers are what they are. In this case, the main culprit behind the weak headline print is nonfarm business inventories fell in Q2, which is highly unusual during an expansion. The decline in inventories took 1.2 percentage points off top-line real GDP growth. This is something we are not concerned with, as businesses have for some time been trying to right-size inventories, which has acted as a persistent drag on top-line growth in recent quarters. Also, in the workings of the GDP math, the decline in inventories in Q2 means inventory accumulation is likely to significantly add to Q3 GDP growth, which, if this does prove to be the case, won't have any more to do with the underlying details of the data than does Q2's decline.

Real consumer spending grew at an annualized rate of 4.2 percent in Q2, with solid gains in spending on durable goods, nondurable goods, and services. This more than accounted for all of Q2's GDP growth and was the main factor behind the 2.8 percent annualized growth in private domestic demand. The latter measure strips out inventories, trade, and government spending and captures private sector spending in the consumer and business sectors. That growth in private domestic demand so easily outran top-line GDP growth, however, does not mean there is no cause for concern. Real business fixed investment spending fell at an annualized rate of 3.2 percent, the worst performance since the end of the 2007-09 recession. We've for some time now been pointing to the corporate sector as the main source of downside risks in the domestic economy, and today's data do nothing to dispel our concern. On top of the longer-term implications for already anemic growth in labor productivity, the more immediate implication of persistently weak business investment spending is that it could at some point translate into diminished hiring if not outright layoffs, which in turn would take the rug out from under U.S. consumers. Additionally, government spending unexpectedly fell in Q2, on the federal level (due to a sharp decline in defense spending), and on the combined state and local levels. The latter is of more concern, as it may be an indicator of stresses on the revenue side of state and local ledgers. This is clearly something to watch over coming quarters.

Despite the Q2 real GDP growth falling well short of our expectations, the details of today's report don't materially alter our view of the economy. Even as many analysts have been telling contrary stories, we have been pointing to the underlying strength in consumer spending and the underlying weakness in the corporate sector, and we continue to see the latter as a risk to the former. As such, the risks to our outlook for continued middling GDP growth remain tilted to the downside.





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