ECONOMIC UPDATE

REGIONS

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Q1 2017 GDP: Still Bad, Just Not As Bad . . .

- The BEA's second estimate shows real GDP grew at an annualized rate of 1.2 percent in Q1 2017, up from the initial estimate of 0.7 percent.
- Upward revisions to consumer spending, business investment, and government spending pushed top-line growth higher.
- Pre-tax corporate profits were down 1.9 percent, quarter-on-quarter, in Q1 but up 3.7 percent year-on-year.

Well, it was better than expected and better than it at first looked, so there's that. Revised and more complete source data show real GDP grew at an annualized rate of 1.2 percent in Q1. This was ahead of the consensus forecast of 0.9 percent growth, which was also our call, and better than the BEA's initial estimate of 0.7 percent growth. So, while Q1 was still a bad quarter, it just wasn't as bad as first thought, nor was it actually as bad as it looks. Measured Q1 growth reflected the long-running problem of residual seasonality in the GDP data that biases Q1 growth lower in any given year, and also what was a higher than normal degree of noise in the underlying source data. In short, the assessment we offered after the initial estimate of Q1 GDP still holds – the reality is that the U.S. economy is neither as weak as implied by the Q1 GDP report nor as robust as we expect the Q2 GDP report to imply.

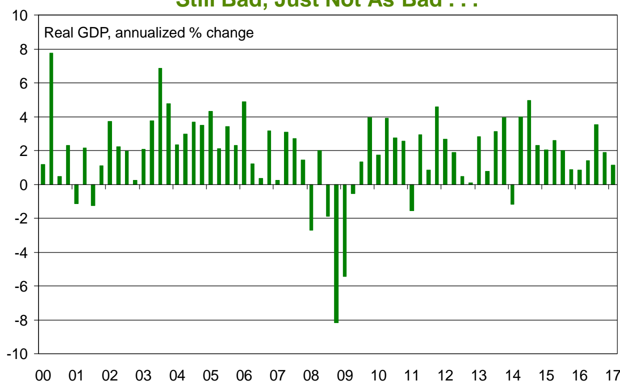
Real consumer spending is now reported to have grown at a 0.6 percent annualized rate, up from the initial estimate of 0.3 percent growth. The decline in spending on consumer durables, mainly reflecting the slower pace of motor vehicle sales in Q1, is now shown to be less severe than initially reported, while growth in spending on household services is now shown to be stronger than initially estimated.

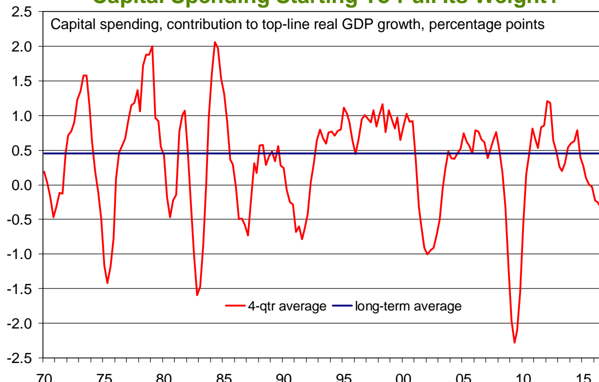
In our analysis of the initial report on Q1 GDP we noted that the sole bright spot was business investment spending. The revised data show real business fixed investment spending rose at an annualized rate of 11.4 percent, compared to the initial estimate of 9.4 percent growth. Growth in business spending on structures was revised higher, as was growth in spending on intellectual property products. The one blemish, albeit a small one, here is the downward revision to business spending on machinery and equipment, which is now reported to have grown at an annualized rate of 7.2 percent compared to the initial estimate of 9.1 percent growth. Still, even the revised number is an encouraging one given how weak such spending had been over the prior several quarters. Indeed, as we have noted on numerous occasions, business investment spending has been weak over the life of the current expansion, which we have argued is the primary factor behind the anemic trend rate of labor productivity growth. Business spending on structures, equipment, and machinery added 1.08 percentage points to top-line real GDP growth in Q1, the largest contribution since Q4 2013 (our chart below shows the four-quarter moving average). What remains to be seen, however, is whether the rebound in capital spending will be sustained over coming quarters, which has implications for productivity growth and overall economic growth.

As for other revisions, the trade deficit is slightly smaller than was first estimated, thanks to a downward revision in the growth of imports into the U.S. Also, the contraction in government spending in Q1 is less severe than initially estimated. Note that government spending, particularly federal government spending, is one component of the GDP data in which the residual seasonality issue is the most pronounced.

Pre-tax corporate profits, adjusted for inventory valuation and capital consumption, fell 1.9 percent from Q4 2016 to Q1 2017 but were up 3.7 percent year-on-year. This is the BEA's initial estimate of Q1 corporate profits, so there is not much industry detail, but the data show profits from domestic operations were down 0.9 percent year-on-year in Q1, with profits in the financial sector up 12.3 percent and profits in the nonfinancial corporate sector down 5.6 percent. Profits from foreign operations were up 24.6 percent year-on-year in Q1. The performance of profits in the nonfinancial corporate sector seems at odds with the bounce in business capital spending – something seemingly has to give over coming quarters. Our sense is that with underlying growth, domestic and foreign, improving, firmer top-line revenue growth will support profit growth even as labor costs rise at a faster clip over coming quarters, and meaningful corporate tax reform would also help.

As we've noted before, the U.S. economy is in much better shape than implied by the Q1 GDP report, and we look for real GDP growth to top 3.0 percent in Q2. As usual, the truth lies somewhere in between.





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