ECONOMIC UPDATE

REGIONS

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Q4 2017 GDP: Slight Markdown Doesn't Alter The Outlook

- The BEA's second estimate shows real GDP grew at an annualized rate of 2.5 percent in Q4 2017; the initial estimate was 2.6 percent
- Consumer spending, business and residential fixed investment, and government spending were the main drivers of growth in Q4.

Some downward revisions are more downward than others. To wit, revised and more complete source data show real GDP grew at an annualized rate of 2.5 percent in Q4 2017 as we and the consensus expected. This marks a slight downward revision to the BEA's initial estimate of Q4 growth, the operative word here being "slight" – the BEA's initial estimate pegged Q4 growth at 2.554 percent, the second estimate puts growth at 2.536 percent (annualized rates). While there were changes in many of the underlying details, none of these changes were of any significance. As such, the slight downward revision to top-line real GDP growth doesn't at all change our view that the U.S. economy headed into 2018 with a good deal of positive momentum.

The revised data show real consumer spending grew at an annualized rate of 3.8 percent in Q4. While this is unchanged from the BEA's initial estimate, the composition of consumer spending is a bit different than first reported. Real spending on goods grew at a 13.8 percent rate according to the revised data, down from the 14.2 percent growth rate originally reported, and spending on household services is now reported to have grown at a rate of 2.1 percent, up from the initial estimate of 1.8 percent growth. Growth in spending on consumer durable goods was notably strong, particularly motor vehicles and household furnishings, at least some of which reflects post-hurricane replacement demand. Spending on nondurable consumer goods grew at a 4.3 percent rate, a downwrd revision from the initial estimate of 5.2 percent growth.

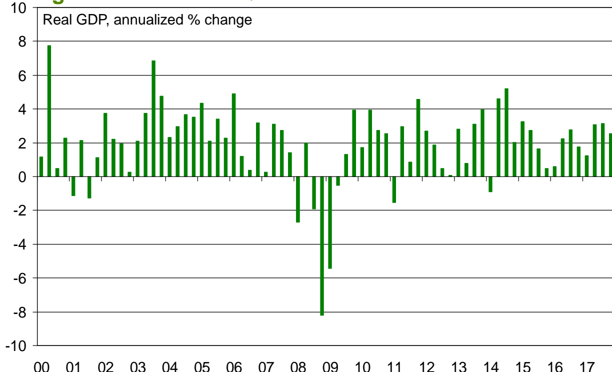
In keeping with the "not much changed" theme, real private domestic demand (consumer spending and private sector fixed investment) grew at an annualized rate of 4.6 percent, unchanged from the initial estimate and the fastest growth since mid-2014. While the growth rate of real consumer spending was, as noted above, left unchanged, growth in real residential investment was revised up to 13.0 percent and business fixed investment was marked down slightly, with annualized growth of 6.6 percent rather than the 6.8 percent reported in the initial estimate.

The trade deficit is now reported to be modestly smaller than initially estimated, while the pace of inventory accumulation in the business sector is now shown to be slightly slower than was initially the case. These two factors – inventories and trade – are notorious "swing factors" in GDP growth from one quarter to the next. After knocking 0.7 points off of top-line real GDP growth in Q4, inventories will be a support for growth in Q1. This will offset a further drag from trade as the trade deficit figures to be larger in Q1 than was the case in Q4 2017.

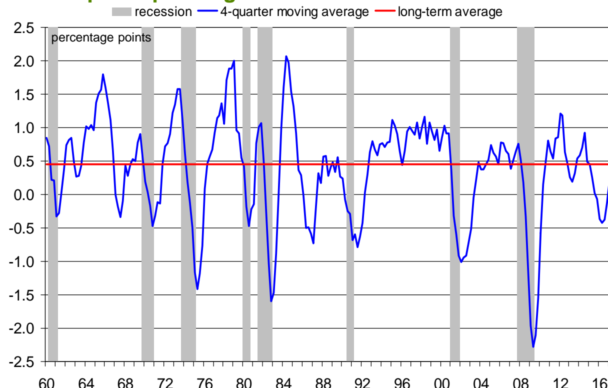
That said, consumer spending and business fixed investment will remain the primary drivers of growth. Real business spending on machinery and equipment grew at a double-digit annualized rate over the final two quarters of 2017, and we expect it to remain robust over the course of 2018. We've consistently argued business investment was overdue for faster growth, and the tax bill passed in late-2017 bolsters our case. Still, it is important to put this into perspective, as we illustrate in our chart below. Even with the rapid growth seen over 2H 2017 capital spending is only now returning to historical norms in terms of its contribution to top-line real GDP growth. As capital spending has been a notable underperformer over the course of the current expansion, there is still plenty of catching up to do. As seen in the chart, capital spending has historically been highly cyclical, the one exception being the sustained period of growth in the 1990s, which corresponded with the "productivity miracle," i.e., a decade in which productivity growth averaged 3.0 percent. Any hopes of the tax bill leading to a meaningful improvement in the economy's capacity for noninflationary growth rest upon a similar boost to capital spending. Our fear, however, is that the phasing out of the provision allowing immediate expensing of capital investment will lead to a barbell effect, i.e., rapid growth in the first and final years in which the provision is in effect and little growth in between. Whether, and to what extent, this proves to be the case will have implications for overall economic growth and for monetary policy.

Those are questions that will only be answered over time. For now, though, the economy is poised for a meaningful late-cycle acceleration in growth in 2018-19.

Slight Markdown To Q4 Growth Doesn't Alter The Outlook



Capital Spending Contribution To Real GDP Growth



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