ECONOMIC UPDATE

REGIONS

August 29, 2018

Q2 2018 GDP: U.S. Economy Continues To Build Momentum

- The BEA's second estimate shows real GDP grew at an annualized rate of 4.2 percent in Q2, up from the initial estimate of 4.1 percent
- Before-tax corporate profits were up 7.7 percent and after-tax profits were up 16.1 percent year-on-year in Q2

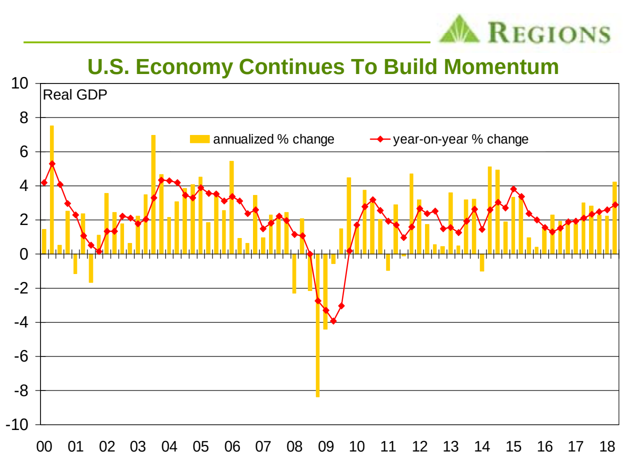
Revised and more complete source data show real GDP grew at an annualized rate of 4.2 percent in Q2, up slightly from the BEA's first estimate of 4.1 percent growth. Business investment, net exports, and government spending were revised higher, offsetting downward revisions to consumer spending and residential investment, but in each instance the revisions were fairly small, to the point that growth in real private domestic demand was left unrevised at an annualized rate of 4.3 percent. As we often note, the annualized quarter-to-quarter percentage changes in real GDP are inherently volatile and shed little light on the economy's trend rate of growth, for which the year-on-year percentage change in real GDP is a much more reliable gauge. In Q2, real GDP was up 2.9 percent year-on-year, up from 2.6 percent in Q1. Of more significance is that Q2 marks the eighth consecutive quarter in which year-on-year growth in real GDP accelerated, the longest such streak in the life of the data. The current expansion, now in its tenth year, clearly has a good deal of momentum, thanks in no small part to fiscal stimulus and a diminished regulatory burden, and the main question at this point is how long this momentum will be sustained.

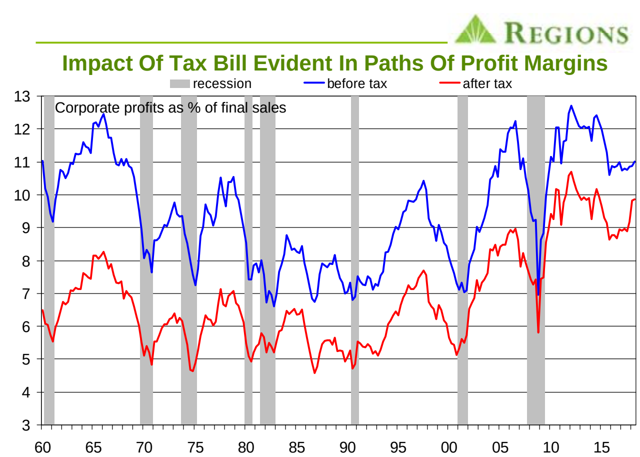
Consumer spending was revised slightly lower, with annualized growth in real consumer spending now pegged at 3.8 percent as opposed to the initial estimate of 4.0 percent. Spending on consumer goods was revised lower while, at 3.1 percent, annualized growth in real spending on household services matches the first estimate. Growth in real business fixed investment was revised up to 8.5 percent from the initial estimate of 7.3 percent (annualized rates). The 11.0 percent annualized growth in spending on intellectual property products in Q2 follows 14.1 percent growth in Q1, which is notable because this cateogory includes the research and development outlays that are typically a precursor of faster growth in labor productivity. Real spending on business equipment and machinery grew at an annualized rate of 4.4 percent in Q2, which at first glance may not seem all that impressive but keep in mind that over the prior five quarters annualized growth averaged 9.4 percent, so some slowing was to be expected. The monthly data on orders and shipments of core capital goods suggest solid Q3 growth in business investment, which matters because an updated and expanded capital stock is also a necessary condition for faster productivity growth on a sustained basis.

With evidence of growing supply constraints in manufacturing and transportation, we do expect growth in business investment to be a key driver of top-line growth over coming quarters, particularly as labor market conditions continue to tighten. Stepped-up growth in corporate profits will help facilitate further growth in capital spending. To be sure, the 2017 tax bill has helped spark growth in after-tax profits, but it would be wrong to ignore the acceleration in the growth of pre-tax profits, which goes to our point about the momentum that has been building in the economy over the past several quarters.

Real exports of U.S. goods grew at an annualized rate of 13.1 percent in Q2, a marginal downward revision, and real imports of goods into the U.S. fell at an annualized rate of 0.3 percent (originally reported as a 1.0 percent increase). The decline in the trade gap between Q1 and Q2 added 1.17 points to top-line real GDP growth in Q2. But, as we have noted, the trade data over recent months have been distorted by firms, domestic and foreign, playing the game of "time the tariffs," i.e., timing orders and shipments to beat the imposition of tariffs or in anticipation of additional tariffs. Much of the growth spurt in U.S. exports in Q2 reflected the timing of foreign purchases of U.S. goods as opposed to stronger growth in foreign demand for U.S. goods. As indicated in the monthly data for July, trade will turn from a driver of growth to a drag on growth in Q3. By the same token, however, that growth spurt in exports of U.S. goods contributed to a sizeable drawdown in business inventories, which itself took 0.97 points off of top-line real GDP growth in Q2, which we look to be reversed in the Q3 data.

More noteworthy than the current expansion now being in its tenth year is that the economy continues to build momentum this late into the expansion. With household balance sheets much improved and the business sector fully engaged, this expansion clearly has further room to run, downside risks from trade notwithstanding.





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