July 29, 2016

TD Economics

Data Release: Second quarter growth disappoints despite consumption strength

- Real GDP increased by an annualized 1.2% in the second quarter of 2016 according to the advance BEA estimate, or about a half of the expected growth rate of 2.5%. To make matters worse, growth in the first quarter was also revised down from 1.1% to just 0.8%.

- Personal consumption led the charge (+4.2% annualized) contributing 2.8 percentage points to growth with all spending categories showing strength. Net exports were also marginally helpful, with exports (+1.4%) outpacing imports (-0.4%), for a combined contribution of 0.2pp.

- But, the rest of components acted as drags for economic growth, with nonresidential fixed investment falling 2.2% (-0.3pp drag), residential investment declining by 6.1% (-0.2pp), and inventories (-1.2pp drag). Government activity also held back economic growth by 0.2pp as both federal (-0.2%) and state & local (-1.3%) governments pulled back on spending and investment.

- As part of the benchmark adjustments, the BEA also revised GDP figures several years back. While the latest four quarters (2015Q2 through 2016Q1) were all revised down, growth was generally lifted in the prior periods which has lifted annual growth rates of the U.S. economy in 2015 from 2.4% to 2.6% and 1.5% to 1.7% in 2013. Annual numbers for 2012 and 2014 were largely unchanged as revisions offset each other.

- The price deflator, on the other hand, surprised to the upside, with the Q2 metric reportedly at 2.2% annualized and well above the 1.8% expected by the markets. Moreover, the deflator was revised from 0.4% to 0.5% during the first quarter.

Key Implications

- This morning's report is undoubtedly a disappointing one given the lack of substantial acceleration from the previous quarters that economists were anticipating. Not only did headline growth not reach the 2%-handle, it barely managed to rise above the 1%-mark as inventories, fixed business investment and government combined to subtract some 2 percentage points from growth.

- Still, many of these drags are unlikely to persist, at least to the same degree. Inventories were ripe for a correction, and the larger than expected pullback suggests some upside to growth in the second half of the year. Residential investment fell in Q2, but this was largely payback for a strong Q1 which saw the pulling forward of activity due to warm winter. As such, residential investment should turn positive next quarter. Lastly, the nonresidential investment, which has been decimated in past quarters by collapsing rig counts, should begin to grow more sturdily soon, with rig counts appearing to have turned the corner at this point

- While the headline number is disappointing, it is important to not lose sight of the bigger picture. Personal consumption, which accounts for nearly 70% of the economy, was very strong and broad based. This is ultimately the segment of the economy that we expect to do the heavy lifting in the coming quarters, helped along by an improving labor market that is creating jobs and has begun to manifest in wage gains and supported by low interest rates.

- The report is a bit of a mixed bag as far as the Fed is concerned. The weak growth will certainly suggest more patience as far as rate hikes. However, the strong price growth, with the PCE deflator rising by 1.9% annualized in the second quarter – an eight quarter high – suggests that price pressures may be building and the Fed can't wait indefinitely.

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