LPL RESEARCH

WEEKLY ECONOMIC COMMENTARY

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U.S. GDP GROWTH TOPS 4% IN Q2
A LOOK BEHIND THE NUMBERS

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KEY TAKEAWAYS

The economy grew 4.1% in the second quarter, topping 4% for the first time since the third quarter of 2014.

Consumer spending rebounded strongly and business spending was solid.

Growth was strong despite a large contraction in inventories, which should rebound, but net exports were artificially inflated ahead of tariffs.

The U.S. economy grew 4.1% in the second quarter to post its strongest quarter since the third quarter of 2014 and fifth strongest quarter of the expansion. Despite slightly missing the Bloomberg-surveyed economist consensus of 4.2%, the details behind the report were generally positive, with strong growth despite a headwind from a large contraction in inventories, as well as an added hurdle from an upward revision of first quarter growth from 2.0 to 2.2%. Fiscal stimulus had a clear impact, with a strong rebound in consumer spending from first quarter weakness, solid business spending, and increased government spending, although a rising budget deficit remains a concern.

The biggest negative on a forward-looking basis was a big jump in exports ahead of the implementation of previously announced tariffs, which is likely to unwind in upcoming quarters. Gross domestic product (GDP) grew at an annualized rate of 3.1% over the first half of the year, so growth could slow to 2.9% over the next two quarters and still hit 3% for the calendar year. Indications of underlying economic strength make hitting that mark or better increasingly likely, but even something close to 2.9% growth over the rest of the year would be an upbeat number compared with the expansion average of 2.3%.

STRONG GDP GROWTH OVERCOMES INVENTORY CONTRACTION

While a drag on current quarter GDP, a large inventory drawdown may actually help the economy sustain above-average growth over the rest of the year. GDP came in over 4% despite a 1% drag from inventories, making this the strongest quarter of GDP growth excluding inventories of the expansion. Inventories tend to have a negligible impact on GDP over the long run, and the current contraction may reverse if economic demand remains strong and businesses need to rebuild depleted inventories.

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FISCAL STIMULUS: A TAILWIND FOR GROWTH

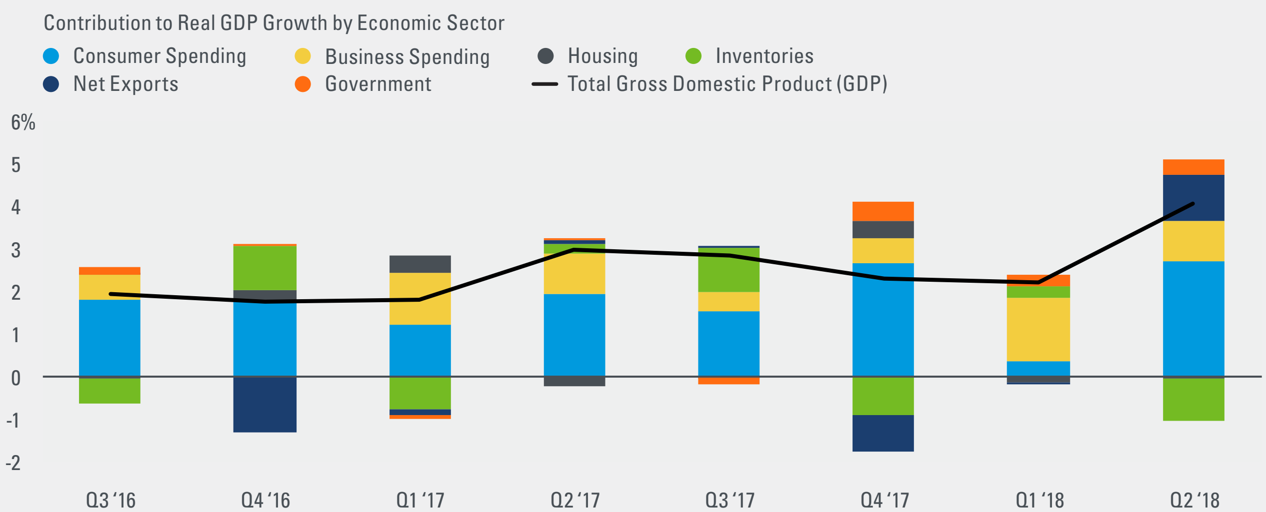
The domestic economy has begun to reap the benefits of supportive fiscal policy, which includes lower tax rates for individuals and corporations, deregulation, and increased government spending. The breakdown of GDP by economic sector [Figure 1] helps to highlight the drivers of strong GDP growth and how fiscal policy has been making an impact.

A key driver of the pickup in growth in the second quarter was a rebound in consumer spending, which had slowed in the first quarter due to seasonal effects and a strong fourth quarter in 2017. Real consumer spending, which accounts for the effects of inflation, grew at an annualized rate of 4.0%, the fourth strongest quarter of the expansion. Strong consumer confidence and a healthy job market, both influenced by fiscal policy, are likely to continue to support consumer spending. The only concern is a downward trending savings rate, typical of late cycle behavior, but we believe consumer balance sheets still remain healthy overall.

One of the key aspects of fiscal stimulus, in our view, was the inclusion of provisions aimed at increasing business investment. Real business fixed investment grew at an annualized rate of over 7% in the second quarter, supported by investment in structures. While not a standout quarter for business investment, the numbers were solid and come on the heels of a very strong first quarter. Of all the segments of GDP, business investment has the greatest potential to support long-term GDP growth because of the impact it can have on overall productivity. We remain optimistic about steady business spending overall, but believe that trade uncertainty may undermine some of the impact of fiscal stimulus as anecdotal evidence mounts that some businesses are delaying spending, pending greater clarity on trade agreements.

Continued contributions from government spending have also helped nudge GDP higher, although the longer-term impact of these contributions may be mixed in light of the potential impact on deficits. Spending by the federal government has grown at an average annualized rate of 3.4% over the last three quarters, compared with an average contraction of 1.5% over the previous five years. Government spending contributed about 0.4%

1 ECONOMIC GROWTH ACCELERATED IN SECOND QUARTER



Source: LPL Research, U.S. Bureau of Economic Analysis 07/27/18 to GDP growth this quarter, a little under half the contributions that came from increased state and local spending.

A TEMPORARY JUMP IN EXPORTS MAY HURT FUTURE GROWTH

Anxiety around a potential global trade war fueled a jump in U.S. exports ahead of tariffs, which, in turn, has closed the trade deficit to its lowest level since 2016. Net exports averaged $144 billion in March, April, and May, the highest three-month rolling average of the current expansion. Net exports contributed 1.1% to second quarter GDP growth, the second highest number of the expansion and 1.3 percentage points more than the expansion average. The increase in exports is primarily from increased demand as purchasers try to beat retaliatory tariffs, evidenced by soybeans and civilian aircrafts comprising almost all of the jump in exported goods in May.

As a result, the positive impact on GDP from the increase in exports may just be borrowing growth from future quarters, as the effect reverses and the negative economic impact of tariffs makes itself felt. A strong dollar, which makes U.S. exports more expensive abroad, may compound the difficulty. The U.S. dollar rallied to a 12-month high relative to its peers recently, reflecting the strength of the economy.

CONCLUSION

As we noted in our *Midyear Outlook 2018* publication, we expect U.S. GDP growth of up to 3% in 2018. GDP growth averaged just over 3% in the first half of the year, so our target is achievable even with a modest contraction from first half levels. Although we are watching the impact of tariffs closely, we expect that the benefits of fiscal stimulus may outweigh any negative implications and the economy should be able to maintain a solid growth trajectory over the remainder of the year. ■