First Trust
Monday Morning OUTLOOK
October 20th, 2014
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Q3 Real GDP Still Looks Solid

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The current recovery started in mid-2009. Since then, real GDP has grown at a 2.2% annual rate (what we have called a Plow Horse Economy). Now, despite a negative first quarter (caused by weather and inventories), the economy is picking up some speed. It's not a race horse, yet, but we expect 2.5% to 3% real GDP growth, on average, in the year ahead.

The main reason for faster growth is that government spending as a percent of GDP is falling, down to 20.3% of GDP in Fiscal Year 2014, the lowest since 2008, and down substantially from the peak of 24.4% in 2009. Don't get us wrong, government is still a drag on the economy, just less of one. The Sequester (1/2 of which still stands), an end to extended unemployment benefits, and tapering by the Fed are all signals that the tide may have turned.

Smaller government means a bigger and more vibrant private sector. The unemployment rate fell to 5.9% last month and initial claims for jobless benefits plummeted to 264,000 last week, the lowest since 2000. The labor market is still far from its full potential, but layoffs are few and far between.

Some worry that Ebola is a Black Swan. We aren't physicians or experts on pandemics. But, Thomas Duncan, the Liberian patient who passed away in Dallas, was admitted into a Dallas hospital on September 28th, twenty-two (22) days ago. Since then, the only domestically-contracted cases of Ebola were two nurses who had immediate medical contact with Mr. Duncan. Not his family, not those who rode on the plane with him, not anyone else who he met while in the US.

It's the fundamentals that we think we are qualified to speak on and next week we get the initial government report on real GDP in the third quarter. After a 4.6% growth rate in Q2, we expect real GDP to rise at a 2.9% annual growth rate in Q3.

Below is our "add-em-up" forecast for Q3 real GDP.

Consumption: Auto sales increased at a 6% annual rate in Q3 and "real" (inflation-adjusted) retail sales outside the auto sector grew at a 2% rate. Services make up about 2/3 of personal consumption and those appear to be up at about a 1% rate. As a result, it looks like real personal consumption of goods and services combined, grew at a 1.9% annual rate in Q3, contributing 1.3 points to the real GDP growth rate (1.9 times the consumption share of GDP, which is 68%, equals 1.3).

Business Investment: Business equipment investment looks like it grew 12% at an annual rate in Q3. Commercial construction looks like it grew at a healthy 3.4% rate. Factoring in R&D suggests overall business investment grew at a 7% rate, which should add 0.9 points to the real GDP growth rate (7.2 times the 13% business investment share of GDP equals 0.9).

Home Building: A 6% annualized gain in home building in Q3 will add about 0.2 points to real GDP (6 times the home building share of GDP, which is 3%, equals 0.2).

Government: Public construction projects, which had been slowed by the weather in Q1 and rebounded sharply in Q2, continued to increase in Q3. In addition, military spending grew at its fastest pace since 2008 during the third quarter. As a result, it looks like real government purchases grew at a 1.6% annual rate in Q3, which should add 0.3 percentage points to real GDP growth (1.6 times the government *purchase* share of GDP, which is 18%, equals 0.3).

Trade: At this point, the government only has trade data through August, but what it does have looks very good for US GDP. The "real" trade deficit in goods has gotten smaller in Q3. As a result, we're forecasting that net exports add 1.0 points to the real GDP growth rate.

Inventories: After a weather-related lull in Q1, companies built inventories at a very rapid pace in Q2, correctly anticipating faster economic growth ahead. Now companies are still building inventories, but not at quite the same rapid pace. As a result, it looks like inventories will subtract 0.8 points from the real GDP growth rate in Q3.

Earlier this year some analysts saw the drop in Q1 real GDP as a sign that the US recovery was done. Instead, we told you to get ready for a rebound in Q2. That's exactly what we got. One day, the expansion will come to an end, but we don't see this anytime soon. Even with tapering, monetary policy is still loose, and government is shrinking relative to GDP, giving the private sector more room to grow. Get ready for more respectable growth ahead.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
10-21 / 9:00 am	Existing Home Sales – Sep	5.100Mil	**5.140 Mil**		5.050 Mil
10-22 / 7:30 am	CPI – Sep	0.0%	**0.0%**		-0.2%
7:30 am	"Core" CPI – Sep	+0.1%	**+0.2%**		0.0%
10-23 / 7:30 am	Initial Claims – Oct 18	283K	**283K**		264K
10-24 / 9:00 am	New Home Sales – Sep	0.470 Mil	**0.453 Mil**		0.504 Mil