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2ND QUARTER GDP (ADVANCED)

- Real GDP increased a less-than-expected 2.5% at an annual rate in Q2, after growing an annualized 5.6% in Q1. The GDP chain-weighted price index increased an annualized 3.3% in Q2. Nominal GDP (or aggregate demand) rose an annualized 5.8% in Q2, down from 9.0% in Q1. In the past year, real GDP is up 3.5% and nominal GDP is up 6.9%.
- Real business investment grew an annualized 2.7% in Q2, the slowest growth since Q1 2004. Real equipment and software investment fell 1.0% at an annual rate last quarter, the first decline since Q1 2003. Nonetheless, in the past year, business investment is up 6.8% and equipment and software spending is up 6.9%. Residential investment fell an annualized 6.3%, the largest decline since Q3 2000. However, business construction took up some of the slack, rising an annualized 12.7% in Q2. Real personal consumption expenditures grew 2.5% at an annual rate in Q2 versus an annualized 4.8% in Q1.
- Real inventories expanded by \$52.6 billion in Q2 versus a \$41.2 billion increase in Q1, which added 0.4% to real growth. The trade deficit shrunk to \$627.1 billion last quarter from \$636.6 billion in Q1, adding 0.3% to real growth. Removing the impact of inventories, the trade deficit, and government purchases, “core” real GDP (consumption + fixed investment) grew 1.9% at an annual rate in Q2 and “core” nominal GDP grew 5.8%.
- Revisions to 2003-2005 GDP data indicate slower real growth during that period but higher inflation. From 2003-2005, real GDP grew 3.2% at an annual rate (originally +3.5%) and the GDP price deflator increased 2.7% (originally +2.5%).

Implications: Weak business investment, the outright decline in equipment and software expenditures, slow growth in government spending, and a sharp decline housing pulled GDP below our forecast in the second quarter. The weakness in business investment is especially worrisome as this supply-side indicator is a great bellwether for growth and calls into question whether the economy is significantly slowing or if the weakness is just a case of data volatility. Real GDP grew a weak 1.8% in Q4, surged 5.6% in Q1, and then pulled back to a soft 2.5% in Q2. Removing this volatility, real GDP has grown at a 3.5% rate in the past year. Moreover, in June, Industrial Production increased 0.8%, Durable Goods orders rose 3.1% and the ISM Manufacturing Index was 53.8. These contradict the GDP data and suggest that the supply-side of the economy remains robust. Nonetheless, today’s report increases uncertainty about the economy and the Fed. Clearly the market expects the Fed to pause, but this is not a done deal and any pause would be short-lived. We do not expect significant slowing in the economy or inflation in 2006 and continue to believe a neutral Fed Funds rate is 6%.

2nd Quarter GDP <i>All Data Seasonally Adjusted</i>	Q2-06	Q1-06	Q4-05	Q3-05	4 Quarter Change
Nominal GDP	5.8%	9.0%	5.1%	7.6%	6.9%
Real GDP	2.5%	5.6%	1.8%	4.2%	3.5%
Chain-Weight Price Index	3.3%	3.3%	3.3%	3.3%	3.3%
PCE	2.5%	4.8%	0.8%	3.9%	3.0%
Durable	-0.5%	19.8%	-12.3%	9.0%	3.3%
Nondurable	1.6%	5.9%	3.9%	3.4%	3.7%
Services	3.5%	1.6%	2.0%	3.2%	2.6%
Nonresidential Fixed Investment	2.7%	13.7%	5.2%	5.9%	6.8%
Structures	12.7%	8.8%	12.0%	-7.1%	6.3%
Equipment, Software	-1.0%	15.6%	2.8%	11.0%	6.9%
Residential Investment	-6.3%	-0.3%	-1.0%	7.1%	-0.2%
Change in Inventories* (Level, \$Bn)	52.6	41.2	43.5	-12.7	31.2
Net Exports* (Level, \$Bn)	-627.1	-636.6	-636.6	-607.6	-627.0
Exports	3.3%	14.0%	9.6%	3.2%	7.4%
Imports	0.2%	9.1%	13.2%	2.5%	6.1%
Government Purchases	0.6%	4.9%	-1.1%	3.4%	1.9%
GDP Final Sales	2.1%	5.6%	-0.3%	4.4%	2.9%

Source: Commerce Department

*4-Quarter Change = Avg. Quarterly Change

