Solid Growth Continues in the Third Quarter

The U.S. economy grew at a 4% annual rate in the second quarter of 2007, and 4.7% excluding the housing sector. Third quarter real GDP growth will not be released until late October, but available data puts our add-em-up third quarter real GDP forecast at a solid 3.0%.

This growth rate would be consistent with recent purchasing managers’ surveys, and it would boost the two quarter real GDP growth rate to 3.5%, a sharp acceleration from the 1.3% average between July 2006 and March 2007. With GDP accelerating like this, it’s hard to see the Federal Reserve cutting interest rates.

**Personal Consumption:** The monthly pattern of consumption through July suggests real consumption will grow at about a 2.5% rate in Q3. With consumption accounting for 70% of GDP, real PCE growth in Q3 will contribute about 1.8 percentage points to real GDP growth (1.8 equals 70% of 2.5).

**Housing:** Residential construction will still be a drag on the economy but the rate of decline in the sector bottomed out in the third quarter of 2006 and has since been in an improving trend. Our model suggests residential construction declines at a 9% annual rate in Q3. Given that the sector makes up 4.8% of GDP, this translates into a drag of 0.4 percentage points on real GDP growth (0.4 equals 4.8% of 9).

**Business Investment:** Shipments of capital goods started off strong in the third quarter while the most recent data on business construction (June) left off at an all-time high. These numbers suggest business investment will add about 0.9 points to growth in Q3. To get this we (pessimistically) assume capital goods shipments fall slightly in August/September and business building keeps growing at the same rate as it has grown in the past year.

**Inventories:** On average, inventories were a full 1.0 percentage point drag on real GDP growth in the last quarter of 2006 and first quarter of 2007. Given this retrenchment in stockpiles, the 0.2 points in real growth that inventories added in Q2 looks relatively small. We assume more inventory build in the third quarter but are cautiously penciling-in only a 0.1 point boost to growth.

**Trade:** The inflation-adjusted trade deficit has been declining for the past year. We expect this trend to continue as trade flows respond to a weaker dollar and solid economic growth abroad. But even if we assume that the trade deficit stabilizes at current levels, trade would add about 0.3 points to real GDP growth as the average trade gap would still be narrower in Q3 than Q2.

**Government:** In the past five years, on average, government spending has accounted for 0.3 points of GDP growth. We assume this trend continues.

**Third Quarter Total: = 3.0%**