Economy Remains Resilient in Q1

Two-thirds of the way through the second, third and fourth quarters of 2007, the consensus forecasts for real GDP growth were 2.6%, 2.4% and 1.0%, respectively. With final data now in, the actual rates of growth in Q2, Q3, and Q4, were 3.8%, 4.9% and 0.6%. In other words the consensus was off by an average of 1.0% in the past three quarters.

It is likely that this trend will continue in the first quarter of 2008. The only question is whether or not the miss is on the high side or the low side. Our review of the data available so far suggests that the economy will exceed the consensus forecast of just 0.5% real growth.

The biggest “if” in our forecast of 2.0% annualized real GDP growth in the Q1 is inventories. We assume inventories rebound in Q1, adding 0.7 points to growth. Last quarter they subtracted 1.5 points. Although this is our best guess for inventories we are much more confident in our forecast that final sales (which is everything but inventories) will grow at about a 1.3% annual rate. This would also be close to the 1.5% real GDP prediction we get from unemployment claims.

**Personal Consumption:** If real consumption is unchanged in February/March it would still grow at an annual rate of 0.5% in Q1. However, we expect real consumption to rebound as inflation temporarily slows from the breakneck pace of the last two months, resulting in a 1.6% real consumption growth rate. With consumption accounting for 70% of GDP, real PCE will contribute 1.1 points to real GDP growth (1.1 equals 70% of 1.6).

**Business Investment:** Shipments of capital goods (excluding/aircraft) were up in January but business construction fell in early 2008. Continuing recent trends through March for each indicator suggests business investment will grow at about a 3% annual rate in Q1. With business investment accounting for 10.5% of GDP, this translates into another 0.3 points for real GDP growth (0.3 equals 10.5% of 3).

**Housing:** Data on home building suggests a decline at about a 24% annual rate in Q1. Given that the sector makes up 4.1% of GDP, this translates into a drag of 1.0 points on real GDP growth (1.0 equals 4.1% of 24).

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

**Trade:** The inflation-adjusted trade deficit has been declining for two years. Assuming the trend continues – which is likely given the falling dollar – net exports will add about 0.6 points to real GDP growth in Q1.

**Inventories:** Inventories dropped in Q4 by the most in almost six years, subtracting 1.5 points from real GDP growth. We are penciling in a relatively small increase in inventories for Q1. A shift from declining inventories to a moderate increase would add 0.7 points to growth.

First Quarter GDP: = 2.0% / Final Sales = 1.3%

Consensus forecasts come from Bloomberg. This report was prepared by First Trust Advisors L. P., and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.