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First Trust

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Monday Morning Outlook

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GDP Report "Mis-Underestimated"

Initial estimates of second quarter real GDP put growth at 1.9% annualized, less than consensus expectations, and weaker than the First Trust forecast. At the same time, the Commerce Department revised its estimates to show a very small 0.2% decline in Q4-2007 real GDP.

However, government estimates of inventories – the part we have the least information about – fell by the second largest amount in history. We believe this decline was overstated and Q2 real GDP growth will be revised up in the months ahead. Real final sales (which exclude inventories) grew at a robust 3.9% rate.

In response to the data Dr. Victor Zarnowitz, who serves on the recession dating committee of the NBER, told the Wall Street Journal that "There is no cyclical decline, yet."

Despite this, some analysts argue that Q2 data *overestimated* the true pace of real growth because the government *underestimated* inflation. This argument is bolstered by some very interesting developments in the GDP accounts, which show that nominal GDP grew at a very weak 3% annual rate in Q2 – 1.9% real GDP growth and a surprisingly low 1.1% inflation rate.

The reason the government's estimate of GDP inflation was so low was because of the way the data is calculated. GDP = Consumption + Investment + Gov't Spending + Exports – *(minus)* Imports.

So, the argument goes, the absurdly low 1.1% GDP inflation was just a technical artifact of the way the government calculates GDP. Deflating nominal GDP with a 4% inflation rate, calculated by *including* the 28% jump in import prices, would push Q2 real GDP into negative territory. For pessimists, this is an appealing argument.

Fortunately, it's not true. If import prices are added back into inflation, then the total dollar volume of imports must be added back into nominal GDP as well. This is the only way to compare apples to apples. Adding back imports pushes nominal GDP growth to 5.5% at an annual rate in Q2. Then, using the 4% inflation data (that includes import prices) means real GDP growth was still positive by 1.5%, or so.

A second issue to think about is that unlike the Consumer Price Index (CPI) – which attempts to measure changes in the cost of the *things we buy* – GDP inflation is designed to measure changes in the prices of the *things we produce*, regardless of whether the purchasers are foreign or domestic. Due to oil, prices for the items Americans buy have been increasing much more rapidly than the items they produce. As a result, GDP inflation looks artificially low, when in reality it is not comparable to the CPI.

What surprises us is how little attention is being paid to the data on final sales. Every recession in the last 60 years has had at least one negative quarter for real final sales (real GDP excluding inventories). In the fourth quarter of 2007 – the one that now shows that real GDP contracted at a 0.2% rate – final sales grew at a 0.8% rate. Real final sales have yet to go negative and we doubt they will.

Even if the government is right about the rapid drop in inventories it is probably not enough to declare a recession. Meanwhile, it means plenty of room for increases in production growth in the months ahead.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
8-4 / 7:30 am	Personal Income - Jun	-0.2%	**-0.1%**		+1.9%
7:30 am	Personal Spending - Jun	+0.5%	**+0.5%**		+0.8%
9:00 am	Factory Orders - Jun	+0.7%	**+0.7%**		+0.7%
8-5 / 9:00 am	ISM Non-Man. - Jul	48.5	**47.9**		48.2
8-7 / 7:30 am	Initial Claims - Aug 2	410K	**417K**		448K
8-8 / 7:30 am	Q2 Non-Farm Productivity	+2.6%	**+2.4%**		+2.6%
7:30 am	Q2 Unit Labor Costs	+1.5%	**-1.2%**		+2.2%

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.