First Quarter GDP: Don’t Judge A Book By Its Cover

Get ready, first quarter gross domestic product data will be released on Wednesday and it will show the second sharp quarterly contraction in a row. We expect an annualized 4.2% decline in Q1, after a 6.3% drop in the last quarter of 2008.

But judging this book by its cover will be a little misleading. There is a stark difference between the economic pain of late 2008 and the economic pain in Q1. A huge drop in the velocity of money pulled consumption down by 3.8% at an annual rate in Q3-2008, and then 4.3% in Q4. The panic was so widespread that food consumption fell at the fastest pace since the late 1940s – a very strange occurrence.

This changed in early 2009 as velocity apparently picked up. Food sales turned up and our models show consumer spending increased at a 1.5% annual rate in Q1, which would be its best showing since 2007. But this strength will be more than offset by weakness on the business side of the economy. Businesses, in a reaction to the consumer pull-back, dropped investment spending, slowed production, and cut inventories. Despite the rebound in consumer spending this year, businesses are still not certain that velocity has returned.

But businesses can’t contract forever if consumers are bouncing back. With Fed policy super easy, velocity reviving, and inventories shrinking, a revival on the business side of the economy is on tap for later this year.

In addition, it is important to remember that quarterly real GDP reflects a moving average of economic activity. It shows the three-month production average versus the previous three month average. As such, real GDP is most heavily influenced by economic performance early in the quarter. Recent data show the recession is rapidly losing steam but that change will not show up in real GDP until the Q2 GDP report in late July.

Below, we set out the components of real GDP that comprise our -4.2% forecast for Q1.

**Personal Consumption:** We already have full consumption data for January/February as well as auto sales and retail sales for March. The only piece missing is March services. We estimate real consumption grew at a 1.5% annual rate in Q1. With consumption accounting for 70% of GDP, real PCE will contribute 1.1 points to real GDP growth (1.1 equals 70% of 1.5).

**Business Investment:** Data through February suggest weakness in both investment in equipment and software as well as business construction. We estimate that overall business fixed investment shrank at a 27% annual rate in Q1. With business investment accounting for 10.5% of GDP, this translates into a drag of 2.8 points for real GDP growth (-2.8 equals 10.5% of 27).

**Housing:** Data on home building suggests a decline at about a 36% annual rate in Q1. Given that the sector now makes up only 3% of GDP, this translates into a drag of 1.1 points on real GDP growth (-1.1 equals 3% of 36).

**Government:** Defense spending and public construction were unusually weak, suggesting gov’t spending will be a 0.2 point drag on real GDP rather than the usual positive 0.3 or 0.4.

**Trade:** The inflation-adjusted trade deficit shrunk rapidly in Q1, suggesting net exports will add about 1.3 points to real GDP growth.

**Inventories:** We assume businesses around the country reduced stockpiles at an annual rate of $111 billion, the largest drop on record, resulting in a drag of 2.5 points on GDP.

**First Quarter GDP: = -4.2%**