GDP at 2%: Seventh Consecutive Quarter of Growth

Anyone forecasting first quarter real GDP growth (which is due to be reported next week on April 28th) with a high degree of confidence needs to have their head examined.

On the positive side – make that the VERY positive side – industrial production grew at a 6.1% annual rate in the first quarter. Manufacturing output was up at a stellar 9.2% rate – the most rapid rate of increase for any quarter since 1997.

Unemployment claims fell sharply in the first quarter, another sign the economy was growing at a robust rate. Meanwhile, total hours worked in the private sector climbed at a 2% annual rate in Q1. Add 2% increases in productivity to that increase in work effort and a 4% growth rate in private sector output is easily reachable.

But, even with all this good news about growth, when we look at each major component of GDP, we end up with an estimate of only about a 2% real growth rate in Q1.

Going through each component, two things jump out. First, gross domestic purchases – what we buy, not what we produce – are still growing at about a 3% annual rate. In other words, if the Federal Reserve is worried about weak domestic demand, it’s barking up the wrong tree. Consumers and businesses are spending and have been for quite some time.

Second, some of the weaker components – including commercial construction and home building – appear to have been influenced by the unusually harsh winter snowstorms that blanketed much of the country earlier this year. If so, we should see these parts of GDP accelerate noticeably in the second quarter and beyond. Bottom-line: we still anticipate a 2% annual rate in Q1, which should cut the real GDP growth rate by 0.8 points. However, growth in both imports and exports suggests that the economy continues to recover.

Here are the assumptions behind our estimate of 2% real GDP growth in the first quarter of 2011.

**Consumption:** Auto sales surged at a 25% annual rate in Q1. Retail sales overall, adjusted for inflation, rose at a 4.2% rate. However, services, a major component of overall consumption, were up only slightly. As a result, real personal consumption – goods and services combined – probably climbed at a 1.8% annual rate in Q1, contributing 1.3 points to the real GDP growth rate. (1.8 times the consumption share of GDP, which is 71%, equals 1.3.)

**Business Investment:** Business investment in equipment and software grew strongly in Q1, led by an almost 40% annualized gain in high-tech equipment. Overall, equipment/software probably rose at about a 12% annual rate. However, commercial construction got hammered in Q1, dropping at almost a 20% rate. Combined, these two components of non-residential investment grew at about a 4% rate in Q1, as equipment/software investment is almost three times larger than investment in structures. In turn, 4% growth in business investment should add about 0.4 points to the real GDP growth rate. (4 times the business investment share of GDP, which is 10%, equals 0.4.)

**Home Building:** Residential construction appears to have been unchanged in the first quarter. Home builders still face the headwind of excess inventories. In addition, unusually prolonged snow cover in much of the country created more problems. As a result home building was a neutral factor in Q1, neither adding nor subtracting from real GDP growth.

**Government:** Real government purchases shrank at about a 2% rate in Q1, which should cut the real GDP growth rate by about 0.4 percentage points. (-2 times the government purchase share of GDP, which is 20%, equals -0.4).

**Trade:** The trade sector continues to exhibit extreme volatility. In late 2010, net exports added 3.3 points to the real GDP growth rate. This quarter net exports were a drag of about 0.8 points. However, growth in both imports and exports suggests that the economy continues to recover.

**Inventories:** Inventories remain a wild card. At this point, we only have data on inventories through February and inflation-adjusted numbers are only available through January. Right now it looks like inventory accumulation increased sharply in Q1, adding 1.5 points to the real GDP growth rate. If we are wrong about our forecast – whether too high or too low – it will be this inventory component where most of the error was made.

Add ‘em all up and you get a 2% real GDP growth rate for the first quarter of 2011. Despite being weaker than we had hoped, it’s still the seventh consecutive quarter of growth.

### GDP at 2% Report Table

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<tr>
<th>Date/Time (CST)</th>
<th>U.S. Economic Data</th>
<th>Consensus</th>
<th>First Trust</th>
<th>Actual</th>
<th>Previous</th>
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<tbody>
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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.