Three months ago, we added up the major components of real GDP for the third quarter and predicted a solid annualized growth rate of 3.5%. Instead, the advance report came in at 2.5% and was later revised down to a tepid 1.8%.

We were too high on inventories as well as government purchases, and that made our overall forecast too high. However, our estimates of consumer spending, business investment, home building, and the trade balance were all pretty darn close to the mark. Final sales (GDP excluding inventories) grew at a 3.2% annualized rate.

So, while we missed on overall GDP, the underlying pace of final sales to the private sector made it clear that the economy did not need more government spending, temporary Keynesian-style tax cuts or more quantitative easing.

Now, once again we have added up the major parts of GDP and are forecasting… a 3.5% annual pace of growth in Q4. Be aware up front, however, that our predictions for consumer spending, business investment and home building are quite modest. Much of the growth we see in Q4 is due to our forecast that a surprising drop in business inventories during Q3 will be offset by a rebound in Q4. Another check on the forecast is that hours worked in the private sector were up at a 3% annual rate in Q4, so even modest productivity growth (growth in output per hour) suggests more than 3% increases in output.

**Consumption:** Auto sales were up at a 36% annual rate in Q4 while retail sales ex-autos were up at a 5.1% rate. Services, a major part of consumption, are not up as much, but it looks like real personal consumption – goods and services combined – probably climbed at a 2.3% annual rate in Q4, contributing 1.6 points to the real GDP growth rate. (2.3 times the consumption share of GDP, which is 71%, equals 1.6.)

**Business Investment:** Business investment in equipment and software as well as commercial construction appear to have grown at an annualized 5% rate in Q4. This should add about 0.5 points to the real GDP growth rate. (5 times the business investment share of GDP, which is 10%, equals 0.5.)

**Home Building:** Residential construction appears to have grown at about a 5% annual rate in Q4. This translates into 0.1 point for the real GDP growth rate. (5 times the home building share of GDP, which is 2%, equals 0.1.)

**Government:** Due to the wind-down of operations in Iraq, defense outlays were unusually soft in Q4. So, despite signs of a bottom in government construction – think schools and bridges – real government purchases shrank at about a 3.5% rate in Q4, which should subtract about 0.7 percentage points from the real GDP growth rate. (-3.5 times the government purchase share of GDP, which is 20%, equals -0.7).

**Trade:** In the last five years, the trade sector has added an average of 1.2 points to the real GDP growth rate in Q4. We probably won’t get the same size boost this time, but do expect a modest add of about 0.3 points on the growth of real GDP.

**Inventories:** As always, inventories are a wild card. Inventories actually fell in Q3, which is rare for an economic expansion. We think businesses were way too cautious. They didn’t want to get caught holding too much merchandise just in case the pessimists were right about a “double-dip” recession. Now that it’s clear they were wrong, we look for a solid build to inventories in Q4 of about $55 billion at an annual rate. This translates into an additional 1.7 points for real GDP growth.

Add-em-up and you get 3.5% real GDP growth for Q4, although with final sales (GDP excluding inventories) growing at a more modest 1.8% pace.

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**Date/Time (CST)** | **U.S. Economic Data** | **Consensus** | **First Trust** | **Actual** | **Previous**
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1-17 / 7:30 am | Empire State Mfg Index - Jan | 11.0 | 13.0 | 13.5 | 9.5
1-18 / 7:30 am | PPI – Dec | +0.1% | +0.0% | +0.3% | +0.1%
7:30 am | "Core" PPI – Dec | +0.1% | +0.1% | +0.1% | +0.1%
8:15 am | Industrial Production - Dec | +0.5% | +0.6% | -0.2% | 78.1%
8:15 am | Capacity Utilization - Dec | 78.1% | 78.1% | 77.8% | 78.1%
1-19 / 7:30 am | CPI - Dec | +0.1% | +0.1% | +0.0% | +0.0%
7:30 am | "Core" CPI - Dec | +0.1% | +0.1% | +0.1% | +0.2%
7:30 am | Housing Starts - Dec | 0.680 Mil | 0.677 Mil | 0.685 Mil | 0.685 Mil
7:30 am | Initial Claims - Jan 14 | 385K | 390K | 399K | 399K
9:00 am | Philly Fed Survey - Jan | +10.3 | +8.7 | +6.8 | +6.8
1-20 / 9:00 am | Existing Home Sales - Dec | 4.650 Mil | 4.760 Mil | 4.420 Mil | 4.220 Mil

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.