Ignore the GDP Headline

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Next week, Fourth Quarter Real GDP will be released. Our forecast of 0.9% annualized growth, if correct, will encourage the pessimists to continue fretting about the economy in the year ahead. But we will ignore that dour response. Beneath the surface of the report will be evidence that the plow horse economy is picking up some steam.

If we are correct with our forecast, Q4 will be the weakest quarter of growth since early 2011 and it will be a noticeable dip from the 3.1% rate in Q3. Nonetheless, the headline will be misleading because the primary cause of the slowdown will be inventories.

The crop-damaging drought the US experienced this summer, which cut the amount of crops harvested in the fall, led to large drop in inventories. Meanwhile, after non-agriculture companies lifted inventories in Q3, many seem to have reversed that process during Q4.

We suggest looking at real final sales (real GDP excluding inventories), which we expect to grow at a more respectable 2.2% annual rate. If so, real final sales would also be up 2.2% in all of 2012, the fastest pace since 2007. More importantly, when we narrowly focus on consumer spending, business investment, and home building, we get a healthy growth rate of 3.4% in Q4. This leaves out government, inventories and trade.

We are still a far cry from the consistent rapid economic growth of the 1980s and 1990s, when public policy was moving in the direction of smaller government, but it's nothing to sneer at and it certainly isn't a sign of recession. Looking ahead, we see a modest acceleration of economic growth in 2013, the result of a loose monetary policy, the downstream effects of a housing recovery, and a replenishment of farm inventories, offsetting the negative effects of the recent tax hike.

Here's our "add-em-up" calculation of real GDP growth in Q4, component by component.

Consumption: Sales of cars and light trucks were up at a 16% annual rate in Q4, while "real" (inflation-adjusted) retail sales ex-autos were up at a 2.6% rate. However, services make up about 2/3 of personal consumption and they grew at about a 1% rate. So far, it looks like real personal consumption of goods and services combined, grew 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 & software looks like it grew at a 5.5% annual rate in Q4 while commercial construction was unchanged. Combined, they grew at 4% pace, which should add 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: Construction activity is still relatively low compared to several years ago, so you have to be careful how you talk about this sector. What's important to recognize is the *growth rate* for residential construction is fantastic. And it's not just apartment buildings anymore. Single-family construction is rebounding sharply. Home building appears to have grown at a 28% annual rate in Q4, the fastest pace since the early 1980s. This translates into 0.7 points for the real GDP growth rate. (28 times the home building share of GDP, which is 2.5%, equals 0.7.)

Government: Military spending grew in Q4 but no more than it usually does. Meanwhile, state/local government construction is up only slightly from the prior quarter. On net, real government purchases shrank at about a 1% rate in Q4, which should subtract 0.2 percentage points from real GDP growth. (-1 times the government *purchase* share of GDP, which is 20%, equals -0.2).

Trade: At this point, the government has only reported trade data through November. On average, the "real" trade deficit in goods has grown compared to the Q3 average. As a result, we're forecasting the trade sector subtracted 0.3 points from the real GDP growth rate.

Inventories: As we already discussed, this summer's drought in the farm sector suppressed farm inventories this fall. Other companies appeared to slow the pace of inventory accumulation after a brief pick up in Q3. We are assuming inventories cut 1.3 points from the real GDP growth rate in Q4.

Add-em-up and you get 0.9% real GDP growth for Q4. This headline may scare some investors away. But if you focus on the details, you'll see slightly smoother skies ahead.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
1-22 / 9:00 pm	Existing Home Sales – Dec	5.100 Mil	**5.130 Mil**	4.940 Mil	5.040 Mil
1-24 / 7:30 am	Initial Claims – Jan 19	355K	**348K**		335K
9:00 am	Leading Indicators - Dec	+0.4%	**+0.4%**		-0.2%
1-25 / 9:00 am	New Home Sales - Dec	0.385 Mil	**0.385 Mil**		0.377 Mil