First Trust
Monday Morning OUTLOOK
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GDP: Soft Headline, Solid Fundamentals

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The most important part of the quarterly GDP reports is not the headline number. Instead, we like to focus on the underlying trend and what the details of the report mean for future growth.

Ten days from today the government will issue its initial estimate of real GDP growth in the third quarter and we expect the headline to be a relatively soft reading of growth at a 1.5% annual rate. That pace of growth in Q3 would mean real GDP growth has averaged 2.5% annualized for the past two years, just about as Plow Horse as you can get.

However, we follow something we like to call "core" GDP, which is real GDP growth excluding the effects of government, inventories, and international trade, all of which are very volatile from quarter to quarter and none of which the US can rely on in accounting for long-term economic growth. Instead, core GDP only includes consumer spending, business investment, and home building.

And even though it looks like overall real GDP grew at only a 1.5% rate in Q3, it looks like core GDP expanded at a robust 3.5% annual pace. If so, core GDP will also be up at that same 3.5% rate for the past two years. In other words, despite tepid headlines, there's no sign the US economy is about to lurch into recession. Instead, the Federal Reserve needs to start raising short-term rates sooner rather than later.

Below is our "add-em-up" forecast for Q3 real GDP.

Consumption: Auto sales increased at a red hot 16.3% annual rate in Q3. But "real" (inflation-adjusted) retail sales outside the auto sector were up at a 2.4% annual pace in Q3 and services, which make up more than 2/3 of personal consumption, grew at about a 2.3% rate. So it looks like real personal consumption of goods and services, combined, grew at a 3.3% annual rate in Q3, contributing 2.2 points to the real GDP growth rate (3.3 times the consumption share of GDP, which is 68%, equals 2.2).

Business Investment: Both business equipment investment and commercial construction look like they were up at a 3.5% rate in Q3, while R&D probably grew around its trend of 5%. Combined, we estimate business investment grew at a 4% rate, which should add 0.5 points to the real GDP growth rate (4.0 times the 13% business investment share of GDP equals 0.5).

Home Building: The home building recovery continued in Q3 with residential construction up at a 6% rate, which should add 0.2 points to the real GDP growth rate (6.0 times the home building share of GDP, which is 3%, equals 0.2).

Government: Both military spending and public construction projects grew in Q3, suggesting real government purchases rose at a 1.5% rate, which would add 0.3 percentage points to real GDP growth (1.5 times the government *purchase* share of GDP, which is 18%, equals 0.3).

Trade: At this point, the government only has trade data through August, but the data so far suggest the "real" trade deficit in goods has gotten bigger due to weaker economies abroad. As a result, we're forecasting that net exports are a drag of 0.4 points on the real GDP growth rate.

Inventories: At present, we have even less information on inventories than we do on trade, but what we have suggests companies added to inventories at a much slower pace than in Q2. As a result, we're forecasting inventories subtracted 1.3 points from real GDP in Q3.

Put it all together, and we get 1.5% as a forecast for real GDP growth in Q3. But, with the components that make up the "core" adding a total of 2.9 points and those components making up only 82% of total GDP, the growth rate for those core components appears to be healthy 3.5%. (Sorry for the extra math, but if 82% of GDP grows at a 3.5% rate, then those parts of GDP contribute 2.9 points to the overall GDP growth rate.)

Keep all of this in mind when the Pouting Pundits of Pessimism react to the GDP report with their usual tales of woe ahead for the US economy.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
10-20 / 7:30 am	Housing Starts – Sep	1.142 Mil	**1.146 Mil**		1.126 Mil
10-22 / 7:30 am	Initial Claims – Oct 17	265K	**263K**		255K
9:00 am	Existing Home Sales – Sep	5.390 Mil	**5.500 Mil**		5.310 Mil