

Real GDP Accelerating

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Forecasting economic growth from quarter to quarter is a humbling experience. Even when you get the trend right – and it's hard to beat our forecast of Plow Horse growth – there's always a quarter here and there that will throw you for a loop.

Trying to estimate growth in the second quarter is even tougher than others because that's the time of year when the government goes back and revises the GDP reports for the past few years. Moreover, the government has had persistent problems seasonally adjusting GDP, tending to underestimate growth in the first quarter each year while overestimating growth in the middle two quarters. Government statisticians say they're trying to fix that problem, but who knows how much they'll do this time.

With all this in mind, we're forecasting that the economy grew at a 2.2% annual rate in Q2, maintaining a Plow Horse pace. However, there are important signs of improvement. For example, it looks like "real" (inflation-adjusted) personal spending rose at the fastest pace in a decade. And the key reason holding down overall growth in Q2 is an inventory correction that may end up overshooting, helping boost growth in the quarters ahead.

Meanwhile, the M2 measure of the money supply has grown at an 8.2% annual rate in the first six months of 2016, the fastest pace since 2012. This is consistent with our forecast that both real GDP growth and inflation should be accelerating more than most investors expect in the next year or so, which, in turn, should be good for equities and bad for most bonds.

Below is our "add-em-up" forecast for Q2 real GDP.

Consumption: Auto sales declined slightly in Q2, but retail sales outside the auto sector rose at a 7.1% annual pace in Q2, and services, grew at about a 2.5% rate. Overall, it looks like real personal consumption of goods and services, combined, grew at a 4.4% annual rate in Q2, contributing 3.0 points to the real GDP growth rate (4.4 times the consumption share of GDP, which is 69%, equals 3.0).

Business Investment: Business equipment investment looks like it declined at a 1% annual rate in Q2 while

commercial construction fell at a 10% rate. R&D probably grew around its trend of 5%. Combined, we estimate business investment slipped at a 1% rate, which should subtract 0.2 points from the real GDP growth rate (-1.0 times the 13% business investment share of GDP equals -0.1).

Home Building: Residential construction looks like it took a breather in Q2, dropping at an 8% annual rate. Don't get worried, though. This a temporary breather; builders still need to ramp up production to fill a shortage of homes. In the meantime, the temporary drop in Q2 will trim 0.3 points off of the real GDP growth rate. (-8.0 times the home building share of GDP, which is 4%, equals -0.3).

Government: Military spending rose in Q2 while public construction projects declined. On net, we're estimating that real government purchases rose at a 1% rate in Q2, which would add 0.2 percentage points to real GDP growth (1.0 times the government *purchase* share of GDP, which is 18%, equals 0.2).

Trade: At this point, the government only has trade data through May, but the data so far suggest the "real" trade deficit in goods has gotten a little smaller. As a result, we're forecasting that net exports add 0.3 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 were surprised by the acceleration in consumer spending, resulting in a sharp slowdown in the pace of inventory accumulation during Q2. We're forecasting inventories subtracted 0.9 points from real GDP growth in Q2.

Put it all together, and we get a forecast of 2.2% for Q2, another Plow Horse quarter. However, the sharp inventory slowdown suggests production and, therefore, real GDP is likely to pick up in the third and fourth quarters. Corporate profits and stock prices are likely to keep rising as well. We expect this to affect the Fed and Fed speakers to become more hawkish, letting investors know a rate hike is a serious possibility by September.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
7-19 / 7:30 am	Housing Starts – Jun	1.166 Mil	1.198 Mil		1.164 Mil
7-21 / 7:30 am	Initial Claims Jul 16	265K	266K		254K
7:30 am	Philly Fed Survey – Jul	4.8	4.1		4.7
9:00 am	Existing Home Sales – Jun	5.480 Mil	5.530 Mil		5.530 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.