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November 28, 2018 • 630.517.7756 • www.ftportfolios.com

3rd Quarter GDP (Preliminary)

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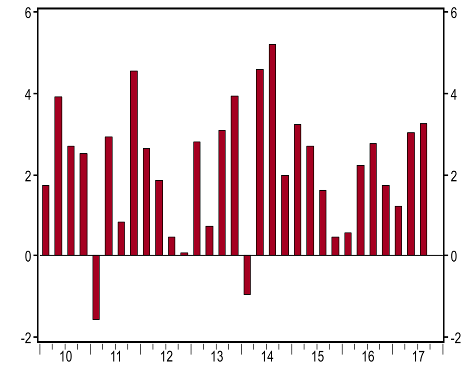
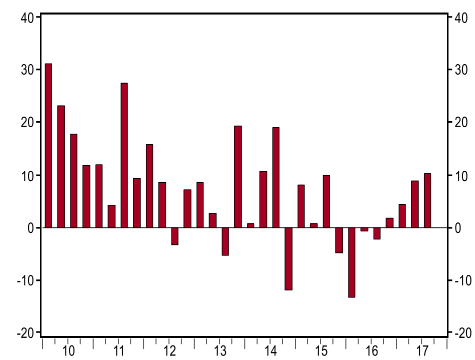
- Real GDP grew at a 3.5% annual growth rate in Q3, matching the initial estimate as well as consensus expectations.
- Business investment and inventories were revised higher, but offset by downward revision to consumer and government spending, residential investment, and net exports.
- The largest positive contributions to the real GDP growth rate in Q3 were personal consumption and inventories. The largest drag was net exports.
- The GDP price index increased at a 1.7% annual growth rate, matching the prior estimate. Nominal GDP growth – real GDP plus inflation – was revised up to a 5.0% rate from a prior estimate of 4.9%.





Implications: Hold off on the GDP data for a second, because this morning's first look at corporate profit growth in the third quarter is the real headline. Pre-tax corporate profits rose 3.4% in the third quarter - the fastest quarterly growth rate since Q2 2014 – and are up 10.3% in the past year, the largest four-quarter increase since mid-2012 (and thanks to the tax cuts, after-tax profits are up nearly 20% in the past year). Plugging this data into our capitalized profits model puts our estimate of "fair value" for the S&P 500 at 3,614, or roughly 35% above yesterday's closing value. Even if the 10-year Treasury yield (the denominator in our model) rose to 3.5% today, the market would still be undervalued by nearly 20%. In other words, the correction we have seen since mid-September is emotional, not logical, and we expect markets to move higher in the months ahead. With that out of the way, on to the GDP data. Real GDP growth in the third quarter showed no net change from the first to the second estimate, staying at 3.5%. The best news in today's report was the upward revision to business investment to a 2.5% annual rate from an initial estimate of 0.8%, while the government spending estimate was revised lower. Inventories were also revised higher, helping to offset a decline in consumer spending, but not something that can be relied upon for sustained growth. We like to follow "core" real GDP, which excludes inventories, government purchases, and international trade. Inventories and government don't generate long-term growth, while the way trade is counted does a bad job of showing that rising imports signal strong spending. Core GDP grew at a 3.2% annual rate in Q3 versus a prior report of 3.1% and is up at a healthy 3.5% in the past year. Nominal GDP growth (real growth plus inflation) was revised to 5.0% annual rate in Q3 from a prior estimate of 4.9%. Nominal GDP is up 5.5% in the past year and up at a 4.8% annual rate in the past two years. All of these figures suggest the economy can sustain higher short-term interest rates, but the question looms whether the Fed will stick to its guns or blink in the face of market volatility. All eyes will be on the December FOMC meeting – where a hike looks nearly certain - for a clearer picture on the path of rates in 2019. In other recent news, the national Case-Shiller index shows home prices up 0.4% in September. In the past year prices are up 5.5%, a deceleration from the 6.0% gain in the year ending in September 2017. The major city with the fastest price growth, by far, was Las Vegas, up 13.5% from a year ago. Meanwhile, the FHFA index, which measures prices for homes financed by conforming mortgages, rose 0.2% in September and is up 6.0% from a year ago. That's a deceleration from the 6.7% gain in the year ending in September 2017. In other words, home prices are still rising on a national basis, just not as fast as a year ago.

3rd Quarter GDP Seasonally Adjusted Annual Rates	Q3-18	Q2-18	Q1-18	Q4-17	4-Quarter Change
Real GDP	3.5%	4.2%	2.2%	2.3%	3.0%
GDP Price Index	1.7%	3.0%	2.0%	2.5%	2.3%
Nominal GDP	5.0%	7.6%	4.3%	5.1%	5.5%
PCE	3.6%	3.8%	0.5%	3.9%	3.0%
Business Investment	2.5%	8.7%	11.5%	4.9%	6.8%
Structures	-1.7%	14.5%	13.9%	1.3%	6.8%
Equipment	3.5%	4.6%	8.5%	9.9%	6.6%
Intellectual Property	4.3%	10.5%	14.1%	0.7%	7.3%
Contributions to GDP Growth (p.pts.)	**Q3-18**	**Q2-18**	**Q1-18**	**Q4-17**	**4Q Avg.**
PCE	2.5	2.6	0.4	2.6	2.0
Business Investment	0.4	1.2	1.5	0.6	0.9
Residential Investment	-0.1	-0.1	-0.1	0.4	0.0
Inventories	2.3	-1.2	0.3	-0.9	0.1
Government	0.4	0.4	0.3	0.4	0.4
Net Exports	-1.9	1.2	0.0	-0.9	-0.4