

Economy Surges in Q2

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Economic growth surged in the second quarter this year. The only question is, by how much?

Predicting this Friday's GDP report is trickier than usual. First, it's the initial report for the quarter. Second, we have to wait until Thursday for key data on exports and imports, which is particularly important because the trade sector looks to have had an unusually large influence on second quarter growth. And third, this is the release each year where the government goes back several years and makes revisions to its methods and calculations.

Over recent years, GDP releases have suffered from problems with "seasonality." For example, over the past eight years, real GDP has grown at a 2.2% annual rate. But the average annualized growth rate in the first quarter each year has been 1.3%, while the second quarter has averaged 2.8%. The government is supposed to apply seasonal adjustments to make sure normal winter weather doesn't artificially drive down GDP growth, but apparently those adjustments haven't been working.

So what happens if the government fixes this problem, resulting in upward revisions to Q1 growth rates and slower growth rates in Q2? We have no way of knowing if the government plans to tweak their methodology and, if so, by how much. As a result, our forecast faces atypical risks.

All that said – and keeping in mind that we might make adjustments when we get Thursday's data on durable goods, inventories, and trade – our forecast for real GDP growth in Q2 stands at 4.8%. If so, and assuming no net revisions to recent quarters, real GDP growth would be at a 3.4% annual rate so far this year and 3.2% in the past year.

Here's how we get to 4.8%:

Consumption: Automakers reported car and light truck sales declined at a 1.4% annual rate in Q2. Meanwhile, "real" (inflation-adjusted) retail sales outside the auto sector grew at a 6.0% annual rate. However most consumer spending is on services, and growth in services was moderate. Our models

suggest real personal consumption (goods and services combined), grew at a 3.2% annual rate, contributing 2.2 points to the real GDP growth rate (3.2 times the consumption share of GDP, which is 69%, equals 2.2).

Business Investment: It looks like another quarter of solid growth, with commercial construction growing at a 10% annual rate, equipment investment growing at about a 2% rate, and intellectual property growing at a trend rate of 5%. Together, that means business investment grew at a 4.5% rate, which should add 0.6 points to real GDP growth. (4.5 times the 13% business investment share of GDP equals 0.6).

Home Building: Residential construction paused in Q2, although we think the recovery in this sector will pick right back up in Q3. For the time being, though, the sector will have no impact on the real GDP growth rate.

Government: Both public construction projects and military spending were up in Q2. As a result, it looks like real government purchases rose at a 1.8% annual rate, which would add 0.3 points to the real GDP growth rate. (1.8 times the government *purchase* share of GDP, which is 17%, equals 0.3).

Trade: At this point, we only have trade data through May. Based on what we've seen so far, net exports should add 1.2 points to the real GDP growth rate. However, an advance glimpse at June trade figures arrives Thursday, which could shift this key estimate up or down.

Inventories: We're also working with incomplete figures on inventories. But what we do have suggests companies were accumulating inventories more rapidly in Q2 than in Q1. This should add 0.5 point to the real GDP growth rate.

Add it all up, and we get 4.8% annualized growth. The Plow Horse economy is dead. That doesn't mean we're in a boom like the mid-1980s or late 1990s, but tax cuts and deregulation have finally killed off the plodding roughly 2% growth rate of 2010-2016.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
7-23 / 9:00 am	Existing Home Sales – Jun	5.440 Mil	5.350 Mil	5.380	5.430 Mil
7-25 / 9:00 am	New Home Sales – Jun	0.668 Mil	0.660 Mil		0.689 Mil
7-26 / 7:30 am	Initial Claims - Jul 22	215K	217K		207K
7:30 am	Durable Goods – Jun	+3.0%	+3.8%		-0.4%
7:30 am	Durable Goods (Ex-Trans) – Jun	+0.5%	0.0%		0.0%
7-27 / 7:30 am	Q2 GDP Advance Report	4.2%	4.8%		2.0%
7:30 am	Q2 GDP Chain Price Index	2.3%	1.5%		2.2%
9:00 am	U. Mich Consumer Sentiment- Jul	97.1	97.1		97.1