First Trust
Monday Morning OUTLOOK

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630-517-7756 • www.ftportfolios.com September 25, 2023

Don't Fall for the Q3 Head-Fake

We have plenty of data reports to go, but, so far, the third quarter is shaping up to be a strong one for the US economy. The Atlanta Fed's GDP Now model is tracking a Real GDP growth rate of 4.9% for Q3, which would be the fastest quarterly growth rate since the earlier part of the COVID recovery.

Our models aren't tracking quite so high but are projecting growth at about a 4.0% rate, still strong by the standards of the past couple of decades.

However, we would not get too excited about what's happening in the third quarter and don't think one quarter of strong economic growth means a recession is off the table.

With all the oddities of the COVID era – first overly strict lockdowns and then overly gradual re-openings – it's entirely possible the GDP reports are exhibiting some "seasonality," where certain quarters look better than the underlying economy really is. The third quarter is when children typically go back to school, for example, but, unfortunately, they did that less so during COVID. As a result, normal back-to-school behaviors might make the economy look extra strong for now.

To put some numbers on this, statistical adjustments to retail sales (called seasonal adjustments) subtracted 1.8% from reported sales in July 2019, prior to pandemic shutdowns. Back to school spending in July (much like Christmas) makes for some big spending months, and the statisticians adjust the numbers down. But in 2020, 2021 and 2022 July sales fell because so many schools were closed. This reversed the seasonals and this July (2023) seasonal adjustments added 1.4% to reported sales. We think this is distorting our view of the economy.

Meanwhile, the economy is likely feeling the last positive remnants of the surge in the money supply in 2020-21. The lags between monetary policy and the economy have always been long and variable, as Milton Friedman taught us. Beyond the third quarter, the economy is likely to show more of the effects of the drop in the M2 measure of the money supply from mid-2022 through early 2023.

Another reason we think the third quarter is a head-fake is that deficit spending by the federal government is very unlikely to expand in 2024 like it has in 2023. Were it not for President Biden announcing his student loan debt forgiveness plan last year the budget deficit would have been 4.0% of GDP in Fiscal Year 2022, high but not extraordinary.

And if it hadn't been for the Supreme Court striking down that plan this year, the deficit would have been about 7.8% of GDP for Fiscal Year 2023, well beyond even the highest deficit under President Reagan in the 1980s and all while the unemployment rate is averaging about 3.6%.

The rise in the deficit of almost four percentage points of GDP with the unemployment rate so low is unprecedented. Other prior leaps in the deficit of this magnitude have been during major wars or recessions, not when the US is at peace and the unemployment rate is unusually low.

In particular, the way some of the extra deficit spending is structured looks designed to temporarily and artificially boost economic growth. The CHIPS Act, for example, is encouraging private investment in chip manufacturing facilities in the US. So far this year (through July), private spending to construct manufacturing facilities in the computer, electronic, and electrical sector are up 228% versus the same period in 2022.

But these buildings don't have to be rebuilt every year. Sometime soon the gains in this sector will dwindle and reverse, with collateral damage to other sectors, like trucking.

To be clear, we do not believe government spending is a positive for long-term growth. In fact, it often distorts and diminishes overall activity. However, in the short-term, as we saw during COVID (and apparently this year as well) it can make the economy look stronger than it really is. A price will be paid, and as all this extra stimulus wears off a recession is highly likely. We don't see how it is avoided.

The next recession is unlikely to be as devasting as the ones in 2008-09 or 2020. But our view remains that a recession is on the way.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
9-26 / 9:00 am	New Home Sales – Aug	0.699 Mil	**0.706 Mil**		0.714 Mil
9-27 / 7:30 am	Durable Goods – Aug	-0.5%	**-1.4%**		-5.2%
7:30 am	Durable Goods (Ex-Trans) – Aug	+0.2%	**+0.2**		+0.4%
9-28 / 7:30 am	Initial Claims – Sep 23	215K	**212K**		201K
7:30 am	Q2 GDP Final Report	+2.2%	**+2.2%**		+2.1%
7:30 am	Q2 GDP Chain Price Index	+2.0%	**+2.0%**		+2.0%
9-29 / 7:30 am	Personal Income – Aug	+0.4%	**+0.5%**		+0.2%
7:30 am	Personal Spending – Aug	+0.5%	**+0.4%**		+0.8%
8:45 am	Chicago PMI – Sep	47.6	**47.7**		48.7
9:00 am	U. Mich Consumer Sentiment - Sep	67.7	**68.0**		67.7