RCF Economic & Financial Consulting, Inc.

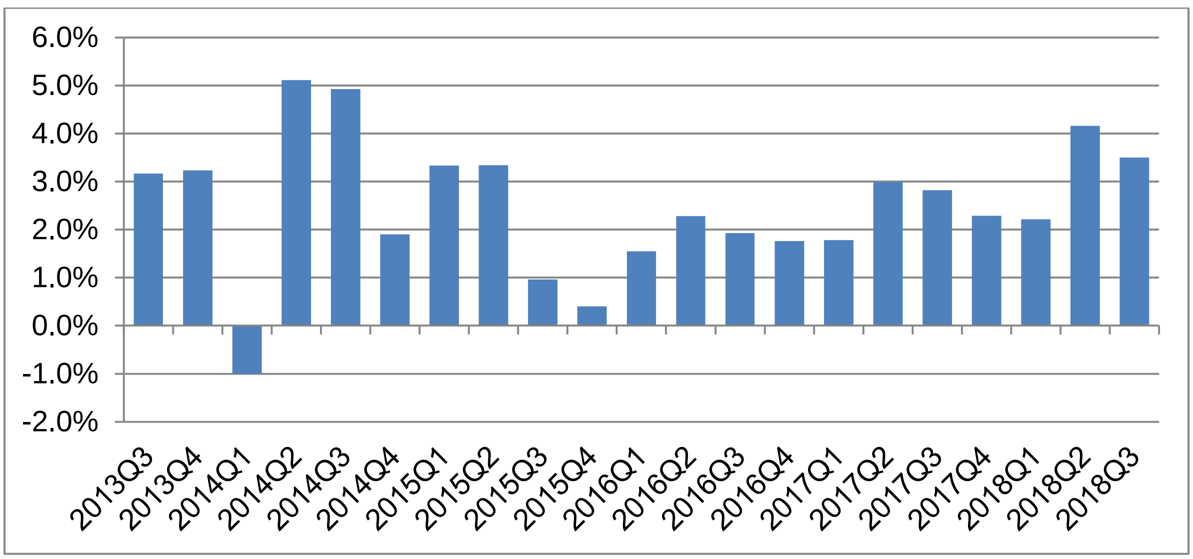
Peter Bernstein, Vice-President

The Good, the Bad, and the Ugly from the 2018Q3 GDP Report

The Good

Real GDP grew at annualized rate of 3.5 percent in the third quarter, a solid top-line number following the 4.2 percent growth rate in the second quarter. GDP was boosted by strong growth in real consumer spending which expanded at a 4.0 percent clip during the quarter.

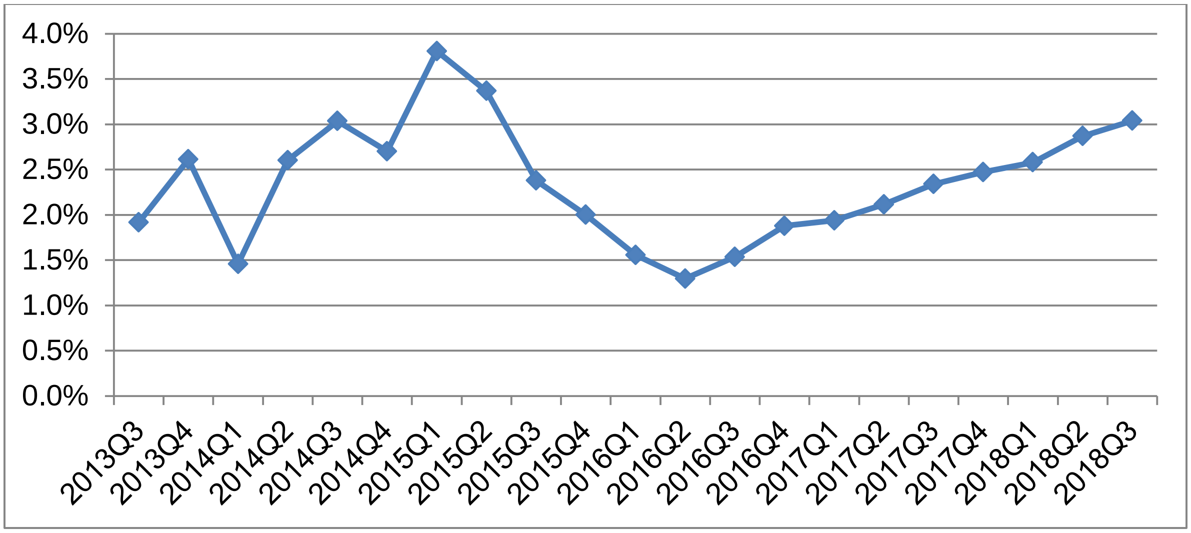
Chart 1: Quarterly Real GDP (% change at an annualized rate)



Source: U.S. Bureau of Economic Analysis

A better measure of economic growth is the annual percent change from a year ago, which smooths out short-term quarterly variations. By this measure, the economy grew 3.0 percent versus a year ago, the best performance in four years. Whether this strength is due solely to the "sugar-high" from recent tax cuts and increases in government spending, or evidence of a more sustainable improvement in the economy's upward trend remains to be seen. But for now, the GDP numbers are good news.

Chart 2: Real GDP (% change from a year earlier)



Source: U.S. Bureau of Economic Analysis

The Bad

Real business investment spending expanded at a 12 percent rate in the third quarter. What's bad about double-digit growth in investment? The fact that it was entirely due to an increase in business inventories, which are included in the calculation of investment. Excluding inventories, fixed investment actually declined in the third quarter. Residential investment – mostly construction of new housing – declined at a 4 percent rate.

It is true that the increase in inventories reverses an unusual inventory decrease from the second quarter. But that is mostly beside the point. The decline in fixed business investment suggests that the positive impact from the cut in corporate taxes is waning. The stock market seems to think so, as the S&P 500 has dropped 10 percent from its recent all-time high.

The Ugly

Exports declined at a 3.5 percent rate in the third quarter while imports rose at a 9.1 percent rate. The result was a huge increase in the trade deficit. In fact, adjusted for inflation the quarterly trade deficit hit an all-time high in 2018Q3. One might think that this is evidence that the focus on tariffs and trade wars is not working. But given President Trump's emphasis on reducing the trade deficit don't be surprised if he doubles-down on his protectionist policies.

The Bottom Line

As shown in Chart 2, the economy has been gradually gaining strength over the past two years. But Chart 2 also shows that an earlier period of stronger growth (in 2014) was followed by a slowdown. We expect this pattern to repeat itself going forward. As noted, the gains from the recent tax cuts are waning and the Federal Reserve will continue to increase interest rates. The current weakness in the housing sector is concerning; sales of new homes are down 13 percent from a year ago which explains why new housing starts have dropped 10 percent since the start of the year. Slower growth doesn't mean a recession, though that cannot be ruled out for the not-too-distant future. For now, however the labor market is strong and inflation seems to be stabilizing at a little more than 2.0 percent. That suggests that workers' real wages will start to grow, the one ingredient that has been mostly missing from the nearly decade-long economic recovery. If somewhat slower growth is what is needed to keep inflation in check, it might be a price worth paying. Boom and bust – that's the scenario we'd rather not see.

For additional information or questions, please contact Mr. Peter Bernstein, RCF Vice President, 312-431-1540 ext. 1515 or by email: pbernstein@rcfecon.com