US

Good enough for the Fed?

Data released over the summer confirmed that the US economy slowed dramatically in the first half of the year. The BEA's first estimate for GDP growth suggested that the economy expanded at just a 1.1% annualised rate in the second quarter, after increasing by 0.8% in Q1 (see Chart 2). **This left real GDP growth at just 1.2% over the past four quarters; the slowest annual rate since the middle of 2013 when the Eurozone crisis and fiscal cliff were both weighing on economic activity**. Meanwhile, annual nominal growth slowed from a peak of 4.9% in Q3 2014 to just 2.4% in Q2; the weakest of the entire expansion.

Encouragingly, however, both the details of the report and more forward-looking evidence suggest that Q2 most likely represented a local trough in nominal growth. Though headline growth was weak in the quarter, personal consumption expenditures increased at a 4.1% annualised rate, which was the fastest pace since the end of 2014, with durable goods, non-durable goods and services spending all growing rapidly. Consumer spending growth appears to have remained healthy into Q3 despite an August drop in auto sales. Why then was headline growth so weak? **The main reason was that the production side of the economy is yet to catch up with the recovery in consumer demand (see Chart 3), which meant that the increase in spending was satisfied by a further drawdown in inventories**. The second factor was further weakness in fixed business investment. Equipment investment was estimated to have fallen by 3.8% in Q2 – the third consecutive decline – while non-residential structures investment fell by 8.4%, also continuing a long swoon driven by falling energy-related investment. The good news is that both of these factors are likely to partially reverse over the next few quarters. Setting aside what looks like an unrealistically large drop in the manufacturing ISM in August, business survey data suggest that industrial production and investment intentions have troughed, while the Baker Hughes oil rig count has begun to recover, which together should see inventories making a positive contribution to growth in the second half of the year and fixed business investment also gradually improve. That should more than offset the mild slowing in private consumption growth we expect due to moderating real income growth, though we anticipate that the labour market will continue to tighten.

Given our view that the Q2 GDP data told us more about the past than the future, **we did not expect Fed officials to be unduly concerned about the downward surprise as forward-looking economic indicators continued to point to better growth ahead, financial stress remained subdued and the labour market and underlying inflation continue to make progress towards the Fed's goals – and that is precisely what has happened**. In the lead up to Jackson Hole, there was a steady drumbeat from Federal Open Market Committee members making the case for lifting rates later this year and Yellen backed those views up in her speech by saying that her own conviction levels in the appropriateness of raising rates this year had increased. Although this points to September's meeting being a live one, the pending November presidential election and the fact that the market implied probability of a September increase is still low, suggest to us that another December move is more likely.

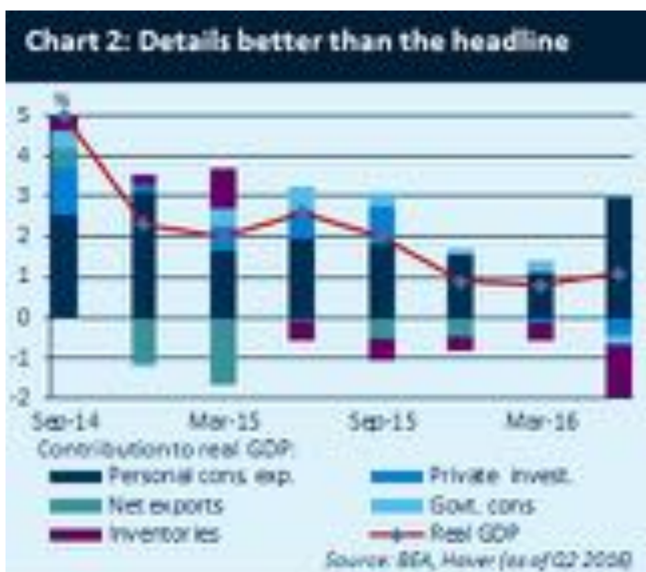

Chart 2: Details better than the headline

Source: BEA, Haver (as of Q2 2016)

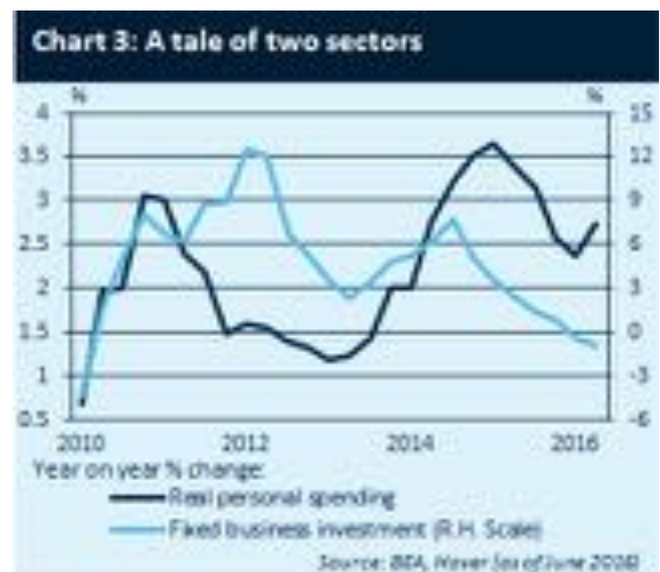

Chart 3: A tale of two sectors

Source: BEA, Haver (as of June 2016)