

THE ECONOMIC OUTLOOK GROUP



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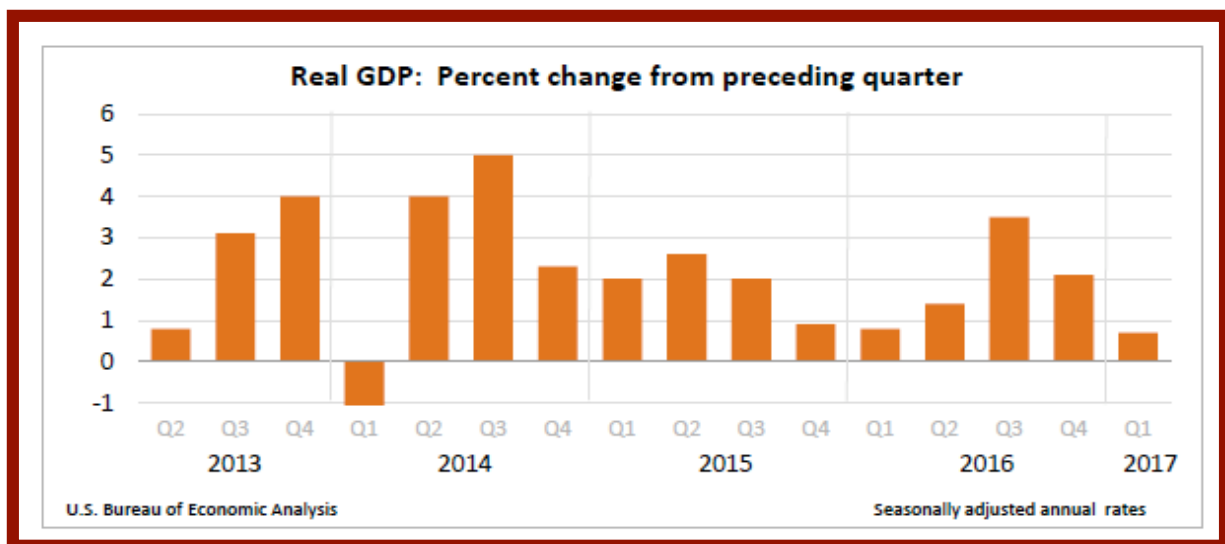
ECONOMIC TALKING POINTS

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Ignore Q1's GDP? Yes, But Washington Better Take Notice!

GDP may be the mother of all economic indicators. But it has also become a less useful barometer on the health of the US economy lately. The alleged 0.7% growth rate in the first quarter is just the latest example of its questionable value. From our viewpoint, the latest data set was a stunning misdirection of the economy's underlying strength.



Here's why in a nutshell:

1. That dismal growth rate --- the weakest since early 2014 --- makes little sense at a time when payrolls grew an average of 178,000 in Q1. Remember, during the fourth quarter the economy grew three times faster (2.1%), yet payrolls averaged just 148,000. It is therefore hard to reconcile a faster pace of hiring in Q1 with a growth rate that's nearly flat-lining.
2. You don't get 0.7% GDP growth when employers are furiously trying to fill 5.74 million job openings in February (latest available), which is largest number in seven months.
3. Nor is it possible to have confidence among consumers, business leaders, investors, and homebuilders at or near multi-year highs with a Q1 economy that's so profoundly weak.
4. It's also difficult to give this GDP figure much credibility when new home sales in March surged to an 8-month high!
5. Consumer prices also raced past 2% in the Q1, which is difficult to do in the absence of significantly higher wages and energy prices, and certainly not with a meager growth rate of 0.7%.
6. Moreover, the meek GDP growth rate dramatically conflicts with the rise in activity seen in both manufacturing and services during the first quarter, based on the ISM surveys.

Of course, it is not sufficient to simply downplay this GDP report. We have to drill down and see why there was this sharp dichotomy between the headline number and what is really happening in the macroeconomy.

Let's immediately give the BEA at least one pass by acknowledging the advance report includes several key estimates simply because some hard data was not yet available. OK, done.

Another factor for the awful growth in Q1 was the weakness in personal consumption expenditures (PCE). Shoppers apparently slammed the brakes in the first quarter. Consumer spending rose a barely noticeable 0.3%, the smallest quarterly increase in more than eight years. Yes, retail sales fell in February and March due entirely to a cutback in auto purchases. But no one should construe that trend as an indication that consumers are in retrenchment mode. Just the opposite, Americans are ready and able to ramp up spending. After all, the job market continues to be strong. Family debt burdens have eased after years of deleveraging. Household wealth is at record high levels, both in nominal and inflation-adjusted dollars. Pay continues to rise faster than inflation, which boosts purchasing power.

In short, consumers are in solid financial shape and spirits remain high. Today's release by the University of Michigan on consumer sentiment shows April's

optimism rose to 97.0, even higher than the already impressive 96.9 at the end of March.

So what could account for the disappearance of shoppers last quarter? Probably four factors:

First, households took a brief breather at the start of the year, after raising spending at an average quarterly pace of 3.6% the previous nine months. So Q1 may have been time for a brief pause.

Second, March turned out to be an unusually stormy month in the Northeast and Midwest and kept shoppers away from stores.

Third, tax refunds were coming in later than usual and that curbed household outlays.

The fourth reason is a more intriguing but for now an intangible one. Beneath the overt show of consumer confidence in the economy may be a growing undercurrent of concern about the bizarre political machinations in Washington. Americans could be getting edgy when there is so much uncertainty over what will replace the Affordable care Act, or of future tax policy, or of the numerous Congressional and Justice department investigations that could incriminate key officials in the White House over ties with Russia during the Presidential campaign.

Remember it was not supposed to be this way, not with one party in control of the executive and legislative branches. People expected more policy clarity and faster progress. Instead, the nation's capital looked like a political war zone with some wondering even about the longevity of the Trump Administration.

It's difficult at this stage to quantify the extent these concerns have seeped into the mindset of consumers, but it could become an emerging issue in the coming months, and thus worth monitoring closely.

Two other broad issues have devalued this GDP report.

Economic statisticians at the BEA have had a hellishly difficult time recalibrating the seasonal adjustment factors during the winter months. It's why Q1 numbers have proven to be been notoriously unreliable in helping us understand the strengths and weaknesses in the economy these months. And it would seem prudent for investors and business leaders not to make any strategic decisions on allocating capital based on first quarter GDP numbers.

The other issue, one we believe is often misunderstood, is the relationship between our trade balance and how GDP is calculated. A strong US economy will draw in more imports of consumer products and capital goods. Those foreign-made goods help satisfy the demands of US households and businesses in an expanding domestic economy.

On the other hand, if foreign economies are soft, they will purchase fewer US products. This results in a larger trade deficit (or a bigger negative to net exports), which is then subtracted from US GDP. (One way of looking at this is to follow the

money. Who produces those products and gets paid for selling them? A trade deficit means more money is flowing out to foreign producers, than what is being paid to US exporters.)

Fortunately, we now see economic growth has picked up in Europe and Japan and this has increased demand for US products during the first three months of 2017. Thus, instead of subtracting from US GDP growth, the smaller trade deficit in the first quarter actually contributed a miniscule 0.07% to US growth.

To avoid the issue of trade entirely and focus purely on how strong US demand is among consumer and business, we look at “final sales to domestic purchases,” which rose 1.5% to show that real US demand for goods and services is more than twice as strong as the GDP headline suggests.

So, what’s next?

Looking ahead, we fully expect to see the economy bounce back in the second quarter with a GDP growth rate of 2.3%, followed by an even stronger third (2.5%) and fourth quarter (2.6%). But again --- all this presupposes that the turmoil in Washington lessens and there’s progress in pushing forward personal and corporate tax reform legislation, infrastructure spending and deregulation.

However...if the chasm between moderate Republicans and the more conservative faction of the GOP widens and/or the White House becomes paralyzed by the numerous investigations underway, then the first quarter GDP may, in the end, represent the start of a dull and lasting plateau in US economic activity, and not merely a Q1 aberration.

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Key Economic Forecasts

- Actual
- Forecast

United States

	I 2016	II 2016	III 2016	IV 2016	I 2017	II 2017	III 2017	IV 2017	I 2018	II 2018	III 2018	IV 2018
Real Gross Domestic Product (GDP):												
%	0.8	1.4	3.5	2.1	0.7	2.3	2.5	2.6	2.5	2.7	3.0	2.7
Personal Consumption Expenditures:												
PCE	1.6	4.3	3.0	3.5	0.3	3.1	2.6	2.9	2.6	3.5	3.3	2.5
Inflation, end of period, year-over-year:												
CPI %	0.9	1.0	1.5	2.1	2.4	2.5	2.6	2.5	2.5	2.6	2.6	2.8
Unemployment Rate (end of period):												
%	5.0	4.9	4.9	4.7	4.5	4.7	4.9	5.0	4.8	4.7	4.6	4.5
Non-farm Payrolls, monthly avg. thousand:												
	196	164	239	148	178	166	170	180	177	165	150	155
Treasury 10-yr Note Yield % (end of period)												
	1.78	1.49	1.60	2.45	2.39	2.28	2.36	2.60	3.00	3.15	3.15	3.20
Federal funds rate % (end of period)												
	0.38	0.38	0.38	0.63	0.88	1.13	1.13	1.38	1.63	1.88	2.13	2.13

GDP Growth - Global Economy

Country	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
US	1.8	-0.3	-2.8	2.5	1.6	2.2	1.7	2.4	2.6	1.6	2.1	2.6
Eurozone	2.6	0.6	-4.1	1.7	1.4	-0.9	-0.3	1.2	2.0	1.7	1.3	1.7
United Kingdom	3.1	0.6	-5.2	1.7	0.7	0.3	1.8	2.9	2.2	2.0	1.2	1.5
Japan	2.1	-0.7	-5.4	4.6	-0.4	1.6	1.5	-0.1	1.1	1.0	1.2	1.3
Canada	2.7	0.7	-2.8	3.1	3.1	1.7	2.2	2.5	1.2	1.4	2.0	2.5
India	9.1	8.8	6.3	8.4	8.6	6.7	4.9	7.4	7.8	7.2	7.3	7.8
China	14.2	9.6	9.2	10.5	9.5	7.8	7.7	7.3	6.9	6.7	6.7	6.5
Brazil	5.7	5.1	-0.3	7.5	2.7	0.9	2.3	0.1	-3.8	-3.6	0.2	2.2
Mexico	3.3	1.4	-4.7	5.2	4.0	3.9	1.4	2.3	2.5	2.2	1.8	2.4
Australia	4.0	2.3	1.2	2.8	2.6	3.6	2.4	2.6	2.5	2.5	2.5	2.8
Russia	8.1	5.6	-7.9	4.0	4.3	3.4	1.3	0.6	-3.7	-0.8	0.7	1.8
World	5.4	1.6	-1.9	4.2	3.0	2.6	2.9	3.0	2.6	2.5	2.8	3.2

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