TheStreet

Why the GDP Number Is Better Than It Looks

By Tim Mullaney 4/28/16

The U.S. economy grew at an annual rate of 0.5% in the first three months of the year, a lackluster performance that nonetheless topped increasingly gloomy forecasts.

As expected, business investment tanked, falling 3.5%, after the plunge in oil prices nearly halted new drilling and the market's worries over China and other U.S. trade partners inflated the value of the dollar, hurting exports. Consumer spending rose just 1.9%, a drop from the 3% or better pace consumers were setting in mid-2015. Gross domestic product, or GDP, rose 1.4% in the fourth quarter of last year and 2.4% for the year as a whole.

Overall, the quarterly number was slightly worse than the 0.7% consensus forecast reported by *Econoday*, but it ran ahead of the most pessimistic estimates. Moody's Analytics' forecast had actually turned negative for a short time earlier this month.

Signs that the slowdown may have been caused by the panic in the markets early this year are littered through the report. Consumers stopped buying durable goods -- that category of the economy dropped 1.6 percent, shaving 0.33 percentage point off overall growth -- a decline that independent economist Joel Naroff said was caused entirely by weak car and truck sales in March. Business spending on equipment, which can be adjusted more quickly than spending on structures, fell 8.6%.

The bright spots were a nearly 15% climb in residential investment, great for companies like Home Depot (HD - Get Report) and Toll Bros. (TOL - Get Report) and a 2.7% annualized jump in consumer spending on services, which includes discretionary spending like eating out and travel. That's good for airlines like United Continental (UAL - Get Report) and hoteliers such as Marriott International (MAR - Get Report)

Both numbers suggest that the slowdown in consumers' spending on goods is likely to be short-lived.

"It's groundhog day," Moody's Analytics (MCO - Get Report) economist Ryan Sweet said. "Another poor first quarter, but it's not reason for concern as there are likely some lingering measurement issues. Inventories and trade weighed down the economy in the first quarter but GDP will bounce back through the rest of this year."

Basically, Sweet says, while the numbers aren't great, there are some easily understood reasons why it's more "eh" than terrible.

First, wary companies built up less inventory than normal during the quarter, cutting their short-term risk and reducing GDP growth by 0.33 percentage point. The slowdown in exports also helped to cut GDP about a third of a percentage point.

Add both of those to the 0.5% reported growth rate, and you get 1.2%. On top of that, economists have been having an arcane debate over whether the government's seasonal adjustment process, which is designed to smooth the numbers so that markets are not spooked by normal fluctuations in hiring and construction, has been routinely making the first quarter of each year look worse than it really is.

Full-year growth of 2.5% is still likely, said **Bernard Baumohl, chief economist of the Economic Outlook Group** in Princeton, N.J. The reversal of some of the dollar's gains in recent weeks, coupled with a rise in energy prices that will stop the bleeding in business investment, will lead to better reports by mid-year, he said.

"The drag from the dollar and lower exports will be coming to an end," he said -- good news for exporters like Boeing (BA) and Caterpillar (CAT) . "And consumers are still spending on experiences. They're taking flights and staying in hotels. ...The home building [data] is the

strongest it has been in three years."

Markets should remember that the GDP report will be revised twice before the government settles on a final estimate of first-quarter growth, Regions Financial economist Richard Moody said. But the data suggest that the bottom in inventories and investment has probably been reached, and that residential construction and consumer spending will lift the economy by mid-year, he said.

That could even keep a June interest-rate hike in play for the Federal Reserve, depending on data covering April and May, **Baumohl** said.

"It's a 50/50 shot," he said. But economists have been ahead of bond traders on rate calls: Futures markets put the odds of a June hike at only 15%.

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