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Q4 GDP: Not so bad after all

Capex and consumer spending beat expectations, helping to drive GDP growth of 2.6%.

Published 02-28-2019

Philip Orlando, CFA
Senior Vice President
Chief Equity Market Strategist
Head of Client Portfolio Management

BOTTOM LINE

Fourth-quarter gross domestic product (GDP) grew at an annualized pace of 2.6%. While not keeping pace with third and second quarter growth of 3.4% and 4.2%, respectively, it was better than many feared. President Trump's tax cuts likely had a positive effect, as stronger-than-expected corporate investment spending drove the unexpectedly high figure. U.S. GDP has now grown to nearly $20.9 trillion.

Based on the stocks market's 20% fourth-quarter collapse, December's 1.2% month-over-month (m/m) plunge in retail sales and the federal government shutdown, we were expecting only a 2% gain here at Federated. The Bloomberg consensus was 2.2%, and the Atlanta Fed's GDPNow estimate was1.8%.

Capital expenditures (capex) were better-than-expected in the fourth quarter, but a true surprise was consumer spending's 2.8% gain—although this could be revised lower to come more in line with the poor Christmas retail sales. Inventory rebuilding was more robust than anticipated, as was net trade (strong exports growth combined with weaker imports). To round out the report, government spending slowed and housing sales declined for the fourth consecutive quarter. Because of the government shutdown, today's flash report takes the place *of the advance and second estimates; the final revision will be released March 28. Here are key details:*

Government shutdown slowed growth Beginning on Dec. 22, it lowered growth about 0.1% per week due to reductions in services, according to the Commerce Department. It cautioned there likely is a multiplier effect that can't be fully quantified.

Consumer spending surprises Personal consumption expenditures, which account for 70% of GDP, rose 2.8% in the fourth quarter compared with 3.5% in the third quarter and 3.8% in the second. The gain added 1.92 percentage points to fourth-quarter GDP growth. But the stock market plummeted 20% from late September to Christmas Eve, creating a hugely negative wealth effect as nominal retail sales in December plunged 1.2%, their largest m/m decline in nine years. Moreover, control results (which strip out autos, gasoline, building materials and food-service, and feed directly into the quarterly GDP report), plummeted 1.7% in December, their sharpest m/m decline since the terrorist attacks in New York City in September 2001. So we were expecting a much uglier number this morning.

Strong business fixed investment Adding 0.82 points, nonresidential real business fixed investment rose for the 11th consecutive quarter by 6.2% versus 2.5% in the third quarter, 8.7% in the second and 11.5% in the first. Looking at the three key subcomponents:

- Nonresidential structures fell for the second consecutive quarter. The drop of 4.2% (primarily due to declining oil prices) was its largest in a year, subtracting 0.13 points, compared with a decline of 3.4% in the third quarter.
- Business equipment rose for the ninth consecutive quarter. Its increase of 6.7%, versus a 3.4% gain in the third quarter, added 0.39 points.
- Intellectual property soared 13.1%, compared with healthy gains of 5.6% in the third quarter, 10.5% in the second and 14.1% in the first, adding 0.56 points. We believe that President Trump's corporate tax cuts, repatriation and automatic expensing of capex sparked this increase in business investment, helping to lift productivity growth in a sustainable manner.

Inventory remains elevated Inventory rebuilding surprisingly rose by $97.1 billion in the fourth quarter, adding a modest 0.13 points, compared with an $89.8 billion increase in the third quarter (which had added 2.33 points to third-quarter GDP, the most in more than three years). These more than reversed the second-quarter's liquidation of $36.8 billion that was due to tariff-related supply chain disruptions. We expect inventory building to recede this quarter.

Net trade modestly lower The ongoing trade and tariff dispute with China likely contributed to a moderate decline of 0.22 points, but that's substantially less negative than the third quarter's sizable 1.99 point negative impact, the largest drag on trade in 33 years. Exports rose 1.6%, adding 0.19 points, compared with the decline of 4.9% in the third quarter, which subtracted 0.62 points. Imports rose 2.7%, which subtracted 0.41 points, compared with a sizable increase of 9.3% in the third quarter, which subtracted 1.37 points. A favorable resolution of the China trade deal could result in a sizable boost to net trade.

Housing remains weak Residential construction fell for the fourth consecutive quarter and for the sixth time in the past seven quarters. Its decline of 3.5%, which subtracted 0.14 points, was similar to the third quarter's 3.6% drop. The housing market remains under pressure, with the $10,000 SALT deduction cap, higher mortgage rates, rising home prices, increasing labor and material costs, and more than $1.5 trillion in student loan debt impacting millennial first-time home buyers.

Government spending flat Spending by the three levels of government likely was impeded by the partial government shutdown. But the total still rose 0.4% in the fourth quarter, adding 0.07 points. This was the fifth consecutive quarter of increases, and follows a 2.6% bump in the third quarter. Federal spending rose 1.6%, paced by a nine-year-high of a 6.9% increase in national defense and a 5.6% decline in non-defense spending, the largest contraction in five years. State and local spending slipped 0.3%.

Final sales remain strong Private domestic final sales—which exclude volatile net trade, inventory building and government spending—rose at a solid 3.1% pace, compared with 3% in the third quarter and 4.3% in the second (the second-fastest pace since 2014). This metric is a better indication of underlying fundamental demand and suggests economic growth remains sustainably strong. The savings rate rose to 6.7% from 6.4% in the third quarter, so consumers should have some dry powder to deploy around Easter.

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DISCLOSURES

Views are as of the date above and are subject to change based on market conditions and other factors. These views should not be construed as a recommendation for any specific security or sector.

Gross Domestic Product (GDP) is a broad measure of the economy that measures the retail value of goods and services produced in a country.

Personal Consumption Expenditure (PCE) Index: A measure of inflation at the consumer level.

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