First-quarter growth much better than feared

Q1 GDP growth was driven by stronger inventory and net trade.

Published 04-26-2019

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

BOTTOM LINE

GDP grew by a much stronger-than-expected annualized pace of 3.2% in the first quarter versus 2.2% in last year's fourth quarter. It was driven by surprisingly stronger inventory accumulation and net trade, whose combined boost was the strongest in six years. U.S. GDP has now grown to slightly more than $21 trillion.

The first-quarter GDP report certainly was more robust than expected given numerous transitory hurdles, such as the government shutdown, brutal winter weather and a negative wealth effect sparked by the fourth-quarter's 20% stock-market collapse. The latter resulted in poor retail sales in December and February and weak employment growth in February.

Consequently, the Blue Chip consensus was estimating only 1.5% for first-quarter growth and we were expecting only 1.8% here at Federated. But with several key economic metrics strengthening sharply in March, signaling that the soft patch likely bottomed in February, the Bloomberg consensus raised its estimate to 2.3% in recent days. Likewise, the Atlanta Fed's widely followed "GDPNow" model goosed its estimate from 0.2% last month to 2.8% this week.

The first-quarter corporate earnings season is following a similar script, with consensus expectations for a 3-5% year-over-year decline in profits. But with nearly half the S&P 500 companies already reporting, earnings appear to have risen 4-5% thus far, with more than three-quarters beating expectations.

Here are the key details from the first-quarter GDP report:

Government shutdown slowed growth The federal government's 35-day shutdown, which ended Jan. 25, cost us 0.1 percentage points in GDP growth in the fourth quarter and 0.3 percentage points in the first quarter due to reduced services from furloughed federal government workers. The Commerce Department also believes there was a negative private multiplier effect that likely further reduced economic growth, but they are unable to fully quantify it.

Consumer spending not as bad as feared Personal consumption expenditures (PCE), which account for 70% of GDP, rose 1.2% in the first quarter (versus an estimated 1% gain), compared with 2.5% in the fourth quarter. That added 0.82 percentage points to overall first-quarter growth. As a hangover from the fourth quarter's negative wealth effect and the worst Christmas retail sales figures in nearly 20 years, the "Frugal February" phenomenon took February retail sales into modestly negative territory, too. But March sales soared into a late Easter, salvaging PCE in the first quarter.

Inventories surprisingly soar Manufacturing inventory rebuilding rose by $128.4 billion in the first quarter, adding a robust 0.65 percentage points to GDP growth versus $96.8 billion in the fourth quarter and $89.8 billion in the third quarter. These three consecutive inventory builds more than reversed the second-quarter's liquidation of $36.8 billion due to tariff-related supply chain disruptions. This elevated inventory building pace is unsustainable, in our view, and it could recede in the second quarter.

Net trade strongly positive The sharp improvement in net trade during the first quarter added a powerful 1.03 percentage points to growth. Exports rose 3.7% in the first quarter, adding 0.45 percentage points compared with an increase of 1.8% in the fourth quarter and a decline of 4.9% in the third. Imports plunged 3.7% in the first quarter, adding 0.58 percentage points, compared with increases of 2% in the fourth quarter and 9.3% in the third. This could be a blueprint for a favorable resolution of the ongoing U.S./China trade deal by midyear, resulting in a sizable boost to net trade to benefit U.S. GDP.

Government spending rises Driven by state and local infrastructure spending, total government spending (which accounts for about 17% of total GDP) rose 2.4% in the first quarter, adding 0.41 percentage points to growth, the strongest pace since 2017. Federal government spending was flat in the first quarter, although a 4.1% increase in defense spending was offset by a 5.9% decline in nondefense spending. State and local spending rose 3.9%.

Business fixed investment slows Although nonresidential real business fixed investment rose for the 12th consecutive quarter, its pace halved in the first quarter to a gain of 2.7%, adding 0.38 percentage points to GDP growth versus 5.4% in the fourth quarter. Looking at the three key subcomponents, nonresidential structures declined for the third consecutive quarter by 0.8% in the first quarter versus -3.9% in the fourth. Business equipment rose for the 10th consecutive quarter, but its pace also slowed to a marginal gain of only 0.2% (smallest gain since 2016) versus 6.6% in the fourth quarter. Intellectual property, however, remained strong, growing 8.6% in the first quarter versus 10.7% in the fourth.

Housing remains weak Residential construction fell for the fifth consecutive quarter and for the seventh time in the past eight quarters, declining 2.8% in the first quarter, which subtracted 0.11 percentage points from GDP growth versus -4.7% in the fourth quarter. The housing market remains under considerable pressure, with the $10,000 SALT deduction cap impacting high-tax states, rising home prices, labor and material costs, and more than $1.5 trillion in student loan debt that's impacting millennial first-time home buyers. But mortgage rates have fallen in recent months, so we're watching to see if we may get a bounce during the seasonally strong second quarter.

Final sales soften Private domestic final sales—which exclude volatile net trade, inventory building and government spending—rose a much softer 1.3% pace in the first quarter (its slowest rate of growth since 2013) versus 2.6% in the fourth. This metric is a better indication of underlying fundamental demand, which suggests that while the economy has successfully navigated the winter soft patch, the growth contribution from inventory restocking (and perhaps some of net trade) is unsustainable. However, with an elevated savings rate at 7% in the first quarter versus 6.8% in the fourth, we expect continued consumer strength through the important "Mapril" season.

Connect with Phil on **LinkedIn**

TAGS

EQUITY | MARKETS/ECONOMY | UNITED STATES

DISCLOSURES

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.

S&P 500 Index: An unmanaged capitalization-weighted index of 500 stocks designated to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. Indexes are unmanaged and investments cannot be made in an index.

The University of Michigan Consumer Sentiment Index is a measure of consumer confidence based on a monthly telephone survey by the University of Michigan that gathers information on consumer expectations regarding the overall economy.

Federated Advisory Services Company

918661

Federated®