LPL RESEARCH

WEEKLY ECONOMIC COMMENTARY

April 30 2018

A CLOSER LOOK AT FIRST QUARTER GDP

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KEY TAKEAWAYS

The economy posted solid first quarter growth of 2.3% in the face of seasonal headwinds.

Consumer spending and CAPEX slowed as temporary factors weighed.

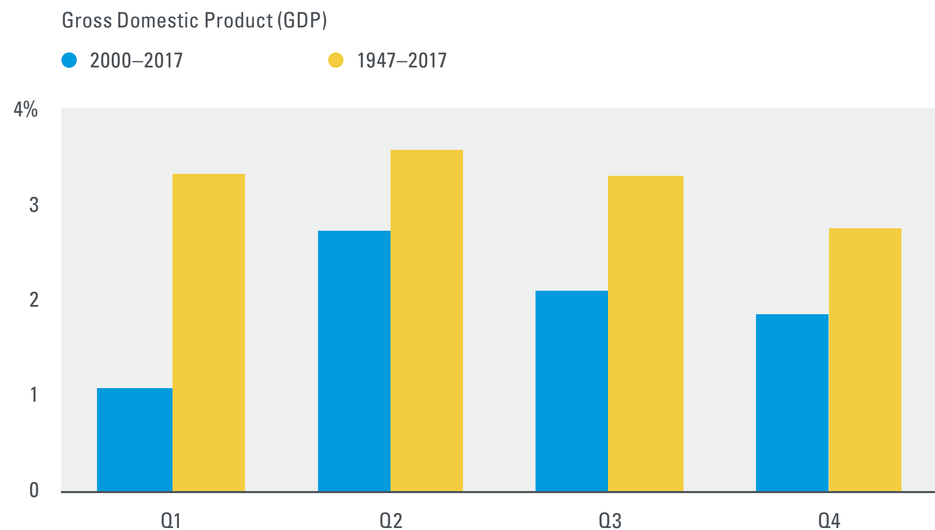
Leading indicators, economic surprises, and the overall policy and economic backdrop point to a rebound in growth in the second quarter.

The U.S. economy grew at 2.3% in the first quarter, better than the consensus estimate of 2.0%, but a slowdown from the near 3% growth of the prior three quarters. Persistent problems with seasonal adjustment of first quarter data and a lull in consumer activity after some spending was pulled forward in the fourth quarter, likely due to post-hurricane recovery and anticipated tax gains, all weighed on first quarter growth. We continue to expect U.S. growth to accelerate over the rest of the year as these temporary factors roll off, with a strong job market, fiscal stimulus, and global demand providing potential support for consumer and business spending.

RESIDUAL SEASONALITY

Gross domestic product (GDP) data is adjusted to remove seasonal effects. If the seasonal adjustments work, the average GDP for each quarter over the long term should be similar. However, despite seasonal adjustments, first quarter data has underperformed the other quarters consistently enough that economists believe the seasonal adjustments aren't quite doing their job and there is still "residual seasonality" in the data [Figure 1].

1 Q1 GDP HAS BEEN WEAK SINCE 2000



Sources: LPL Research, U.S. Bureau of Economic Analysis 04/27/18

Illustration is historical and no guarantee of future results.

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Therefore, it may be helpful to look at first quarter 2018 GDP growth in the context of typical first quarter underperformance. While we don't know exactly how large an impact residual seasonality may have, even just half a percentage point would be enough to put the first quarter basically in line with the last three. First quarter growth, at 2.3%, was still slightly better than the expansion average of 2.2% for all quarters, and significantly better than the average of 1.3% in the first quarter, which should be read as a modest positive in the face of seasonal headwinds.

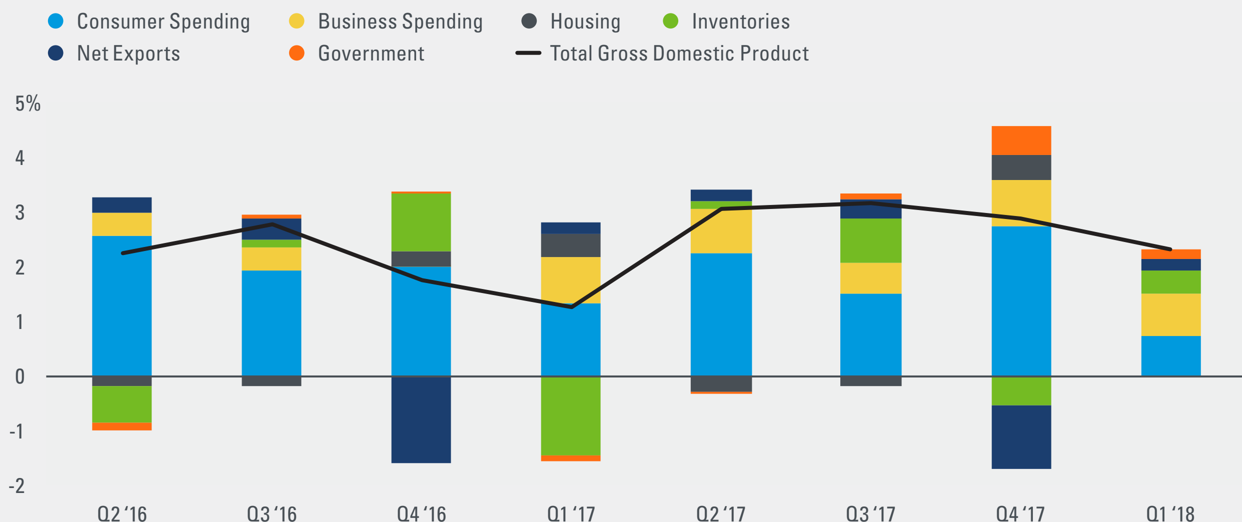
CONSUMER SPENDING AND CAPEX SLOW BUT DON'T STALL

The standard way of breaking down GDP is to look at total spending on final goods and services by economic sector, an approach that makes it easy to focus on how different segments of the economy are doing. When you hear the line, "consumer spending makes up 70% of the economy," this is the approach that's being used. In Figure 2, we break down the contribution of each segment to the final GDP number over the last two years.

Just from reviewing the chart, it becomes clear that weakness in consumer spending was one of the key culprits for slower growth in the first quarter. Consumer spending only contributed 0.7% to GDP in the first quarter, the sixth weakest contribution of the expansion (now at 35 quarters total). Comparing consumer spending this quarter to the other first quarters of the expansion doesn't really help, since this quarter is the worst of the nine first quarters so far. However, we do think the quarter needs be looked at in the context of the strong fourth quarter last year. The contribution from consumer spending in the fourth quarter was the third best of the entire expansion, helped by a rebound in economic activity following the devastation of hurricanes Harvey and Irma, and likely by spending pulled forward in anticipation of the passage of the new tax law.

2 CONSUMER SPENDING WEAKENS, BUSINESS SPENDING STEADY IN Q1

Contribution to Real GDP Growth by Economic Sector



Sources: LPL Research, U.S. Bureau of Economic Analysis 04/27/18

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In fact, if you average consumer spending in the fourth quarter of 2017 and the first quarter of 2018 together, the resulting contribution is above average for the expansion.

Capital expenditures (CAPEX), a segment of business spending that we follow closely, also weakened meaningfully in the first quarter. An increase in CAPEX can help increase productivity growth, which is the key to a sustainable increase in GDP. Again, context helps. The contribution to GDP from CAPEX in the fourth quarter of 2017 was the eighth best of the expansion, following above-average second and third quarters of 2017. Once again, the last two quarters combined come in a little above average. In addition, business investment in structures was strong relative to the rest of the expansion, contributing to an overall picture of steady business investment growth. With strong investment incentives in the new tax law and strong expectations of increased CAPEX based on survey-based data, we view the slowdown as temporary.

LOOK BACKWARD, THINK FORWARD

Markets are forward looking and GDP numbers are backward looking; in fact, the most recent GDP reading includes economic activity as far back as January. As a result, GDP data becomes a heavily lagging indicator for markets. The situation is even worse around recessions, since advance data can be subject to large revisions. From a market perspective, what we really want to know from the GDP report is what it might be telling us about the economy moving forward. Here's what we currently see:

Positives

- Average GDP for the expansion has been about 2.2% per quarter. An above-average number (2.3%) in the first quarter is solid given residual seasonality.
- The positive surprise versus consensus expectations of 2.0% was modest but tilts positive and broader averages of economic surprises remain well within positive territory.
- Indicators that tend to lead broader economic growth, as captured in the Conference Board's Leading Economic Index (LEI), continue to signal low odds of recession.
- Weaker data was most pronounced in January and has stabilized since, indicating the economy has been showing greater momentum more recently.
- Business spending overall was solid thanks to strength in spending on structures and survey data still points to potential improvement, spurred by tax incentives.
- The drop off in consumer spending is a concern, but we believe much of that is payback for an unusually strong fourth quarter. A healthy labor market, lower tax rates, and strong consumer confidence may support consumer spending moving forward.
- Net exports and inventories, two of the most volatile elements of GDP, made positive contributions in the first quarter. Part of that was payback for unusually weak data in the fourth quarter of 2017, and we believe the positive quarter was largely bringing sectors back into balance and is unlikely to see a strong reversal.

Negatives

- There has been some evidence in consumer surveys that concerns about trade have had a negative impact on consumer confidence at the higher end of the income spectrum. Uncertainty around trade may also be delaying some business decisions.
- Similarly, uncertainty around immigration policy may already be contributing to labor shortages in some areas of the economy, especially housing but also technology, which may be having a negative impact on growth.

- Markets historically have been largely indifferent to deficits, since deficit-financed growth can stimulate economic activity. However, deficits can have an impact on interest rates, as increased Treasury supply to cover deficits and a marginal increase in default worries at higher debt-to-GDP ratios push rates higher. Nevertheless, we believe that rising rates thus far largely reflect accelerating growth and the slow normalization of inflation, and that both the economy and markets can absorb gradually rising rates.

Overall, we believe the scale of the potential negatives is small compared to the positives, but still bears watching.

CONCLUSION

GDP is our best measure of overall economic activity, but it is also backward looking and the "advance" estimate is often subject to meaningful revisions as more data is collected. Overall, we believe first quarter GDP shows a continuation of the economic momentum of the prior three quarters and we see little in the data that raises red flags. Consumer spending and CAPEX should be monitored, but the roll-off of temporary factors, support from fiscal policy (still in its early stages), and a strong macroeconomic backdrop lead us to believe a solid rebound is possible. We continue to see 2.75–3.0% economic growth in 2018, and would not be surprised to see growth well in excess of 3% in the second quarter.* ■

*As noted in *Outlook 2018: Return of the Business Cycle*, LPL Research projects real gross domestic product (GDP) growth of around 2.75-3% in 2018. This is in line with historical mid-cycle growth of the last 50 years. Economic growth is affected by changes to inputs such as business and consumer spending, housing, net exports, capital investments, and government spending.

IMPORTANT DISCLOSURES

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Investing involves risk including loss of principal.

DEFINITIONS

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments, and exports less imports that occur within a defined territory.

INDEX DESCRIPTIONS

The Leading Economic Indicators (LEI) Index is an economic variable, such as private-sector wages, that tends to show the direction of future economic activity.

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