Q3 US GDP: Look Under the Hood

The US economy grew at a seasonally adjusted rate of 2.9% in the third quarter – a strong print that paints a healthy picture of the world's largest economy. However, our Chief Economist Megan Greene thinks the strength we saw in the last quarter could be a one-off. In this note, she explains why expectations for a repeat performance could lead to disappointments.

If I were Hillary Clinton, I'd probably be standing on a street corner right now with a big, neon placard that says "2.9%!!!!" in huge, black characters. A 2.9% annualized growth rate in Q3 2016[1] should support the candidate of the incumbent political party in the upcoming election. As one Wall Street Journal headline writer put it, "US Economy Roars Back, Grew 2.9% in Third Quarter[2]". This is surely how Joe Sixpack on the street will look at the latest GDP print, if he's looking at it at all. But we "econodorks" like (and are paid) to dig into the underlying data. And on that front there is considerably less reason to get excited about this GDP report.

A Number of Drivers of Growth…

I'll start with some good news. After contracting for three consecutive quarters, gross private fixed investment grew by 3.1% annualized in Q3[1]. This was mainly driven by investment in structures. Fixed investment and equipment investment continued to contract, suggesting that the economic recovery remains devoid of capital expenditure. In our view, capital expenditure has been stubbornly absent from this recovery in part because of a global glut of cheap labor, whereby companies would rather hire a bunch of cheap workers rather than invest in expensive machinery. The glut of labor is unlikely to disappear, and so private investment will probably not drive this recovery forward over the next few years. Government consumption also contributed to Q3 GDP growth after contracting in Q2, despite indicators suggesting that spending by state and local governments had been weak.

…But Unlikely to be sustained

The two biggest drivers of GDP growth in Q3, however, were exports and inventories. Exports grew by 10% annualized in Q3, up from 1.8% in Q2[1]. One probable cause is soybean exports—with a poor soybean harvest in Argentina and Brazil (the biggest soybean exporters) this summer, the US exporters stepped in to fill the gap. We cannot count on poor soybean harvests in future quarters, and so this phenomenon is unlikely to be replicated. Exports were also bolstered by a weaker USD in Q3. Again, this trend is unlikely to last going forward as the Fed looks to normalize monetary policy and the European Central Bank, Bank of England, Bank of Japan and People's Bank of China look to continue and even augment their monetary stimulus programs.

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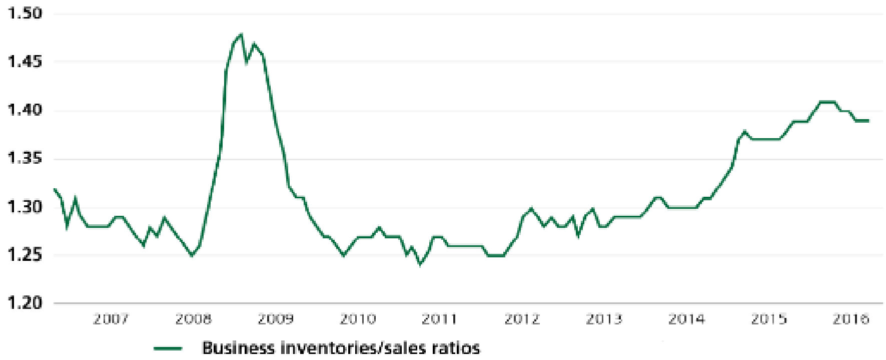
[1] Bureau of Economic Analysis: National Income and Product Accounts: Q3 GDP (Advance Estimate), October 28, 2016
[2] Wall Street Journal: US Economy Roars Back, Grew 2.9% in Third Quarter, October 28, 2016

After contracting for five consecutive quarters, inventories finally expanded in Q3[1]. The swing from being a drag on growth to actually contributing to it has been a tailwind for US GDP. I believe that will not be repeated going forward. Furthermore, the ratio of inventories to retail sales remains elevated (see chart), and so we do not expect a robust expansion in inventories over the next few quarters. This is particularly the case given how weak the US consumer looked in Q3, which may restrain retail sales in Q4. While private consumption continued to grow by 2.1% annualized in Q3, this was a slowdown from the robust expansion (by 4.3%) we saw in Q2[1].

US: Total Business Inventories to Sales



Source: Manulife Asset Management, US Census Bureau, as of October 14, 2016

Net trade contributed 0.83 percentage points to GDP in Q3, while inventories contributed 0.61percentage points[3]. Taken together, they account for 1.4percentage points. If we were to strip these two factors out, we would get GDP growth of 1.5%, which in our view is roughly where potential GDP is.

I think the headline figure in this Q3 GDP report will likely boost Hillary Clinton [4] and give the Fed a green light to hike rates in December. But looking under the hood, there is little reason to expect that 2.9% growth represents a new trajectory in this recovery. Most likely, we will see US growth decelerate to 1.5-2% growth going forward. Our recovery will remain sluggish, but at least more robust than the recoveries in the rest of the developed world.

[3] Manulife Asset Management, Bloomberg, October 28, 2016.
[4] CNBC: Polls Tighten for Trump but along camp GDP, Oct 28, 2016.

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