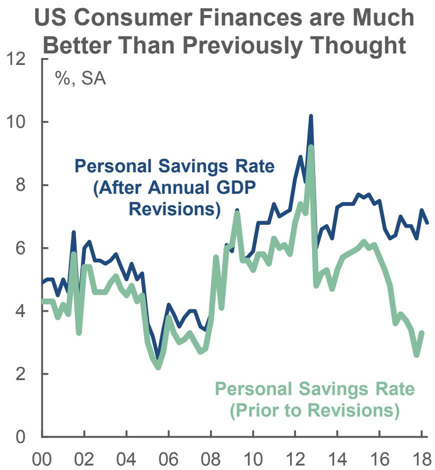
US GDP Drivers May Be Transitory, But Cycle Extension Is The Key

2018Q2 GDP growth, q/q % change SAAR:
Actual: 4.1
Scotia: 3.7
Consensus: 4.2
Prior: 2.2 (revised up from 2.0%)

- **Strong US GDP growth roughly matched consensus expectations after including a slight positive revision to Q1 growth.** The core drivers are less transitory in nature than judged going into the report. What the details say to me on net is that the US economy might indeed have more juice in the tank over the summer and even longer term than I had figured before seeing the composition of today's growth numbers and that should be especially true for the late cycle camp. A key part of this understanding is informed by massive revisions to consumer saving and that may materially alter late cycle risks as long as the US administration doesn't blow it with protectionism by falsely believing that the US economy is strong enough to withstand more trade policy aggression. **It is important to emphasize that I don't think Trumponomics explains much of anything about the Q2 growth picture.** Q2 growth was driven by a variety of complicated one-off effects. That said, in serendipitous fashion, Trump stands to possibly benefit from an improved picture of household finances due to revisions that significantly allay concerns about recession risk later in the forecast horizon as the broad consumer sector was repairing balance sheets at a more frenzied pace over the past decade than anything economists were left to judge from the data available until now.
- **The catch is that revisions that paint a considerably healthier picture of household financial strength should give the Fed more conviction to tighten monetary policy regardless of a small downside miss to core PCE inflation.** If saving and household finances are much better than judged prior to this report, then the mild rally in rates markets following the GDP report may be considering the wrong thing in looking backward at Q2 core PCE inflation of 2% (2.2% consensus).
- Before turning to the saving rate revisions, here are the weighted contributions to Q2 GDP growth:
    - **A sizeable inventory drag knocked one full percentage point off GDP growth** as inventory depletion was likely caused by accelerated consumption and by front-running tariffs to get more product out the door.
    - **This offset a sizeable 1.06 percentage point contribution to GDP growth from net trade (exports minus imports).** That was the third biggest weighted contribution to GDP growth of the post-recession era. Only 2010Q4 and 2013Q4 were very marginally stronger. **Much of this was probably front-running tariffs and is a false and transitory improvement in the US trade deficit.**
    - **The inventory and trade effects on growth could well reverse in Q3 in partly or entirely offsetting fashion.** While the trade deficit

CONTACTS

Derek Holt, VP & Head of Capital Markets Economics
416.863.7707
Scotiabank Economics
derek.holt@scotiabank.com



Sources: Scotiabank Economics, Bureau of Economic Analysis.

could again deteriorate, the effects on Q3 growth could be offset if inventory depletion ends or reverts toward renewed inventory building. Once both effects subside, the bigger question will be Q4 growth.

- **Consumption was up 4% q/q at a seasonally adjusted and annualized rate and this added 2.7 points to GDP growth in weighted terms.** As large as that seems, the peak consumption contributions to GDP growth in weighted terms came in 2014–15 before the US election so **we're not breaking new ground here**. Consumption growth therefore accounted for bang–on two–thirds of growth in the US economy in Q2. **That may be transitory** as the soft 0.4% consumption contribution to Q1 GDP growth was followed by a burst of pent–up demand partly because harsher than usual weather may have adversely affected Q1 consumer spending. **Regardless, in a full cycle sense, one would have to have a more positive outlook on the consumer (see revisions arguments below).**
- As for draining the swamp, **Federal government spending added ¼% to GDP growth in Q2**, up from Q1, in line with Q4 for some of the strongest contributions in some time. **That is partly a function of the one–off lift from the roll–out of the February spending bill** that will dissipate in terms of its influences on GDP growth in future.
- **Housing was a non–issue in weighted contribution terms and contributed nothing. The danger here lies in the fact that housing momentum has turned sour of late**. Possible reasons include the rise in the 30 year fixed mortgage rate and the reduction of mortgage interest write–offs due to the Tax Cuts and Jobs Act.
- **Finally, business investment added ¼% to GDP growth in terms of equipment spending (down from a half point contribution in Q1) with structures adding 0.4% and similar to Q1. That's decent, but doesn't suggest that investment contributions to growth are accelerating due to tax reforms or any other reason.**

- **Now back to the main argument on the consumer which is that there were large upward revisions to the personal saving rate going back years in time. They markedly alters one's perspective on the state of household finances.** From the BEA:
    - "The personal saving rate (personal saving as a percentage of disposable personal income) was revised up from 7.6 percent to 8.9 percent for 2012; was revised up from 5.0 percent to 6.4 percent for 2013; was revised up from 5.7 percent to 7.3 percent for 2014; was revised up from 6.1 percent to 7.6 percent for 2016; was revised up from 4.9 percent to 6.7 percent for 2016; and was revised up from 3.4 percent to 6.7 percent for 2017."
    - "Improved methods for measuring the implicit output of savings institutions and credit unions are introduced. The updated estimates are consistent with the methodology used for estimating the implicit output of commercial banks and provide a better measure of the activities of the financial sector."
- The chart on page 1 portrays the magnitude of the saving rate revisions by comparing the personal saving rate before and after today's revisions (thanks Sam!). This is the statistician's twist on raining manna from heaven down upon US consumers.
- **The BEA flags that the source of upward revision to the saving rate was also primarily due to fresh upward revisions to Internal Revenue Service data on proprietors' income.** Some may dent the quality of the upward revision to the saving rate as a result of this, but that seems foolish to me given the sizeable share of the US workforce that is directly self–employed and the indirect share of their jobs.
- **Furthermore, the saving rate revisions change the argument that recent consumption gains were being financed at the expense of saving and hence would not prove to be durable.** For every quarter since 2017Q1 up to 2018Q1, the saving rate was revised up by between 3–4 percentage points. Instead of a 3.3% saving rate in Q1, for example, we're now told it was actually 7.2%. Wow. The BEA says it was 6.8% in Q2. Double wow. That's pretty impressive by the standards of the US consumer.
- This begs the following question: **Is Trumponomics getting bailed out by revisions?** These are "huuuuge" changes to saving rates! They kill the argument advanced by some including the perennial bears that consumers are not saving enough and would run out of gas. No one can say that now. **Saving at a sustained clip of 6–8% or so for years and years since the GFC and up from under 4% back in 2007 paints a considerably better picture of consumer health than the old narrative that said they weren't saving enough and still working off debts. This is a cycle extension argument and must not be understated in terms of the significance to the consumer outlook.** ***The whole notion that saving was falling out of fashion especially in any late cycle sense is not true.***

- I really think this saving argument negates the market focus on the wiggle in the PCE deflator with core PCE slipping to 2%. **To the Fed, the fact that Americans are saving about 7% off personal disposable income now versus the prior understanding that the saving rate was getting cyclically depressed to just over 3% will be what matters most.** Today's miss on inflation must be weighed against lessened late cycle concerns and greater capacity for the US consumer to keep on driving the cycle. Adjust those saving rates for inflation over time and the real saving rate is rather healthy today. **This will give the FOMC more conviction to keep on hiking.** "For now"? Try "for longer" as the bias in next week's statement. The implication is that the Treasury curve flattening post-GDP may well prove to be an exaggerated response over time. The saving revisions allay late cycle concerns about the consumer and also help to explain why confidence is elevated as the US consumer was repairing balance sheets at a faster clip for years since the GFC than previously understood.

- **Indeed, when paired with the fact that debt payments as a share of disposable income sit at about the lowest on record back to when the Fed started calculating the series in 1980, the saving rate revisions paint a picture of US household finances that looks mid-cycle at the latest.** To repeat, as long as Trump doesn't blow it on trade, the US economy may well shatter records for the longest business cycle.

- Also note that Q1 GDP growth was revised up for many years in the past. It still leaves a generally pattern of fairly soft Q1 growth each year but less so than before revisions.