US: CONSUMPTION, GOVERNMENT PURCHASES LIFT Q3 GDP ABOVE EXPECTATIONS

*U.S. Q3 real GDP increased by 3.5% q/q annualized — above expectations (BCM: 3.2%, consensus: 3.3%) — lifting its yr/yr gain to 3% from 2.9%, the largest since Q2 2015 (Chart 1). Nominal GDP rose by 4.9% q/q annualized in Q3, bumping its yr/yr% gain up to 5.5% from 5.4% in Q2 — the best two-quarter run since 2006 (Chart 2).

*Consumption and government purchases grew solidly, and inventory investment added a massive 2.1pp to real GPP growth — these three categories were the sources of the upward surprise. Residential fixed investment declined for the third consecutive quarter, and exports subtracted from growth after a significant contribution in Q2. Surprisingly, real business fixed investment barely increased (+0.8%), after jumping by 10% annualized in H1.

*We expect a moderation in real GDP growth going forward. The contribution from inventory investment to Q4 growth will probably be negative. Consumption has strong momentum entering the holiday shopping season, but the tax-cut consumption boost should fade in H1 2019. Solid fundamentals point to a rebound in business fixed investment in Q4. We continue to expect 2018 real GDP (Q4/Q4) growth near 3%. If the recent stock market correction weighs on confidence, economic activity will lose some steam.

*In response to the strong near-term growth, the Fed will likely increase its policy rate in December, but as growth moderates in 2019, we expect the Fed to hike its policy rate twice before pausing through 2020 ("Revised Fed funds rate forecast", October 24, 2018).

Real final sales to domestic purchasers (private domestic consumption and investment spending), a proxy for domestic product demand, rose by 3.1% q/q annualized in Q3 — despite the subpar gain in business fixed investment — lifting its yr/yr gain to 3.3%, highlighting the momentum economy from the Tax Cuts and Jobs Act, deregulation, and high confidence (Chart 3).

Based on the strong real GDP growth, measured labor productivity likely increased at a solid pace again in Q3. A sustained pick-up in productivity growth, now above 1% after sub-1% growth between 2011 and 2016, would increase estimates of longer-run sustainable growth and constrain inflation.

Real consumption jumped by 4% q/q annualized in Q3, a surprising pick-up from the already-strong 3.8% Q2 gain, due to improved growth in consumption of services (+3.2% from +3%) and nondurable goods (+5.2% from 4%). See Chart 4. Nondurable goods consumption jumped because of an 11.7% increase in clothing and shoes consumption, the best gain since Q4 2005 (Chart 5). Consumption has been supported by robust job growth and a pick-up in wage growth, and real disposable income growth has benefited from the Tax Cuts and Jobs Act. Household net worth continues to climb to record highs and consumer confidence rose to multi-year highs during Q3. The holiday shopping season looks set to have a repeat strong performance.

Business fixed investment increased by a slight 0.8% q/q annualized, the smallest gain since Q4 2016, due to a large 7.9% drop in structures investment and a slight 0.4% rise in equipment investment (Chart 6). We expect the Tax Cuts and Jobs Act, deregulation, business optimism, and strong corporate profit growth to drive a rebound in business fixed investment. The increase in the oil and gas rig count thus far in October bodes well for Q4 structures investment. Soft core durable goods orders and shipments in
August and September pose some downside risk.

**Residential fixed investment** declined for the third consecutive quarter in Q3 (-4% annualized), with supply issues constraining home building and a lack of reasonably-priced homes and exorbitant price gains in some regions weighing on sales. New residential construction and sales may be temporarily boosted by replacement of hurricane-damaged homes in Q4.

**Government purchases** jumped by 3.3% annualized, lifting its yr/yr gain to 2.4% from 1.3% due to the Bipartisan Budget Act of 2018 that lifts fiscal spending significantly in 2018 and 2019. National defense spending is benefiting the most, rising by 4.1% yr/yr, the best since Q1 2010 (Chart 7). We view this pace of government purchases as unsustainable and it should contribute much less to growth starting in 2020.

**Inventory investment** contributed 2.1pp to Q3 real GDP growth, the largest since Q1 2015. We expected a sizable contribution based on the outright decline in Q2 inventories that resulted from strong demand. Given that inventory-sales ratios remain very low, strong levels of production and inventory investment should continue in Q4.

**Net exports** subtracted 1.8pp from Q3 real GDP growth, due to a 3.5% decline in exports (payback from accelerated exports in Q2 in advance of retaliatory tariffs) and a strong 10% gain in real imports, which is reflective of the strong U.S. domestic demand and a push to rebuild inventories before the holiday shopping season.

The Fed’s preferred measure of inflation, the **PCE price index**, rose by 2.2% yr/yr in Q3 and the core PCE increased to 2% yr/yr from 1.9%. The Fed is pleased that its 2% inflation target is being met and that inflation expectations remain well-anchored.

**Nominal GDP** (real growth plus quality adjusted inflation), which is the broadest measure of aggregate product demand and production, has grown above 5% yr/yr for the second consecutive quarter. Nominal GDP growth influences wage and price-setting behavior and its current rate suggests that longer-run UST bond yields could be higher (“US nominal GDP acceleration: pay more attention to it”, August 6, 2018).

**Chart 1: U.S. Real GDP (quarter-over-quarter, % annualized)**

![Chart 1: U.S. Real GDP (quarter-over-quarter, % annualized)](image-url)

*Source: Bureau of Economic Analysis/Haver Analytics*
Chart 2: U.S. Nominal GDP (year-over-year, %)

Source: Bureau of Economic Analysis/Haver Analytics

Source: Quarterly data. Source: Bureau of Economic Analysis and Haver Analytics

Chart 3: Real Final Sales to Domestic Purchasers (year-over-year, % annualized)

Real Final Sales to Domestic Purchasers
% Change - Year to Year SAAR, Bill.Chn.2012$

Source: Bureau of Economic Analysis/Haver Analytics

Source: Quarterly data. Source: Bureau of Economic Analysis and Haver Analytics
Chart 4: Real Consumption (quarter-over-quarter, % annualized)

Real Personal Consumption Expenditures
% Change - Annual Rate  SAAR, Bill.Chn.2012$

Source: Bureau of Economic Analysis/Haver Analytics

Source: Quarterly data. Source: Bureau of Economic Analysis and Haver Analytics

Chart 5: Real Consumption on Clothing and Shoes (quarter-over-quarter, % annualized)

Real Personal Consumption Expenditures: Clothing & Shoes
% Change - Annual Rate  SAAR, Bill.Chn.2012$

Source: Bureau of Economic Analysis/Haver Analytics

Source: Quarterly data. Source: Bureau of Economic Analysis and Haver Analytics
Chart 6: Real Business Fixed Investment – Total and Structures (quarter-over-quarter, % annualized)

Source: Bureau of Economic Analysis/Haver Analytics

Source: Quarterly data. Source: Bureau of Economic Analysis and Haver Analytics

Chart 7: Real National Defense Consumption Expenditures and Gross Investment (year-over-year, % annualized)

Source: Bureau of Economic Analysis/Haver Analytics

Source: Quarterly data. Source: Bureau of Economic Analysis and Haver Analytics
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