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## Q3 GDP: Love The Headline, The Details, Not So Much . . .

- > The BEA's initial estimate shows real GDP grew at an annualized rate of 3.5 percent in Q3 2018 after 4.2 percent growth in Q2
- > Consumer and government spending and inventory accumulation were the main drivers of Q3 growth; trade was a material drag on growth

The BEA's initial estimate shows real GDP grew at an annualized rate of 3.5 percent in Q3, slightly ahead of our above-consensus forecast of 3.4 percent growth. As we routinely note, the headline number is the least important number in any given data release, and the Q3 GDP report is no exception. So, as much as you may enjoy the top-line growth number – which in tandem with 4.2 percent growth in Q2 make this the fastest two-quarter growth pace since mid-2014 – the details below today's headline number suggest this pace will not be sustained. Growth decelerating over coming quarters should surprise no one, but the details in the report on Q3 GDP raise more fundamental questions about business investment and trade that could lead to growth decelerating to a greater degree than what for some time now has been incorporated into our baseline outlook.

We'll toss out our usual caveat that the initial estimate of GDP is based on highly incomplete source data and, as such, is prone to what can be sizeable revisions. As far as the initial estimate of Q3 GDP, any such revisions will be a matter of degree, not of direction. In other words, it is clear that the U.S. economy has built a considerable degree of momentum over the past several quarters. This is best seen in the year-on-year growth rate, which we show in our first chart below. Real GDP was up 3.0 percent year-on-year in Q3 2018, and Q3 marks the ninth consecutive quarter in which year-on-year growth was faster than in the prior quarter, the longest such streak in the life of the GDP data. Again, though, the question is whether this momentum can be sustained going forward.

Real consumer spending grew at an annualized rate of 4.0 percent in Q3, adding 2.69 percentage points to top-line real GDP growth. Across the components of consumer spending, rapid growth in several discretionary spending categories points to consumers with the means and the confidence to engage in such spending, which largely reflects ongoing improvement in labor market conditions. This will sustain growth in consumer spending through the holiday season and beyond.

Business spending on machinery and equipment surprised us to the downside, with growth of just 0.4 percent after what had been average

growth of 8.6 percent over the prior six quarters (these are annualized growth rates). While the instant analysis is attributing this to mounting uncertainty over trade policy, we'll instead note this sharp slowdown in growth is at odds with monthly data on orders and shipments of core capital goods, so we'll wait for both revisions to the initial estimate of Q3 growth and more monthly observations before drawing any conclusions here. We have been on record with our view that the growth seen in business investment spending over recent quarters will be sustained, and this is key to there being the sustained improvement in labor productivity needed to lift the economy's "speed limit." One encouraging sign is that business investment in intellectual property products grew a 7.9 percent annualized rate, the third straight quarter of robust growth. Stepped up spending on R&D, which rolls up into the broader intellectual property category, generally leads improvements in productivity growth.

Elsewhere in the initial estimate of Q3 GDP, a sizeable build in business inventories added 2.07 percentage points to top-line real GDP growth after inventory drawdowns took 1.17 percentage points off of top-line growth in Q2. The kick to Q3 growth, however, will not be sustained. Faster growth in government spending added 0.56 percentage points to top-line real GDP growth in Q3. Trade, however, was a material drag on Q3 growth, with a wider trade deficit knocking 1.78 percentage points off of top-line growth, the largest drag from trade since Q2 1985. After spiking in Q2, exports of goods fell at a 7.0 percent rate in Q3 as imports of goods grew at a 10.3 rate. The spike in exports in Q2 reflected foreign buyers trying to get ahead of retaliatory tariffs being imposed U.S. goods, while at least part of the jump in imports in Q3 reflected U.S. retailers trying to get ahead of tariffs being imposed on consumer goods. This game of "time the tariffs" points to looming uncertainty over trade policy.

That the initial report on Q3 GDP affirms the health of U.S. consumers is not surprising. What is surprising, however, is the tepid print on capital spending. While we do not see this as the beginning of the end of business investment, it is a source of uncertainty going forward, which adds to the uncertainty over trade policy.

