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US economic engine sputters as goods output takes a hit

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Annualized Qtrly Chg.	22 Q1	21 Q4	21 Q3	21 Q2	21 Q1	20 Q4
Real GDP	-1.4%	6.9%	2.3%	6.7%	6.3%	4.5%
Personal consumption	2.7%	2.5%	2.0%	12.0%	11.4%	3.4%
• Goods	-0.1%	1.1%	-8.8%	13.0%	27.4%	-0.3%
• Durable goods	4.1%	2.5%	-24.6%	11.6%	50.0%	1.1%
• Nondurable goods	-2.5%	0.4%	2.0%	13.9%	15.9%	-1.1%
• Services	4.3%	3.3%	8.2%	11.5%	3.9%	5.3%
Gross private investment	2.3%	36.7%	12.4%	-3.9%	-2.3%	24.6%
• Fixed investment	7.3%	2.7%	-0.9%	3.3%	13.0%	17.7%
• Nonresidential	9.2%	2.9%	1.6%	9.2%	12.9%	12.5%
• Structures	-0.9%	-8.3%	-4.1%	-3.0%	5.4%	-8.2%
• Equipment	15.4%	2.8%	-2.4%	12.2%	14.1%	26.5%
• Intellectual Property	8.1%	8.9%	9.1%	12.5%	15.6%	10.2%
• Residential	2.1%	2.1%	-7.7%	-11.7%	13.3%	34.4%
Exports	-5.9%	22.4%	-5.3%	7.6%	-2.9%	22.5%
• Goods	-9.6%	23.4%	-5.1%	6.4%	-1.4%	25.6%
• Services	3.8%	19.9%	-5.9%	10.4%	-6.0%	16.0%
Imports	17.7%	17.9%	4.7%	7.1%	9.3%	31.3%
• Goods	20.5%	18.9%	-0.3%	4.3%	10.7%	30.1%
• Services	4.1%	13.1%	35.0%	23.6%	2.2%	37.6%
Government consumption	-2.7%	-2.6%	0.9%	-2.0%	4.2%	-0.5%
• Federal	-5.9%	-4.3%	-5.1%	-5.3%	11.3%	-3.2%
• National defense	-8.5%	-6.1%	-1.7%	-1.0%	-5.8%	5.3%
• Nondefense	-2.2%	-2.0%	-9.5%	-10.7%	40.8%	-14.0%
• State and local	-0.8%	-1.6%	4.9%	0.2%	-0.1%	1.2%

Source: Haver Analytics.

- The engines of the US economy sputtered in the first quarter, as weakness in domestic goods production took output down at a 1.4% annualized pace. That was a bit of a shocker against expectations for roughly 1% growth, and masked the fact that major elements of domestic demand were still registering decent gains, while employers seemed to be adding workers as fast as they could find them. But whatever good news there was on the demand front wasn't matched by domestic production on the goods side of the economy, which pulled down GDP growth by nearly 3%-points annualized after being a huge contributor to Q4 growth. That seems at odds with prior reports showing solid growth in Q1 industrial production, but who says the data always have to make sense?

- Final domestic demand was still healthy, growing at a 2.6% pace. That was led by accelerating business investment spending, a sign of confidence about demand ahead that is consistent with the eagerness to add workers. Consumer spending maintained a nearly steady 2.7% growth rate, with all of that coming from services that are benefiting from a more relaxed attitude about the pandemic. We are, however, starting to see consumers feeling the pinch from inflation that is running ahead of their pay rates. The price index for consumption was up at an 7% annualized rate in Q1, so in order to pay for their spending, households pared back their savings rate by more than a percentage point. It now sits at 6.6%, versus an average of 7.6% in 2019. We could see a further drop in Q2, but at some point, Americans will start to pare back demand unless prices start to come down again.
- Where the economy faltered was in the production of goods. That showed up in weakness in inventory accumulation, which subtracted 0.8%-points from the quarter's growth rate. But we also saw that the goods that were bought this quarter tilted heavily to imports. Goods imports jumped at a 20% annualized pace, the second straight quarter of brisk gains. We had seen improvements in supply chains and shipping volumes in Q1, so some of this was catching up to earlier orders. We would expect lighter import growth in the quarter ahead given recent China lockdowns. Either production delays at home, or weak demand from America's trading partners who aren't as far along in their recoveries, took exports lower in Q1. What's difficult to read in all of this is the degree to which fluctuating supply chain conditions, rather than underlying demand, are distorting trade in a given quarter.
- The other surprise was the weakness in real government spending, where we had expected to see marginal growth, but instead it dropped another 2.7% annualized, similar to what we saw in Q4. Our forecast allows for a drag from fiscal tightening in 2022/23, but that was largely based on the lagged impacts from the end of pandemic period support payments for business and households, which aren't factored into this expenditure measure, which relates only to government spending on goods and services (including their own employees).

Implications & actions

Re: Economic forecast — We're expecting a return to healthy growth over the next couple of quarters, with net trade and inventories unlikely to be nearly as big a negative. Nevertheless, the downside surprise in Q1 seems large enough to dent our mid-3% growth forecast for the year as a whole. For the Fed, the fact that core PCE prices are up 5.2% year on year likely means that this quarter of economic retreat won't change their thinking much. For that, we'll need to see a cooling in employment, so next Friday's payrolls numbers will have a greater influence on the pace of hikes ahead. We're still comfortable with our view that the fed funds rate will peak next year in the mid-2% range.

Re: Markets —Bond, equity and foreign exchange markets decided to shrug off this downside miss in growth, likely chalking it up to some one off hits to goods production that won't persist, and focussing on the reasonably healthy pace to domestic demand. It's hard to make the case that the US economy is rolling over given that businesses were still adding workers as fast as they could find them, and increasing their capital spending activities.

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