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US Q2 GDP: Challenging the Fed

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Annualized Qtrly Chg.	23 Q2	23 Q1	22 Q4	22 Q3	22 Q2	22 Q1
Real GDP	2.4%	2.0%	2.6%	3.2%	-0.6%	-1.6%
Personal consumption	1.6%	4.2%	1.0%	2.3%	2.0%	1.3%
• Goods	0.7%	6.0%	-0.1%	-0.4%	-2.6%	-0.1%
• Durable goods	0.4%	16.3%	-1.3%	-0.8%	-2.8%	7.7%
• Nondurable goods	0.9%	0.5%	0.6%	-0.1%	-2.4%	-4.4%
• Services	2.1%	3.2%	1.6%	3.7%	4.6%	2.1%
Gross private investment	5.7%	-11.9%	4.5%	-9.6%	-14.1%	5.4%
• Fixed investment	4.9%	-0.5%	-3.8%	-3.5%	-5.0%	4.8%
• Nonresidential	7.7%	0.6%	4.0%	6.2%	0.1%	7.9%
• Structures	9.7%	15.8%	15.7%	-3.6%	-12.7%	-4.4%
• Equipment	10.8%	-8.9%	-3.5%	10.6%	-2.1%	11.4%
• Intellectual Property	3.9%	3.1%	6.2%	6.8%	8.9%	10.8%
• Residential	-4.1%	-4.0%	-25.1%	-27.1%	-17.8%	-3.1%
Exports	-10.8%	7.8%	-3.7%	14.6%	13.8%	-4.6%
• Goods	-16.3%	12.3%	-7.4%	17.8%	15.5%	-7.2%
• Services	1.8%	-1.4%	5.0%	7.5%	9.9%	1.6%
Imports	-7.8%	2.0%	-5.5%	-7.3%	2.3%	18.4%
• Goods	-8.0%	2.3%	-5.9%	-8.6%	-0.4%	20.4%
• Services	-6.8%	0.4%	-3.7%	-0.8%	16.6%	9.0%
Government consumption	2.6%	5.0%	3.8%	3.7%	-1.6%	-2.3%
• Federal	0.9%	6.0%	5.8%	3.7%	-3.4%	-5.3%
• National defense	2.5%	2.5%	2.2%	4.7%	1.5%	-8.5%
• Nondefense	-1.1%	10.5%	10.6%	2.5%	-9.2%	-1.1%
• State and local	3.6%	4.4%	2.6%	3.7%	-0.6%	-0.4%

Source: Haver Analytics.

- The US economy didn't show the cooling in activity that the Fed has been hoping to see, as GDP advanced by 2.4% annualized in the second quarter. That was above the consensus expectation of 1.8%, and the acceleration in activity from the first quarter was driven by a pickup in business investment and an increase in inventory accumulation. Combined with strong government spending, that masked a deceleration in household consumption growth, and a drop in exports and residential investment. Final domestic demand, which excludes net trade and inventories, showed a 2.3% annualized gain, while the core PCE price index decelerated to 3.8% annualized. The savings rate ticked up to 4.4% from 4.3%, but that's well below pre-pandemic norms still. We continue to look for a deterioration in activity ahead as the impact of past rate hikes materializes, and consumption slows further, in line with the drawdown in excess savings and the recovery in credit card balances. The Fed had already conceded that Q2 growth was stronger than previously thought, and is more focussed on the upcoming employment reports as a forward looking indicator of inflation.

- The deceleration in consumption growth included softer consumption of both goods and services, with a 2.9% annualized drop in food services and accommodations, the first drop since 2020, suggesting that demand for discretionary services that surged post-pandemic may be normalizing. Indeed, the growth in services spending was driven largely by the non-discretionary sectors, with housing, utilities, health care and financial services leading the way. Goods consumption rose by only 0.7% annualized, with the growth driven by a surge in recreational goods/vehicles.
- The softening in consumption reflected a slowdown in disposable income growth to 5.2% annualized from 13.0% in the first quarter, as one-time tax cuts/credits in many states dried up. However, that masked a pickup in labor income growth. Real disposable income growth slowed to 2.5% annualized from 8.5%, and we expect a slowdown in the labor market ahead to limit growth in real aggregate incomes ahead, even as inflation cools further from here. The savings rate at 4.4%, roughly half of the pre-pandemic norm, looks unsustainably low, and leaves little ammunition for spending from here now that credit card balances have recovered and excess savings have been depleted.
- The acceleration in business investment was surprising, and was driven by increases in equipment, structures, and intellectual property products. Within equipment, the growth was driven by transportation equipment, with industrial equipment dropping off. The investment in transportation equipment could have been helped by supply chain normalization. Looking ahead, the capital goods orders data for June, released alongside the GDP figures, which is a leading indicator of business investment in equipment, showed a surprise increase and seems to suggest resilience in that component heading into Q3. For the second quarter in a row, business investment in structures was mostly accounted for by manufacturing structures, which masked drops in mining, commercial and health care structures. Investment in commercial structures will likely continue to be held back by the shift to working from home and the tightening in lending standards that's underway. Total business investment sits 4.6% above year-ago levels, showing that the full impact of rate hikes has not been felt on activity.
- Exports dropped off as international demand waned, but slower domestic consumption also meant that imports fell. Residential investment also continued to be a negative for GDP, but we expect that sector to make a relatively swift rebound once rate cuts are in sight, given undersupply in the existing market. Residential investment is 16% below year-ago levels, showing that activity has responded to higher interest rates.

Implications & actions

Re: Economic forecast — The acceleration in GDP is not what the Fed had hoped for after hiking interest rates aggressively, and this validates our call for a final 25bp hike from the Fed in September, assuming that the employment and inflation data from here show an only modest improvement. We still see the potential for a negative quarter for GDP later this year or in early 2024, particularly as labor income gains dwindle with hiring, leaving consumers with little spending ammunition, which will also put pressure on business investment. Still, the resilience in this report suggests that an outright recession will be avoidable.

Re: Markets —Bond yields rose and the USD strengthened after the upside surprise in the GDP data, which was reinforced by positive surprises in the jobless claims and durable goods orders data that were released at the same time.

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