The US economy grew at a solid pace in Q2 but the headline growth rate masked pockets of weakness in key cyclical components. The 2.1% rate of growth was driven by an acceleration in consumption, leaving final sales (GDP ex-inventories) at 3%. Core PCE prices also picked up to a 1.8% pace. But in addition to negative contributions from inventories and trade, business cycle-sensitive components of growth including residential investment and business investment were weaker than thought, with the latter touching negative territory for the first time since 2016. The mixed picture is consistent with the Fed edging into modest “insurance” cuts rather than a deep easing cycle.
• The consumer was the main driver of growth, consistent with the pickup in retail sales data seen over the quarter. It was the durable goods category, specifically auto purchases, that drove the bulk of the strength. Consumption had been hampered by the government shutdown and a harsh winter at the start of the year, and falling interest rate expectations will work to encourage spending ahead. While the pickup in spending resulted in a lower savings rate, it still remains elevated and suggests that households have ample savings to draw from as job gains shrink.

• A 10.6% drop in business investment in structures will catch the eye of the Fed, as it reinforces other readings of softness emerging in the business sector including industrial production and hours worked. Moreover, forward-looking indicators, including the three-month average annualized pace of core capital goods orders which only stands at 0.3%, suggests that investment could remain on soft footing in Q3. Trade tensions, and slowing global growth, showed up in a contraction in exports.

• Residential investment fell by 1.5% in Q2, and while there could be some relief ahead given the uptick in housing starts seen in Q2 and the lag that translates through to investment with, the impact will be dampened by the composition of starts being tilted towards the multi-family segment. There are signs that lower mortgage rates are bolstering housing demand, however, suggesting that there could be a stabilization in activity.

Implications & Actions

Re: Economic Forecast — Although the beat on the headline would alone imply a faster rate of growth for 2019 as a whole, revisions to the prior year’s quarterly growth rates leave our annual forecast a couple of ticks lower at 2.2%. This report is still in line with our view that the US economy is still on relatively healthy footing, however, and will only require a couple of 25bps rate cuts to prevent a more material slowdown in growth.

Re: Markets — While yields initially rose on the better than expected headline, since other details were not as encouraging, those movements weren’t sustained.