The US economy sprinted ahead in Q1 despite a soft start to the year. The 3.2% pace of growth was above the high-end of the consensus, helped by a massive inventory build that was curiously accompanied by weak import figures. Although the robust pace of stockpiling is set to dissipate in Q2, annual GDP for the US is now likely to expand at a strong 2.4% pace over 2019 as a whole, two ticks higher than our previous forecast. Given that the upside surprise was contained to a select few components, the Fed is likely to look past that strength and cite a slowing in interest-rate sensitive sectors of the economy as a reason to remain on the sidelines, reinforced by the tame inflation readings for Q1.
• A drop in imports was the main catalyst behind net trade posting the second-highest contribution to growth at 1.0%-pts. Curiously, inventories still rose to drive the third-highest contribution to growth. Historically, apart from a few exceptions, imports and inventories have displayed a negative relationship in terms of their contributions to growth, suggesting that the sizeable contribution from each component is unsustainable, and it wouldn’t be surprising if these figures are revised in the second release.

• Although government spending expanded at a respectable pace when considering the length of the government shutdown, it was state and local governments that did the heavy lifting in Q1. Indeed, federal spending on defense was offset by a plummet in non-defense expenditures. The government shutdown exemplifies the difficulty associated with changing the fiscal course of the US, something that will likely remain a point of contention until after the election, leaving the fiscal drag in 2020 intact.

• Other components of GDP evolved largely as expected, with consumption slowing, only partly reflecting the negative impact of the government shutdown on incomes and confidence. Higher interest rates are also working to encourage households to save rather than spend, something that helped send durable goods purchases down by 5%, the largest contraction seen since the recession. Residential investment was also a negative for growth, although a stabilization in housing market indicators amidst lower interest rate expectations lately should help put a floor under activity over the rest of the year.

• Business investment also slowed, with spending softening across the board, despite the recovery in crude over the quarter. Core capital goods orders, a forward-looking indicator of business investment, touched positive territory for the first time since late 2018 in three-month average annualized terms in March, and signs of a nascent pickup in global growth, along with a more dovish Fed, are positive indicators for investment in Q2 and beyond.

• Inflation measures were tame, with core PCE prices growing at 1.3% annualized while the GDP deflator rose by 0.9% annualized, both decelerating from Q4, with the latter reflecting softness in oil prices.

**Implications & Actions**

**Re: Economic Forecast** – Despite the beat on the headline, the good news was contained to a select few components and appears to be transitory. The effects of higher interest rates on consumer spending and...
residential investment were still material in today’s report, and when combined with the tame inflation readings, should keep the Fed on the sidelines, especially given the expected fiscal drag in 2020.

**Re: Markets** — Markets have turned their attention to the soft inflation figures, sending the ten-year yield lower along with the USD.