TrendMacrolytics

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TRENDMACRO LIVE!

On Third Quarter GDP

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The headlines and talking heads insist that this morning's report showing a third quarter GDP growth rate of 3.7% was "weaker than expected." Cutting through some of the statistical quirks of GDP accounting, however, a considerably more robust view of underlying economic fundamentals emerges. As it is, after the oil-induced "soft spot" of the second quarter pushed growth down to 3.3% from the first quarter's 4.8%, this initial estimate indicates that the economy returned to an accelerating path last quarter, even as oil prices continued to shoot higher. Over the last four quarters, in addition, GDP has advanced at a 3.9% rate, compared to an average four-quarter growth rate of 3.3% over the last 40 years.

But, in fact, the actual performance of this economy was even more vigorous once adjustments are made for the anomalies of GDP bookkeeping conventions. Once again, calculation of the contribution of inventories to overall growth is a significant uncertainty in the data. The potential for statistical mischief arising from the treatment of inventories was probably never made more clear than in the in the first quarter of 2002. At that time, the bulk of initially reported growth rates in excess of 5% were accounted for by a sharp *slowdown* in inventory liquidation from the record levels of the previous quarter, not by the increased production that would accompany an actual inventory build. This report, by contrast, shows inventories continuing to be built, but at a somewhat slower pace ($48.1 billion *vs*. $61.1 billion in the second quarter), subtracting half a percent from the reported growth rate. Fact is, though, it's impossible to glean from the GDP data whether the reduced rate of inventory accumulation is consistent with slower growth in any real sense. It's just as plausible that producers failed to stock inventories to the same extent they did in the second quarter because they were fully occupied keeping up with growth in demand.

Another source of misleading accounting relates to the treatment of imports and exports under the GDP heading of "net exports." In the third quarter, both imports (up 7.7%) and exports (up 5.1%) grew, but because imports outpaced exports, net exports took 0.6% off the reported growth rate. In the real world, of course, strong import growth reflects a rapid pace of domestic expansion, while the pace of exports only suggests growth outside the **US** is slower.

To make an accurate assessment of the strength of output, then, we prefer to remove the potentially distorting influences of trade and inventories, which is provided in the GDP tables under the heading "final sales to domestic purchasers." At a rate of 4.6%, this data point shows the economy in the third quarter grew at its fastest rate since the third quarter of 2003. Among the most encouraging aspects of the report was the continued strength in business fixed investment, which indicates that expected returns remain at healthy levels. Equipment and software investment, at an annualized growth rate of 15%, also turned in its best performance since the third quarter of '03, and with year-on-year growth of 12.25%, is showing gains in line with the heady days of the late '90s boom. TM

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