August 30, 2013

Thoughts on End of Summer U.S. Economic Data

Key Insights

- The latest round of economic data painted a mixed picture of the U.S. economy.
- On the positive side, GDP was revised to nearly twice what it was initially estimated (from 1.7% to 2.5%), and the labor market continues to show signs of healing.
- However, upward GDP revisions a strengthening of the labor market, there were signs that the U.S. economy may continue to experience subpar growth.
- In particular, business investment, personal income, and personal consumption expenditures ended the summer on a relatively flat note.
- With a weak start to both consumption and capital expenditures at the start of the third quarter, coupled with higher oil prices, Q3 may well underwhelm.

The U.S. economy continues to be buffeted by cross-currents.

The latest round of economic data painted a mixed picture of the U.S. economy. While the labor market continues to show signs of healing, there is evidence that third quarter business investment has gotten off to a weak start. Looking ahead to the second half of 2013, there are some key strengths in the U.S. economy and also some key headwinds to watch.

The Positives

A key positive this week was another upbeat initial claims report, signaling continued healing on the employment front. Also new surveys of small businesses are beginning to show some rebound in hiring plans, which is particularly notable because the small business sector has been largely absent so far in the economic recovery. In the Washington, D.C. area, we are starting to see more and more "help wanted" signs in stores and shops, which have been largely non-existent for the past 5 years. Before the 2008-09 recession, most stores and restaurants in America had "help wanted" signs in their windows.

Additionally, GDP revisions were positive. GDP growth in Q2 was revised from 1.7% to 2.5%. Exports were faster and imports were lower than previously reported, with revisions together adding 0.8 percentage point to GDP growth. Furthermore, structures investment (including oil and gas drilling activity) came in stronger than expected and added 0.2 percentage point to GDP. There was also a stronger than expected pickup in inventory building, which added

roughly 0.2 percentage point to GDP. Unlike some analysts, at this point we are not worried about any significant inventory overhang. Despite the downward revision to government spending, on balance, the U.S. economy was stronger at the end of Q2 than previously thought. In fact, 2.5% GDP growth in the face of sharp fiscal consolidation, persistently high oil prices, and generally weak international growth is rather impressive. Without these headwinds, growth would have certainly been in the 3-4% range in the second quarter.

The Negatives

Despite strengthening of the labor market and upward GDP revisions, there were signs that the U.S. economy may continue to experience subpar growth. The key negative story this week was the weak durable goods report for July. Both orders (future GDP) and shipments (current quarter GDP) were pretty negative for nondefense capital goods excluding aircraft. These data are volatile from month to month, so it is not a reason to panic. Still, the report suggests that Q3 capital expenditures is getting off to a weak start.

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Additionally, the personal income and expenditure report for July was pretty weak, likely reflecting the rise in oil prices that started in early July. Real consumption spending began Q3 flat, a worrying sign heading into the holiday season.

The Bottom Line

On balance, the end of summer data are in line with expectations. We believe that the August employment report to be released on September 6 will be definitive for the Fed's decision on whether to start tapering QE3. The FOMC members are sharply focused on jobs, and this will be "the" jobs report, with everything else being secondary. Continued declines in initial claims raise the likelihood that the August employment report may show a healthy increase in jobs, which would make tapering more likely.

However, we continue to be worried about real disposable income, particularly when oil goes over $100 as it has in recent weeks. In fact, oil prices are up more than $11/barrel in the past 7 weeks. With a weak start to both consumption and capital expenditures at the start of the third quarter, coupled with higher oil prices, Q3 may well underwhelm.