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FIRST QUARTER'S GDP SURPRISE

John Lynch *Chief Investment Strategist, LPL Financial*
Barry Gilbert, PhD, CFA *Asset Allocation Strategist, LPL Financial*
Callie Cox, *Senior Analyst, LPL Financial*

KEY TAKEAWAYS

First quarter GDP growth was surprisingly strong.

Net exports and inventories were significant contributors amid ongoing trade tensions.

We expect consumer and business spending to carry economic growth more in future quarters.

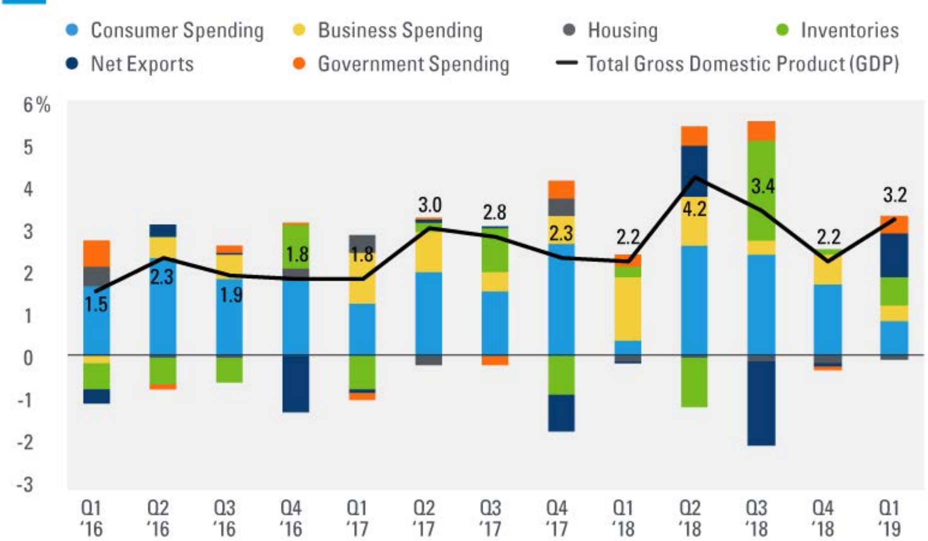
We've finally closed the book on what was one of the most perplexing quarters of this expansion. In January and February 2019, economic data took an unexpected turn as trade and political headwinds weighed on global demand. Tensions then subsided in March, and signs of a rebound started to appear.

These past few months have been full of surprises, so it was only fitting that this chapter ended with a blowout gross domestic product (GDP) report. The April 26 report showed first quarter GDP increased 3.2%, the best first quarter gain since 2015 and above all Bloomberg forecasts for growth [Figure 1].

TRADE AND INVENTORIES

However, the components of first quarter output showed a weaker base under otherwise strong overall growth. Net exports (exports minus imports) contributed 1% to overall GDP, and inventories added 0.7%, accounting for more than half of last quarter's gain in output. Both components have been volatile over the past few quarters amid the ongoing U.S.-China trade dispute.

1 FIRST QUARTER GDP GROWTH BEATS ESTIMATES



Source: LPL Research, U.S. Bureau of Economic Analysis 04/26/19

Global trade volumes have fluctuated recently as purchasers have tried to time shipments around developments in trade talks. Exports jumped in January and February, right before the United States' March 1 deadline for implementing higher tariff rates (a deadline that was ultimately nixed). Net exports' contribution to last quarter's GDP was its second highest in five years.

Inventory levels have swelled as U.S. companies have tried to avoid supply chain disruptions while preparing for a recovery in demand as trade tensions ease. Inventories have contributed an average of 1% to GDP growth over the last three quarters, above its average three-year contribution of just 0.1% to GDP.

Because of these factors, first quarter strength could simply be borrowing growth from future quarters. The swift rise in inventories over the past three quarters could reverse as companies start to work down current stockpiles, and net exports' gain could eventually moderate as global trade activity normalizes. Trade and inventories have historically been volatile components of output, and big swings in both constituents have evened out in subsequent quarters.

CONSUMER AND BUSINESS SPENDING

The first quarter GDP report looks less impressive with trade and inventories stripped out. Excluding these volatile components, GDP increased 1.5% in the quarter, the weakest "real final sales" growth since the end of 2015. However, fundamentals suggest stronger growth may be ahead for both sectors.

Consumer spending added just 0.8% to overall GDP, its lowest contribution in a year. While weaker consumer activity is typical for the first quarter, even seasonally adjusted, sentiment and spending both took a noticeable hit last quarter amid a record government shutdown and an influx of negative global headlines. Global uncertainty has overshadowed an otherwise healthy job market and solid wage gains, which both point to an impending rebound in consumer spending. Consumer activity has already started to recover, evidenced by March's biggest gain in retail sales since September 2017.

Business spending contributed 0.4% to GDP, its second-lowest contribution since the end of 2016. Companies have weathered the same headwinds as consumers, and the cumulative uncertainty has had a chilling effect on capital expenditures (capex). Muted growth in capex, especially recently, has been discouraging. Increased capital spending is key to our economic outlook, as it leads to increased productivity and contained labor costs. Economic conditions also support a pickup in capex. Fiscal incentives for business spending are still in place, companies have benefited from robust profit growth in 2018, and investment in productivity has become more attractive amid accelerating wages.

Fortunately, corporate demand has started to recover as global conditions have perked up. New orders for nondefense capital goods, our best proxy for future business spending, climbed the most in March since July 2018. We still think capital investment could help boost output in future quarters once companies get more clarity on trade and the global economic outlook.

U.S. stocks' swift first quarter rally could also help lift growth, as rising stock prices lead to more confident consumers and businesses. The S&P 500 Index just capped its best quarter since September 2009, climbing 13.1% over the last three months. The benchmark index previously has posted returns that high in only 15 quarters since

1970. In the quarters following those high marks, GDP growth has accelerated by an average of 0.5% over the prior quarter.

CONCLUSION

A perplexing first quarter is behind us, and the U.S. economy escaped without a noticeable dent to output growth. First quarter GDP growth was unusually strong at first glance, but the devil was in the details. Trade and inventories were significant tailwinds, signaling to us that both components will likely drag on growth in the following quarters. But the contributions were timely, helping to get the economy through a rough patch with fundamentals pointing to higher consumer and business spending growth ahead. Overall, the report puts our forecast of about 2.5% GDP growth in 2019 well within play. ■