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Data Watch

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3RD QUARTER GDP (ADVANCED)

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- Real GDP increased 1.6% in Q3, following a 2.6% annualized growth rate in Q2. The GDP chain-weighted price index increased an annualized 1.8% in Q3. Nominal GDP (or aggregate demand) rose an annualized 3.4% in Q3. This is the slowest real and nominal GDP growth since Q4 2002. In the past year, real GDP is up 2.9% and nominal GDP is up 5.8%.
- Real business investment gained an annualized 8.6% in Q3 - a combination of 6.5% growth in equipment and software investment and 14.1% growth in business construction. In the past year, inflation-adjusted business investment is up 7.9%, non-residential construction is up 13.7%, and equipment and software spending is up 5.7%. Residential investment fell 17.4% in Q3 - the largest decline since Q1 1991. Real personal consumption accelerated to 3.1% growth in Q3 versus an annualized 2.6% in Q2.
- Real inventories expanded by $50.7 billion in Q3, but subtracted 0.1% from real growth. The trade deficit widened to $639.9 billion last quarter, subtracting 0.6% from real GDP. Removing the impact of inventories, the trade deficit, and government purchases, "core" real GDP (consumption + fixed investment) grew 2.2% at an annual rate in Q3 and "core" nominal GDP grew 4.3%.

Implications: Although headline GDP was not as strong as expected, the weakness was entirely due to a plunge in residential investment and a widening trade deficit. The underlying picture painted by Q3 GDP is a strong engine with a few dents and dings in the hood. Removing the weak residential investment and trade deficit components shows GDP driving at a 3.3% real rate. This shows that despite a lackluster headline figure for Q3 GDP, the economy still has strong forward momentum. We believe that the economy will grow between 3.0% and 4.0% in Q4 and Q1-07 which is faster than the Fed's estimate of potential growth. As a result, the Fed's Philips Curve model will show that inflation is still a concern. With the "core" CPI rising at a ten-year high and the CRB Spot Index (which does not include oil or precious metals) at an all-time high, inflation also has positive momentum. We still expect the next move by the Fed to be a rate hike.

3rd Quarter GDP *All Data Seasonally Adjusted*	***Q3-06***	*Q2-06*	*Q1-06*	*Q4-05*	***4 Quarter Change***
Nominal GDP	**3.4%**	5.9%	9.0%	5.1%	5.8%
Real GDP	**1.6%**	2.6%	5.6%	1.8%	2.9%
Chain-Weight Price Index	**1.8%**	3.3%	3.3%	3.3%	2.9%
PCE	**3.1%**	2.6%	4.8%	0.8%	2.8%
Durable	**8.4%**	-0.1%	19.8%	-12.3%	3.3%
Nondurable	**1.6%**	1.4%	5.9%	3.9%	3.2%
Services	**2.8%**	3.7%	1.6%	2.0%	2.5%
Nonresidential Fixed Investment	**8.6%**	4.4%	13.7%	5.2%	7.9%
Structures	**14.1%**	20.3%	8.8%	12.0%	13.7%
Equipment, Software	**6.5%**	-1.4%	15.6%	2.8%	5.7%
Residential Investment	**-17.4%**	-11.1%	-0.3%	-1.0%	-7.7%
Change in Inventories* (Level, $Bn)	**50.7**	53.7	41.2	43.5	47.3
Net Exports* (Level, $Bn)	**-639.9**	-624.2	-636.6	-636.6	-634.3
Exports	**6.5%**	6.2%	14.0%	9.6%	9.0%
Imports	**7.8%**	1.4%	9.1%	13.2%	7.8%
Government Purchases	**1.9%**	0.8%	4.9%	-1.1%	1.6%
GDP Final Sales	**1.7%**	2.1%	5.6%	-0.3%	2.3%

Source: Commerce Department

***4-Quarter Change = Avg. Quarterly Change**