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## 1ST QUARTER GDP (ADVANCED)

- Real GDP increased 4.8% at an annual rate in Q1, a rebound from the 1.7% annual growth in Q4. Growth in Q1 was the fastest since Q3 2003. The GDP chain-weighted price index increased an annualized 3.3% in Q1. Nominal GDP (or aggregate demand) rose an annualized 8.2% in Q1.
- Real business investment grew at an annualized 14.3% in Q1, the fastest gain since Q2 2000. During the 12 quarters following the 2003 tax cut, real business investment has increased at an annual average of 9.1%, compared to a 7.3% average annual rate of decline during the nine quarters leading up to the tax cut. Equipment and software investment rose an annualized 16.4% in Q1, while residential investment was up 2.6% at an annual rate. Real personal consumption expenditures grew 5.5% at an annual rate in Q1, led by a 20.6% annualized jump in durable goods consumption.
- Inventories expanded by \$21.9 billion in Q1 versus a \$37.9 billion increase in Q4, which subtracted 0.5% from growth. The trade deficit widened to a record \$678.2 billion last quarter, subtracting 0.8% from growth. Removing the impact of inventories, the trade deficit, and government purchases, “core” real GDP (consumption + fixed investment) grew 6.3% at an annual rate in Q1 and “core” nominal GDP grew 8.8%.

**Implications:** While real GDP grew slightly less than consensus estimates in Q1, the underlying trends suggest that both the economy and inflation are growing faster than previously assumed. A 5.5% jump in personal consumption and 14.3% surge in business investment pushed “core” real GDP (C+FI) up 6.3% in Q1, the fastest gain since Q3 2003. We believe this is the best measure of the economy’s true growth. The chain-weighted price index increased 3.3% in Q1, higher than consensus expectation of a 2.7% gain. This bulge in the price index has been overlooked as analysts chose to focus on the PCE deflator, which grew just 2.0% in Q1. The 1.3% difference between annualized growth rate of the GDP price index and the PCE deflator is the largest gap since Q4 1990, and suggests that producers are feeling price pressures to a much greater extent than consumers. We do not expect this trend to continue and we look for consumer price inflation to rise throughout the rest of the year. Nominal GDP growth reached 8.2% in Q1, and is up 6.7% in the past year. As Chairman Bernanke said yesterday, aggregate demand is directly affected by Fed policy. As such, it appears obvious to us that monetary policy is still accommodative, that a neutral federal funds rate is higher than the conventional wisdom believes, and that inflationary pressures are likely to remain elevated.

1st Quarter GDP <i>All Data Seasonally Adjusted</i>	Q1-06	Q4-05	Q3-05	Q2-05	4 Quarter <i>Change</i>
Nominal GDP	8.2%	5.2%	7.6%	6.0%	6.7%
Real GDP	4.8%	1.7%	4.1%	3.3%	3.5%
Chain-Weight Price Index	3.3%	3.5%	3.3%	2.6%	3.2%
PCE	5.5%	0.9%	4.1%	3.4%	3.4%
Durable	20.6%	-16.6%	9.3%	7.9%	4.4%
Nondurable	5.4%	5.0%	3.5%	3.6%	4.4%
Services	2.8%	2.6%	3.3%	2.4%	2.8%
Nonresidential Fixed Investment	14.3%	4.5%	8.4%	8.8%	9.0%
Structures	8.7%	3.0%	2.2%	2.7%	4.1%
Equipment, Software	16.4%	5.0%	10.6%	11.0%	10.7%
Residential Investment	2.6%	2.8%	7.3%	10.8%	5.8%
Change in Inventories* (Level, \$Bn)	21.9	37.9	-13.3	-1.7	11.2
Net Exports* (Level, \$Bn)	-678.2	-655.2	-617.5	-614.2	-641.3
Exports	12.1%	5.0%	2.5%	10.7%	7.5%
Imports	13.0%	12.1%	2.4%	-0.2%	6.6%
Government Purchases	3.9%	-0.8%	2.9%	2.5%	2.1%
GDP Final Sales	5.4%	-0.2%	4.6%	5.6%	3.8%

Source: Commerce Department

\*4-Quarter Change = Avg. Quarterly Change

