

Growth Stepping Up

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Real GDP has been soft in the past year, growing only 1.3% in the year ending in the second quarter. In the four quarters before that, however, real GDP grew 3%. That's what it's supposed to be like in a Plow Horse economy, with real GDP growth averaging around 2%, sometimes a little faster, sometimes slower.

Now, after going through a relatively soft period, it seems like the economy is starting to pick up again, clocking in at a 2.5% growth rate in the third quarter. In addition, we expect growth to be around this rate in both the last quarter of the year as well as the full year ahead.

Slightly faster growth shouldn't be a surprise. Monetary policy is loose – and will remain loose even when the Fed raises rates in December – and tax rates have not moved up recently. In addition, businesses have been shrinking inventories, and that leaves room for more growth as that process eventually comes to an end.

The problem is that the growth in the size and scope of government is offsetting the strides made by entrepreneurs and innovators. Fixing that problem will take a major change in direction in Washington over the next several years.

Here's how we get to our forecast of a 2.5% annual real GDP growth rate for Q3.

Consumption: Auto sales rebounded in Q3, growing at a 9.2% annual rate, but retail sales outside the auto sector rose at a tepid 1.2% pace. Overall, it looks to us like “real” (inflation-adjusted) personal consumption of goods and services, combined, grew at a 2.5% annual rate in Q3, contributing 1.7 points to the real GDP growth rate (2.5 times the consumption share of GDP, which is 69%, equals 1.7).

Business Investment: Business equipment investment looks like it declined at a 2% annual rate in Q3 while commercial construction was flat. R&D probably grew around its trend of 5%. Combined, we estimate business investment

grew at a 1% rate, which should add 0.1 points to the real GDP growth rate (1.0 times the 13% business investment share of GDP equals 0.1).

Home Building: Looks like residential construction declined for the second straight quarter, shrinking at about a 5% annual rate in Q3. This doesn't mean the housing recovery is over, though. A similar two-quarter lull happened in 2013-2014, with building re-accelerating afterward. Expect the same this time. In the meantime, we think the drop in Q3 will trim 0.3 points off of the real GDP growth rate. (-5.0 times the home building share of GDP, which is 4%, equals -0.2).

Government: Military spending spiked higher in Q3 while public construction projects declined. On net, we're estimating that real government purchases rose at a 1.7% rate in Q3, which would add 0.3 percentage points to real GDP growth (1.7 times the government *purchase* share of GDP, which is 18%, equals 0.3).

Trade: At this point, the government only has trade data through August, but the data so far suggest the “real” trade deficit in goods has gotten smaller. As a result, we're forecasting that net exports add 0.6 points on the real GDP growth rate.

Inventories: At present, we have even less information on inventories than we do on trade, but what we have suggests companies are still cutting inventories in Q3. In part, this may be due to the same reason why trade will add to GDP: a slowdown in Christmas-season goods imports at West Coast ports due to temporary problems with storing extra containers after the bankruptcy of a major international shipper. We're forecasting inventories fall at about the same pace as in Q2, which means no net impact on Q3 real GDP.

Put it all together, and we get a forecast of 2.5% for Q3, a modest acceleration from the previous year and well within the normal range for a Plow Horse economy.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
10-25 / 9:00 am	Consumer Confidence – Oct	101.0	100.9		104.1
10-26 / 9:00 am	New Home Sales – Sep	0.600 Mil	0.585 Mil		0.609 Mil
10-27 / 7:30 am	Initial Claims – Oct 22	255K	254K		260K
7:30 am	Durable Goods – Sep	+0.0%	+0.2%		+0.1%
7:30 am	Durable Goods (Ex-Trans) – Sep	+0.2%	-0.1%		-0.2%
10-28 / 7:30 am	Q3 GDP Advance Report	2.5%	2.5%		1.4%
7:30 am	Q3 GDP Chain Price Index	1.4%	1.4%		2.3%
9:00 am	U. Mich Consumer Sentiment- Oct	88.2	88.4		87.9