

Rearview Mirror OK, Collision Ahead

First, the good news: we estimate that real GDP grew at a solid 2.8% annual rate in the fourth quarter. But you shouldn't dwell on the solid GDP report that comes out Thursday. Why? Because the report shows what's going on in the rearview mirror. Meanwhile, there's an economic collision ahead.

Just think about the news so far for December. The ISM Manufacturing and ISM Service indexes are both below 50. Excluding the early days of COVID, both indexes haven't been below 50, signaling at least a contraction in sentiment, since the aftermath of the 2008-09 Financial Panic.

Retail sales fell 1.1% in December after a 1.0% decline in November. Industrial production fell 0.7% in December after a 0.6% decline in November. Medium & heavy truck sales are still at a respectable level, but dropped sharply in December, down 13.5%, the second fastest drop for any month in the past twenty years. Housing starts declined, as well.

The good news is that the labor market still seems strong. Initial claims for unemployment insurance claims are still very low. But the job market is often a lagging indicator of economic health and jobless claims should be expected to be at or near a bottom very close to the peak in the business cycle.

A recession will arrive sometime in 2023. Given recent data, it would come as no surprise if we're already in a recession and the economy shrinks in the first quarter and beyond. A surge in the M2 measure of the money supply led a rebound in economic growth from the COVID Lockdown and then a surge in inflation in 2021-22. But growth in M2 came to a halt in early 2022. Now, with a time lag, the economy is getting weaker and inflation is coming down. Buckle up, it's going to be rough ride.

In the meantime, our calculations show economic growth at a 2.8% annual rate for the fourth quarter.

Consumption: "Real" (inflation-adjusted) retail sales outside the auto sector declined at a 2.4% annual rate in Q4. However, sales of autos and light trucks grew at a 28% rate and it looks like real services, which makes up most of consumer

spending, should be up at a solid pace. Putting it all together, we estimate that real consumer spending on goods and services, combined, increased at a moderate 2.3% rate, adding 1.6 points to the real GDP growth rate (2.3 times the consumption share of GDP, which is 68%, equals 1.6).

Business Investment: We estimate a 4.1% growth rate for business investment, with gains in equipment and intellectual property more than offsetting a decline in commercial construction. A 4.1% growth rate would add 0.5 points to real GDP growth. (4.1 times the 13% business investment share of GDP equals 0.5).

Home Building: Residential construction is still absorbing the pain of much higher mortgage rates and looks like it fell at a 24.0% rate, which would subtract 1.0 points from real GDP growth. (-24.0 times the 4% residential construction share of GDP equals -1.0).

Government: Only direct government purchases of goods and services (not transfer payments) count when calculating GDP. We estimate these purchases – which represent a 17% share of GDP – were unchanged in Q4, meaning zero net impact on GDP (0.0 times the 17% government purchase share of GDP equals 0.0).

Trade: Looks like the trade deficit shrank a little in Q4, as exports declined at a slower pace than imports. We're projecting net exports will add 0.3 points to real GDP growth.

Inventories: Inventories look like they grew faster in Q4 than in Q3, suggesting an add of about 1.4 points to the growth rate of real GDP. Look for slower inventories in 2023, which should be a significant drag on economic growth this year.

Add it all up, and we get a 2.8% annual real GDP growth for the fourth quarter. That headline sounds good. But when much of the growth is from inventories and the economy is about to get hit from slower M2, investors need to focus on the collision ahead, not the pretty scenery in the rearview mirror.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
1-26 / 7:30 am	Initial Claims – Jan 21	206K	200K		190K
7:30 am	Q4 GDP Advance Report	2.7%	2.8%		3.2%
7:30 am	Q4 GDP Chain Price Index	3.2%	3.2%		4.4%
7:30 am	Durable Goods – Dec	+2.5%	+2.0%		-2.1%
7:30 am	Durable Goods (Ex-Trans) – Dec	-0.2%	0.0%		+0.1%
9:00 am	New Home Sales – Dec	0.610 Mil	0.589 Mil		0.640 Mil
1-27 / 7:30 am	Personal Income – Dec	+0.2%	+0.2%		+0.4%
7:30 am	Personal Spending – Dec	-0.1%	-0.1%		+0.1%
9:00 am	U. Mich Consumer Sentiment- Jan	64.6	64.0		64.6