Q2 Real GDP: Consumers Continue To Do The Heavy Lifting

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- Before-tax and after-tax corporate profits were up 2.7 percent year-on-year in Q2

Revised and more complete source data show real GDP grew at an annualized rate of 2.0 percent in Q2, down slightly from the BEA's initial estimate of 2.1 percent and ahead of our forecast of 1.8 percent growth. Relative to the BEA's initial estimate, faster growth in real consumer spending was offset by a smaller inventory build, a larger trade deficit, and a larger contraction in residential fixed investment, yielding the slight downward revision to top-line real GDP growth. The upward revision to growth in consumer spending was larger than our forecast anticipated, which mostly accounts for our miss on our forecast of headline growth. Today's release offers the BEA's first estimate of corporate profits, with both before-tax and after-tax profits up 2.7 percent year-on-year. Though some of the details are a bit different, the second look at Q2 GDP does not change the view of the broader economy – U.S. consumers remain on solid ground, with both the willingness and the wherewithal to spend, while businesses remain somewhat hamstrung by ongoing uncertainty over trade policy and an inventory correction that has further to run.

Growth in real consumer spending was revised up to an annualized rate of 4.7 percent from the initial estimate of 4.3 percent. Growth in spending in each of the three broad components – consumer durables, nondurable consumer goods, and household services – is now reported to be slightly faster than previously estimated. We think it worth noting that our proxy of discretionary consumer spending, which strips out spending on food, housing, and energy, grew at an annualized rate of better than 6.0 percent in Q2, the fastest growth since Q2 2014. In part, this reflects a bounce from a weak Q1, but trend growth in our proxy has been solid over the past several quarters, which goes to our earlier point about consumers having the willingness and wherewithal to spend. While Q3 growth in consumer spending won't match Q2's heady pace consumers nonetheless continue to do most of the heavy lifting for the U.S. economy, which will remain the case as long as the labor market remains healthy.

Real business fixed investment contracted at an annualized rate of 0.6 percent in Q2, which matches the initial estimate but there are changes to the underlying details. Relative to the BEA's initial estimate, spending on intellectual property products is weaker while spending on business structures fell less sharply, with no change to the initial estimate of spending on equipment and machinery. Still, current quarter growth in business spending on equipment and machinery got off to a weak start, reflecting diminished business confidence.

Real exports of U.S. goods and services were weaker in Q2 than the BEA first estimated but there was no change to the initial estimate of a modest 0.1 percent annualized increase in real imports, with the net result a larger trade deficit than first reported. The trade deficit knocked 0.72 percentage points off of top-line real GDP growth in Q2. The build in business inventories during Q2 was slightly smaller than first reported, and as a result inventories took 0.92 percentage points off of top-line real GDP growth in Q2, a bigger drag than first reported. We have for some time been pointing to what we see as a sizable inventory overhang as a factor that would weigh on real GDP growth from Q2 through year-end, which is one source of weakness in the manufacturing sector.

After having fallen on both a sequential basis and an over-the-year basis in Q1, corporate profits bounced back in Q2. Before-tax profits were up 5.3 percent quarter/quarter in Q2, with after-tax profits up 5.1 percent; on an over-the-year basis, both before-tax and after-tax corporate profits were up 2.7 percent in Q2. It is noteworthy that, on a before-tax basis, domestic profits were down by 0.4 percent on an over-the-year basis in Q2, the second consecutive decline, while profits from foreign operations were up 12.7 percent year-on-year. Though down from cycle highs, profit margins, particularly after-tax margins, remain elevated relative to past cycles. A slightly better trend rate of productivity growth is acting as a buffer against faster growth in labor costs, but the persistent lack of pricing power will remain a source of downward pressure on margins.

Though consumers remain on solid footing, looming uncertainty over trade policy is acting as a drag on business investment. While this weighs on current growth, the bigger issue is that without faster growth in capital spending, there is not much upside for the economy's "speed limit," which we still peg at below 2.0 percent.