ECONOMIC UPDATE

REGIONS

July 28, 2022

Q2 2022 GDP: Whatever You Want To Call It, It Isn't Good

- The BEA's first estimate shows real GDP contracted at an annualized rate of 0.9 percent in Q2 after a 1.6 percent contraction in Q1
- Consumer spending and net exports were supports for Q2 GDP, fixed investment, inventories, and government were drags

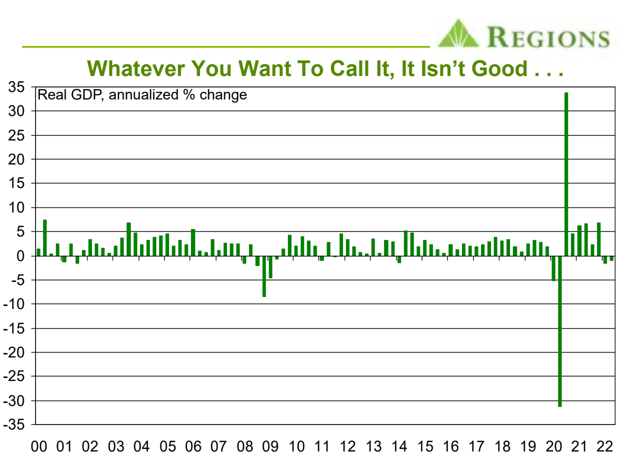
Real GDP contracted at an annualized rate of 0.9 percent in Q2 according to the initial estimate from the Bureau of Economic Analysis (BEA), a touch weaker than our forecast of a 0.8 percent contraction and contrary to the consensus forecast of 0.4 percent growth. The GDP Price Index rose at an annual rate of 8.7 percent in Q2. As we anticipated, consumer spending and net exports were supports for real GDP in Q2, but a smaller build in business inventories and declines in residential and business fixed investment and government spending were drags. As we anticipated, the smaller inventory build took two percentage points off of the quarterly change in real GDP. As we do each and every quarter, we'll note that the initial estimate of GDP in any given quarter is based on incomplete source data, and as more source data become available and other data points are revised, the initial estimate of GDP will be revised, and the revisions to the initial estimate can be and often are significant. Real GDP now having contracted in two straight quarters fits a common definition of recession but, as we've noted, given that business inventories are the primary culprit in these declines, we do not think this fits the definition used by the National Bureau of Economic Research, the unofficial arbiter of turns in the business cycle. Still, whatever you want to call what's going on in the U.S. economy, it clearly isn't good.

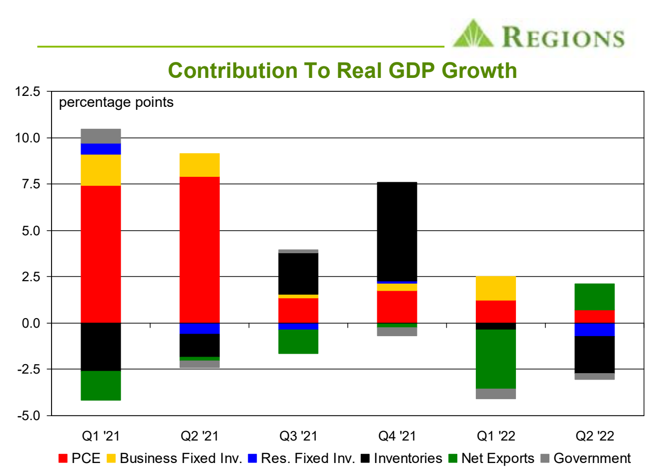
Real consumer spending grew at an annualized rate of 1.0 percent in Q2, contributing 0.7 percentage points to the change in top-line real GDP. Real spending on goods contracted at an annualized rate of 4.4 percent in Q2, which should come as no surprise given the ongoing shifts in patterns of consumer spending. At the same time, real consumer spending on services rose at an annualized rate of 4.1 percent, with particular strength in spending in areas such as travel, dining out, and recreation. Keep in mind that services account for roughly two-thirds of all consumer spending, hence the growth, albeit modest, in total consumer spending despite the decline in spending on goods. The question going forward, however, is how long the strength in services spending will persist, and our expectation is that it will fade as summer comes to an end.

Business fixed investment was marginally lower in Q2, contracting at an annual rate of 0.1 percent, but what is disturbing is that real outlays on business equipment and machinery fell at an annual rate of 2.7 percent. To be sure, this comes on the heels of annualized growth of 14.1 percent in Q1, and it would be natural for it to have settled back a bit in Q2 but the monthly data on orders for new business machinery paint a darker picture for such spending going forward. One area of business investment that shows no signs of slowing is intellectual property products, the bulk of which comes in the form of computer software and R&D outlays. Real spending on intellectual property products rose at an annualized rate of 9.2 percent in Q2, and what has been a run of robust growth in this category bodes well for labor productivity growth going forward. Residential fixed investment fell at an annual rate of 14.0 percent in Q2, knocking 0.71 percentage points off the quarterly change in real GDP.

Real business inventories grew at an annual rate of $81.6 billion in Q2, and if it seems confusing that inventories rose but yet were a drag on the change in Q2 GDP, that's because it is. When it comes to the rate of change in real GDP, it isn't the change in inventories but the change in the change in inventories that matters. As it turns out, the two largest quarterly inventory builds on record in the GDP data came in Q4 2021 and Q1 2022, in that order. So, while inventories were a modest drag on the change in real GDP in Q1, when they rose at a rate of $188.5 billion, they were a much more severe drag in Q2, when they rose at a rate of $81.6 billion. Recall that inventories on all levels – manufacturing, wholesale trade, retail trade – fell precipitously after the onset of the pandemic, reflecting halts in production around the globe and disruptions in global shipping networks that continue to haunt us to this day. While there is further to go in restoring inventories to desired levels, the pace of inventory growth will continue to slow. As such, inventories could remain a drag on real GDP growth for the next few quarters, perhaps longer given that the demand side of the economy continues to slow.

At this point, arguing about whether the economy is in a recession seems little more than quibbling over semantics. The economy has clearly slowed and our baseline forecast has it limping along at barely above stall speed over coming quarters. With the FOMC not yet done "doing a job on demand" the risks to our growth forecast are tilted to the downside.





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