ECONOMIC UPDATE
REGIONS
July 27, 2023

Q2 2023 GDP: Economy Resilient In 1H 2023, But Growth Figures To Slow From Here

- The BEA's first estimate shows real GDP grew at an annualized rate of 2.4 percent in Q2 2023 after 2.0 percent growth in Q1
- Consumer spending and business fixed investment were the main drivers of Q2 growth while trade was a modest drag

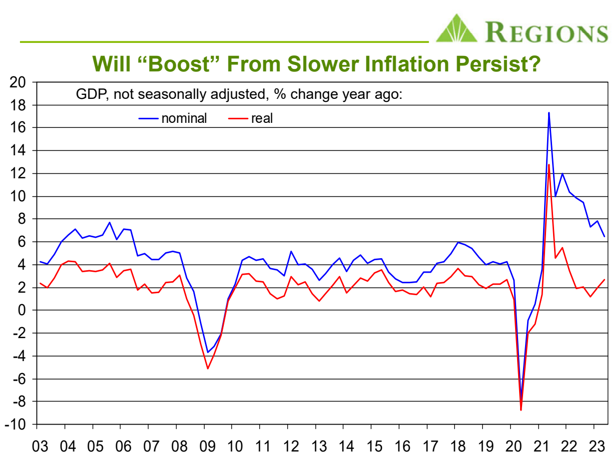
According to the initial estimate from the Bureau of Economic Analysis (BEA), real GDP grew at an annualized rate of 2.4 percent in Q2 2023, better than we (2.1 percent) and the consensus (1.8 percent) expected. For our usual disclaimer, the BEA's initial estimate of GDP in any given quarter is based on highly incomplete source data and, as such, prone to sizable revision. Recall that the initial estimate of Q1 growth was 1.1 percent, which by the third estimate had been bumped up to 2.0 percent. Growth in real GDP was helped along by a milder increase in prices than had been anticipated, meaning that there was, literally, more bang for the buck from a slower rate of nominal GDP growth. Growth in consumer spending slowed sharply from the pace seen in Q1, and while that was in keeping with expectations, the surprise was that the slowdown in growth was milder than anticipated. Business fixed investment spending also came in stronger than we had anticipated, most notably real outlays on machinery and equipment. While we did not get the small increase in that our forecast anticipated, the drag from residential fixed investment was modest and could easily flip to a support in the Q3 data. Though the economy proved to be more resilient over the first half of 2023 than we had anticipated given the cumulative effects of elevated inflation and higher interest rates, we nonetheless continue to expect a markedly slower pace of growth over 2H 2023 even should yesterday's increase in the Fed funds rate prove to be the last of this cycle.

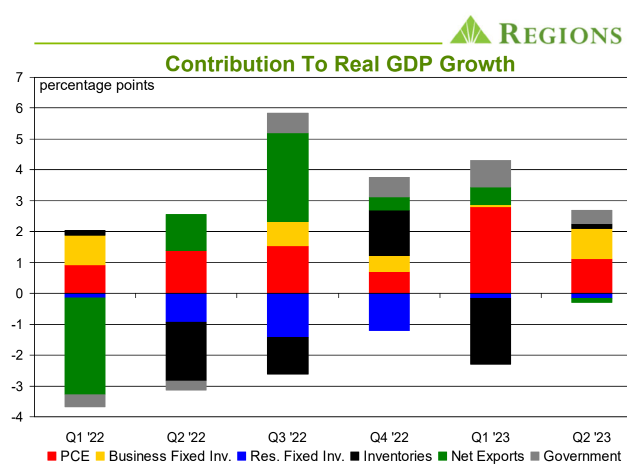
Real consumer spending grew at an annual rate of 1.6 percent in Q2 after 4.2 percent growth in Q1. As anticipated, growth in spending on goods slowed dramatically, rising at an annual rate of just 0.7 percent. Real spending on services grew at an annual rate of 2.1 percent, down from the 3.2 percent rate logged in Q1. In a sense, the extent of that slowdown is a bit misleading, as a spike in health care spending, much of which was financed via Medicaid, contributed to Q1 growth, and there was a similar, albeit smaller, effect in the Q2 data. That said, our proxy for real spending on discretionary services showed growth of just 0.2 percent in Q2, down from 5.6 percent in Q1. This is something we've noted in our discussions of the monthly data on consumer spending, i.e., growth continues to look robust on a nominal basis, but on a real basis discretionary services spending has been fairly flat over recent months. This also goes to the point that this remains one pocket of continued inflation pressures, though we expect this to change come the fall.

Real business fixed investment grew at an annual rate of 7.7 percent in Q2, notably faster than the 0.6 percent growth in Q1. Even more notably, each of the three components of business fixed investment – structures, intellectual property products, equipment/machinery – posted healthy growth in Q2. Spending on structures has been juiced by construction of manufacturing facilities for semiconductor chips and electric vehicles and batteries, a support which will fade at some point. Growth in spending on computer software remains the dominant driver of growth in intellectual property investment, countering a sharply slower pace of growth in spending on R&D. It is the dramatic turnaround in spending on equipment and machinery – up at an annual rate of 10.7 percent after having contracted in three of the prior four quarters – that stands out in the Q2 data. That growth, however, was heavily concentrated amongst transportation equipment, particularly aircraft and motor vehicles. In each case, producers are making up for time, and production, lost due to supply chain snarls and are fulfilling pent-up demand. To the extent that is the case, however, as that process winds down, as it at some point will, we could easily see investment in equipment and machinery revert to being a drag on top-line GDP growth.

Real after-tax income grew at an annual rate of 2.5 percent in Q2, much slower than the 8.5 percent growth seen in Q1. Much of that slowdown, however, reflects sharply slower growth in transfer payments which in Q1 were bolstered by the COLA for Social Security benefits. It is worth noting that aggregate labor earnings grew at a faster pace in Q2 than was the case in Q1, as did asset-based income.

We look for the pace of growth to slow meaningfully over the back half of 2023. Fiscal policy and residential fixed investment should be supports for GDP growth, but consumer spending and business investment will make much smaller contributions than those seen over the year's first half. The net result will likely be flattish real GDP in the quarters ahead.





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