

US GDP Growth Beats, Reaffirms Next Fed Move Is Up

2018Q4 GDP growth, q/q % change SAAR:

Actual: 2.6

Scotia: 2.7

Consensus: 2.2

Prior: 3.4

- **The US economy outperformed consensus expectations in Q4 in line with Scotiabank Economics' estimate by posting growth that continues to eclipse estimates of the long-run non-inflationary potential pace of growth.** The USD strengthened on a DXY basis and the 2 year US Treasury yield jumped by about 3bps with the 10 year performing similarly. US equity futures are little affected thus far perhaps as stronger than expected growth is viewed as a tolerable trade-off to higher rate pressures.
- **The details reinforce the quality of the overall reading and are highlighted below.**
- The stronger than expected performance means that **the economy continues to push further into excess aggregate demand and likely by the greatest magnitude since 2000Q3**—a nearly two-decade high for excess demand. In turn, given lags between such 'output gap' movements and when inflation tends to face incremental upward pressure, market-based measures of inflation protection like the 5y5y inflation swap and 10 year TIPS breakeven may well remain too cheap despite the increase in such measures compared to an undershoot up to early January.
- **What this means for the Fed is that our advice to clients is to continue to downplay market pricing for Fed rate cuts. Scotiabank Economics' forecast remains pointed toward a return to modest tightening later this year.**
- In terms of quality influences, **inventories only added about 0.1 points to GDP growth** on a weighted basis so there wasn't much of a build effect distorting the headline.
- **Net trade dragged about ¼% off headline GDP growth as exports added 0.2% and imports dragged 0.4% off headline.** For net trade to drag on GDP because of a pull effect on imports is not a bad story at all.
- **Consumption led the way with a weighted 1.9% contribution to 2.6% GDP growth.** On consumption, recall that weather and shutdown effects dampened momentum into the end of the year so even with consumption growth at 2.8% (3.0% consensus), controlling for these effects likely would have easily driven 3-handled consumption growth again in Q4 and with that broad Q4 GDP growth closer to 3%.
- **Nonresidential investment added 0.8% to GDP growth in weighted terms. This was led by a 0.4% weighted contribution from equipment spending.**
- **In short, I like it. I like it very much in fact.** Pessimism toward the US economy is grossly overdone with a looming Q1 slowdown likely to prove temporary as activity gets punted into Q2 on shutdown and polar vortex effects among other considerations. With the Fed estimating long-run

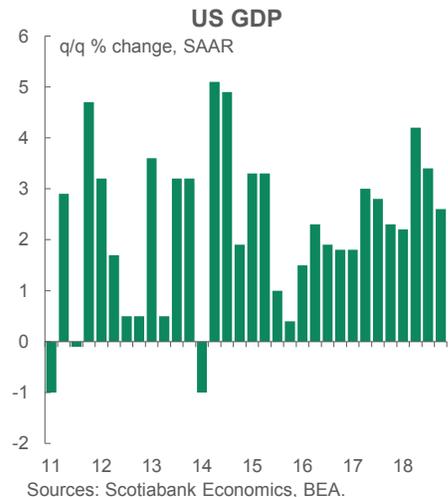
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potential growth at 1.9%, we're still growing above trend. This pushes the output gap further into excess demand territory. It was probably running close to 1% at the end of last year. The last time it was 1% or higher was 2000Q3.

- Over 2018, the output gap went up by over one percentage point. Much of that rise occurred from Q2 onward. **This has not been given enough time to work through inflation with lags even with a less sensitive pass-through effect than historically.** That doesn't mean inflation rips, but to the cautions on inflation provided by NY Fed President Williams the other day, it does mean the risk is tilted upward not downward over 2019H2-onward in terms of inflation. A central bank doesn't cut with growth surpassing expectations, inflation presently near target and likely under slight upward pressure later this year, and the economy fully employing available resources and then some.

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