US GDP & Core PCE: Did The Fed Lose Patience Too Soon?

- GDP growth exceeded expectations in Q2…
- ...and exceeded potential growth, pushing the US further into excess demand…
- ...while the quality of the underlying drivers of growth improved…
- ...and core PCE inflation is turning higher…
- ...all of which suggests Chair Powell lost his patience a bit too soon

US Q2 GDP, q/q annualized growth, seasonally adjusted (%):

Actual: 2.1

Scotia: 1.9

Consensus: 1.8

Prior: 3.1

US GDP growth slightly exceeded expectations, the underlying quality of the growth drivers improved, and core PCE inflation is turning higher. On balance, the report is incrementally hawkish by way of Fed expectations. The US two year yield slightly increased and the USD slightly built upon earlier appreciation.

At 2.1%, US GDP growth not only slightly exceeded consensus expectations (1.8%) and Scotia's estimate (1.9%), it exceeded the FOMC's estimate of the longer run potential GDP growth rate (1.9%). Thus, even with slower headline GDP growth in Q2, **the US pushed slightly further into excess demand conditions with a more positive output gap.**

The reasons the underlying growth drivers are more positive from a quality standpoint are derived from the ways in which the different components of overall activity contributed to GDP growth. **The greater reliance upon consumer spending and lesser reliance upon inventories and imports to drive Q2 growth compared to the drivers in Q1 made for better overall quality despite the softer growth reading.** See the accompanying chart that graphically depicts the drivers of quarterly GDP growth. The following points expand upon the chart.

- **Consumption grew by 4.3%** (q/q % change, seasonally adjusted, annualized) and the prior quarter was revised up to 1.1% (from 0.9%). The consumer definitely rebounded in Q2. In weighted contribution terms, the consumer added 2.85 percentage points to top-line GDP growth.
- **Inventories shaved 0.9%** off GDP growth in Q2 after adding 0.5% to Q1. Inventory accumulation was therefore a headwind in Q2 versus the assist it gave to the first quarter.
- **Imports were flat** in terms of their contribution to growth in Q2 after adding about 1/4% to Q1.
- **Investment was soft** as equipment spending made zero contribution to GDP growth for the second straight quarter, nonresidential structures

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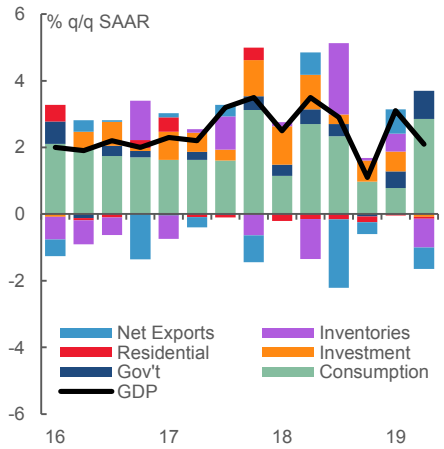
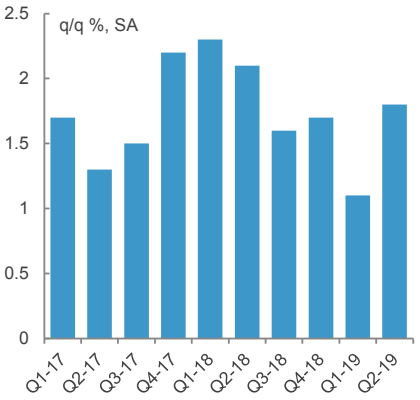
Contributions to US GDP Growth



Sources: Scotiabank Economics, BEA.

US Core PCE Inflation



Sources: Scotiabank Economics, BEA.

investment subtracted 0.3% from overall growth and housing investment made no contribution. The investment complex was therefore relatively soft.

- **Government spending added 0.9 points** to GDP growth after adding 0.5% in Q1. Of that 0.9% weighted contribution to GDP growth in Q1, 0.5 came from federal government spending. **So much for draining the swamp!** Federal government spending has been on a roll for a while as the Trump administration and the Republican party drive the US toward bigger and bigger long-run deficits and higher debt. Nondefense spending drove the government contribution to Q2 GDP growth. State and local governments are also spending, adding 0.35% to Q2 GDP growth in weighted contribution terms.

Further, core PCE inflation is turning higher. That is evident through the quarter-over-quarter seasonally adjusted core PCE gauge that climbed to 1.8% q/q SA in Q2 from 1.1% q/q SA in Q1. This returns core PCE inflation to its fastest since Q2 of last year (chart 2). At the margin, the US shaking off the idiosyncratic and transitory distortions that depressed inflation over the winter months. Perhaps Fed Chair Powell should have been patient a little longer! What the doves are likely to emphasize, however, is a quest to juice inflation well above the 2% target for a time in order to prove symmetry. That exercise is still likely to fail, while the risks to stability and emboldening protectionist trade policies could rise.