US GDP Beats, But Shouldn't Impact Fed

- Q3 GDP growth slightly beat expectations…
- ...and underlying details were solid
- The Fed can still say consumption is "strong"…
- ...and investment has "weakened"
- Core PCE shouldn't motivate the hawks...
- ...after just one quarter's overshoot doesn't prove symmetry
- The FOMC will continue to debate two competing consumer theories
- It's too early to conclude the US economy isn't at risk of stall speed

US GDP, q/q % change SAAR, Q3:
Actual: 1.9
Scotia: 1.8
Consensus: 1.6
Prior: 2.0

US GDP growth slightly beat expectations in Q3 thanks to the consumer while inflation rose in line with expectations. There is little reason to believe that the overall tone of this report will change the Fed's narrative.

There are four supporting takeaways here:

1. Headline growth beat expectations and the underlying details are robust. Inventories played little role in terms of weighted contributions to growth by subtracting only 0.05 points off of 1.9% growth. The accompanying chart depicts the weighted contributions to GDP growth.

2. The Fed can likely still reference how consumption is "strong" in this afternoon's statement, as it grew by 2.9% and contributed 1.9 points to the headline 2.9% growth.

3. The Fed can still reference how investment has "weakened" as it retrenched again. In weighted contribution terms, nonresidential investment dragged 0.4% off headline GDP growth with structures dragging GDP down by 0.5% and equipment spending knocking a quarter point off GDP.

4. The FOMC probably won't—and definitely should not—be fussed by core inflation. Quarter-ago core PCE inflation rose to 2.2% q/q SAAR and that's bang in line with expectations for a pick-up from 1.9% the prior quarter. We had most of the tracking evidence from the monthly PCE figures so there is little/no information revealed here.

Besides, a) the Fed is out to prove symmetry to its 2% inflation target in *sustained* fashion and not just in a single quarter, and b) inflation expectations remain low. Just as transitory headwinds to inflation earlier this year weighed core PCE down, transitory tailwinds that are partly the flipside of the headwinds could still give way to future softening. This is the first time core PCE has tracked above 2% q/q SAAR since five quarters ago in 2018Q2 and only the sixth time in fifteen quarters

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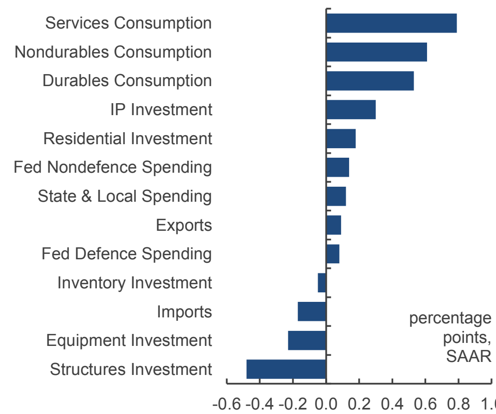
Contributions to Q3 US Real GDP Growth



Sources: Scotiabank Economics, US BEA.

after years of undershooting. **If the Fed shifts its bias because of a one-quarter wonder that was anticipated, then perhaps they deserve at least some of Trump's criticism!**

The debate the FOMC will likely continue to have is the extent to which they should seek comfort in strong consumption growth. One camp argues that it proves resiliency and how the US economy is in a "good place" as several of them put it. The other says hold on a sec, consumers are often last to get the memo after cap-ex and complementary hiring cool and we are obviously already seeing the latter two developments. I'm in the middle of these arguments. Consumer balance sheets are sparkling in the US with record low debt payments as a share of disposable income and an unusually high saving rate for Americans at 8.1%. However, incremental cash flow through job growth and wage gains is still required and it's unclear that absent cash flow gains, a) that a low debt service burden can be leveraged up in today's changed environment (credit changes, aging etc), and b) that pushing the saving rate lower is feasible for similar reasons (an older population, precautionary motives on headline uncertainty, perhaps having to save more to offset soft fixed income derived investment income etc).

Notwithstanding this set of readings, **there remains merit to saying the Fed's emphasis should continue to be to avoid stall speed in the US economy.** The lagging effects of trade policy developments and the monetary policy response are likely still mostly ahead of us. Monetary policy acts with notoriously long and variable lags, but it's safe to assume the lag is longer than the three months since the Fed started cutting! It's also safe to assume that business cap-ex budgets and supply chain decisions that are slow to turn have probably only just begun to react to the uncertainty.