Scotiabank

GLOBAL ECONOMICS

SCOTIA FLASH

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Contributors

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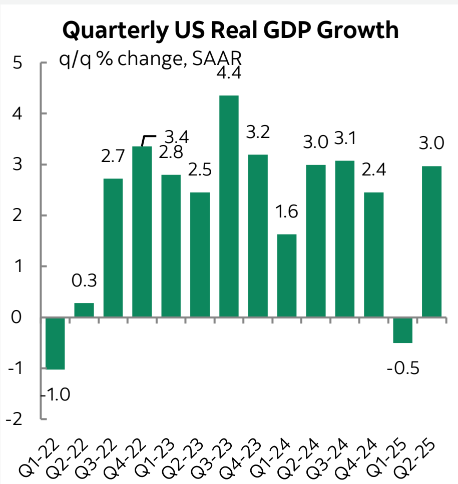
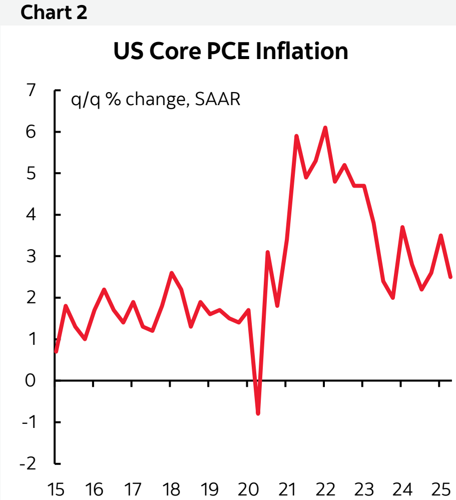
Chart 1



Sources: Scotiabank Economics, BEA.

Chart 2



Sources: Scotiabank Economics, BEA.

Fade US GDP on Soft Details, as Core PCE Inflation Sends Warning

- **US Q2 GDP growth of 3% had soft details**
- **Excluding inventories and imports, the domestic economy posted soft growth**
- **Consumption was ok, not great**
- **Q2 core PCE inflation signalled either a June PCE surprise or upward revisions**
- **Trump botched interpretation of the numbers**

US Q2 GDP, q/q SAAR, %:

Actual: 3.0

Scotia: 2.5

Consensus: 2.6

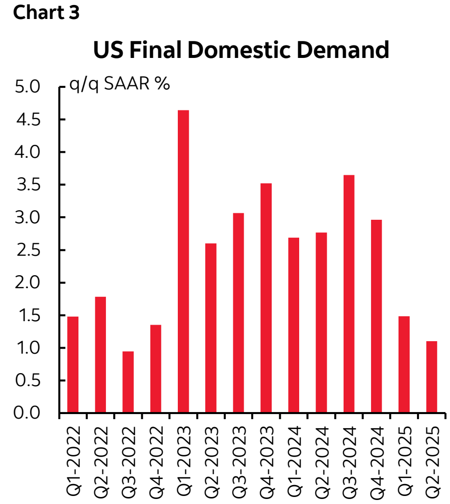
Prior: -0.5

US Q2 GDP grew by 3.0% at a seasonally adjusted and annualized rate but the details were less impressive. That was the strongest headline growth reading since 2024Q3 (chart 1). If 3% is what drove the two-year Treasury yield 3–4bps higher and the dollar stronger, then it's at risk of being faded. Instead, however, I think the increased yield can be attributed to a combination of the net effects of stronger core PCE inflation and Treasury's refunding announcement with US$125B in line with expectations.

US Q2 core PCE inflation landed at 2.5% q/q SAAR (consensus 2.3%). Core inflation continues to oscillate around a stubborn trend that is higher than the Fed's 2% price stability goal for headline PCE (chart 2). I'm not sure what Q2 core PCE of 2.5% says about expectations for Friday's core PCE for June. If there are no revisions to prior months then 2.5% core PCE in Q2 implies June core PCE at about +0.4% m/m SA. There may, however, be revisions to prior months such that June might not be as high as that. So, some combination of revisions and/or firmer core PCE than core CPI may reveal warmer monthly readings.

A better measure of the domestic economy that is free of the direct effects of trade and inventory distortions is final sales to private domestic purchasers that was up by only 1.2% q/q SAAR. That's the weakest growth since earlier on in the post-pandemic period (chart 3) as uncertainty likely stemming from Trump administration policies is costing growth. That's ok, not great, and counsels fading the 3% GDP headline reading. Basically, a lot of the Q2 GDP effect was an unwinding of the Q1 distortions to front-run tariffs. Imports were an addition to growth by weakening (ie: less of an import leakage effect on the GDP accounting) and inventories shrank, dragging GDP lower.

Chart 3



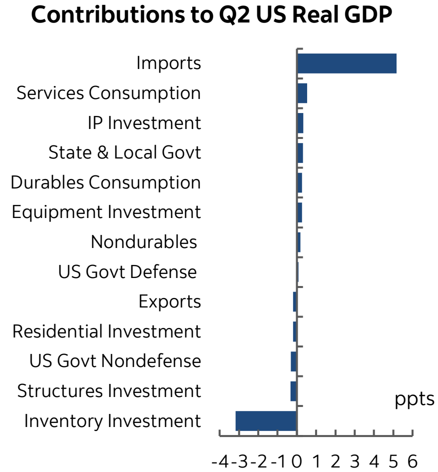
Sources: Scotiabank Economics, BLS.

The detailed drivers of 3% growth were not terribly impressive (charts 4, 5). Imports added about 5.2ppts to GDP as they fell which amounts to a lower leakage effect on GDP accounting. Exports only dragged -0.2 ppts off annualized q/q GDP growth.

Inventories subtracted 3.2 ppts from Q2 GDP growth as the flip side of lower imports. On net, the import and inventory effects added about two percentage points to Q2 GDP growth—or two -thirds of the 3% headline.

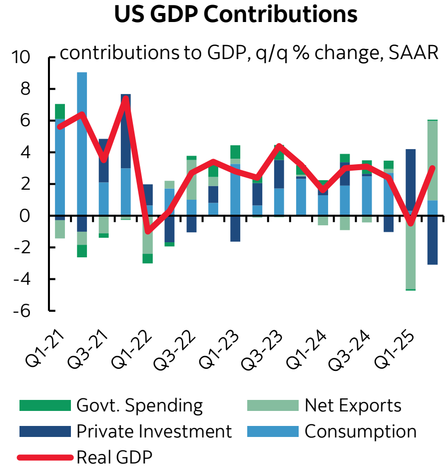
Consumption added under 1 ppt to GDP growth in weighted contribution terms. Breaking down consumption, goods spending by consumers added 0.46 ppts to q/q SAAR GDP growth of 3%. Half of that effect came via durable goods especially autos which is most definitely a tariff front-running effect confirmed by the auto sales numbers. The rest was nondurables. Services consumption added 0.5 ppts to GDP growth.

Chart 4



Sources: Scotiabank Economics, BEA.

Chart 5



Sources: Scotiabank Economics, BEA.

Investment dragged on GDP growth including through inventories. Other than inventories, fixed investment added 0.1 ppt to Q2 GDP growth entirely via nonresidential investment (+0.27 ppts) as residential/housing investment dragged 0.2 ppts off GDP. Within nonresidential, the gain was driven by equipment spending as structures spending fell.

Government added only 0.1 ppts to GDP growth as federal government spending dragged ¼% off Q2 GDP while state and local governments offset that by adding 0.3 ppts to GDP growth. DOGE cuts were negated by state/local governments.

Curiously, none of these cautions on core inflation or GDP details factored into Trump's impulsive and odd reaction. He said "2Q GDP JUST OUT, WAY BETTER THAN EXPECTED. FED MUST LOWER THE RATE. 'TOO LATE' MUST NOW LOWER THE RATE." Ummm…..lower the rate because of 3% GDP growth? Oh my….