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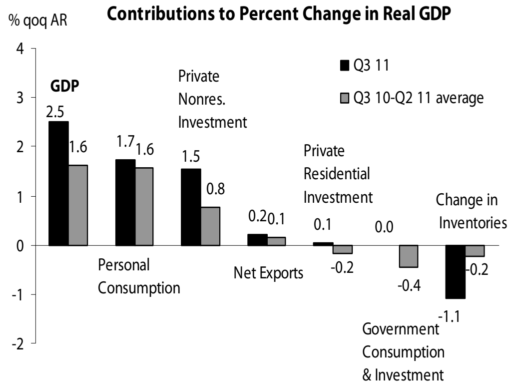
US GDP growth accelerates in Q3, on the back of stronger-than-expected personal consumption and solid gains in capex

- Real GDP retrieved its pre-recession level in Q3 2011, increasing 2.5% q-o-q saar, the strongest gain since Q3 2010.
- Stronger final sales and weaker inventory growth in Q3 is a positive sign for economic activity in Q4.
- We expect GDP to cruise around 2% q-o-q saar in Q4, supported by decent personal consumption and robust capex spending.
- Looking ahead, we continue to expect below-trend growth through next year, averaging at around 2.0%, as the weak labor market and persistent economic slack will probably continue to weigh on personal income.

According to the advance estimate of the Bureau of Economic Analysis (BEA), real GDP retrieved its pre-recession level in Q3 2011, increasing 2.5% q-o-q saar, the strongest gain since Q3 2010. The acceleration in real economic activity relative to the 1.3% growth reported in the previous quarter was mainly driven by stronger-than-expected personal consumption growth and robust business investment (Figure 1). Real final sales rose 3.6% q-o-q saar, reporting the strongest growth rate since Q4 2010, as the deduction in inventories subtracted 1.1% from real GDP growth. Stronger final sales and weaker inventory growth is a positive sign for economic activity ahead. The large inventory drag in Q3 may be reflecting companies' reaction to the softness of domestic demand in H1 2011, setting the stage for stronger growth in Q4 as businesses build back stocks. Meanwhile, net exports added 0.2% to real growth, as export growth of 4% q-o-q saar was partly offset by a 1.9% increase in imports. Last but not least, after three quarters of negative contribution, government consumption and investment remained essentially flat in Q3, as the increase reported at the federal level was fully offset by a decline at the state and local level.

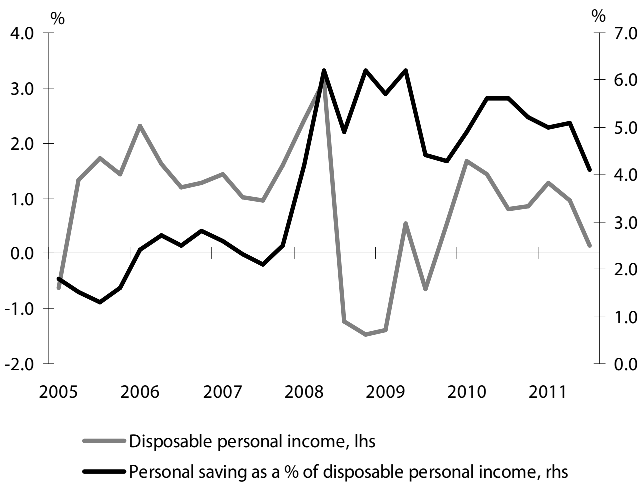
Figure 1



Source: US Bureau of Economic Analysis (BEA), EFG estimates

Real personal consumption expenditures increased 2.4% q-o-q saar, reflecting strength in both the goods sector and the more heavily weighted services sector. In particular, consumption of durable goods increased 4.1% q-o-q saar, after a large contraction of 5.3% in Q2, and services consumption rose 3%, reporting the strongest reading in more than 5 years. Surprisingly, the rebound in durable goods was not driven by motor vehicles but from non-motor vehicles consumption, as auto spending reported a modest decline, subtracting 0.1% from growth. This suggests that spending on durable goods could post another solid gain in Q4, once auto sales feed into the data. Indeed, vehicles sales for October are consistent with a stronger bounce in Q4, after the 24% q-o-q saar decline in Q2, when sales were hit by supply constraints from the events in Japan.

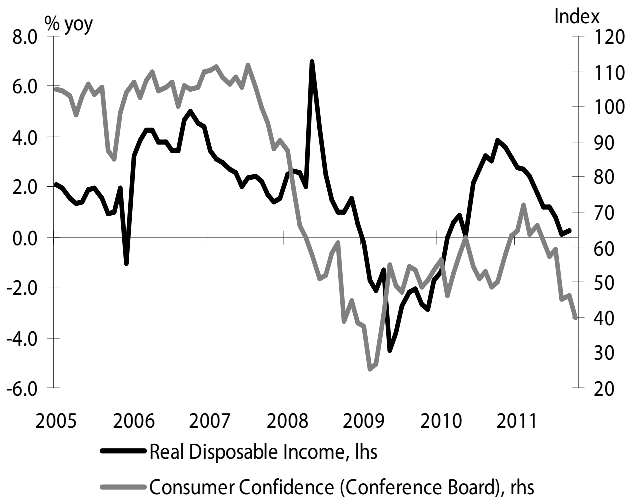
Figure 2



Source: US Bureau of Economic Analysis (BEA)

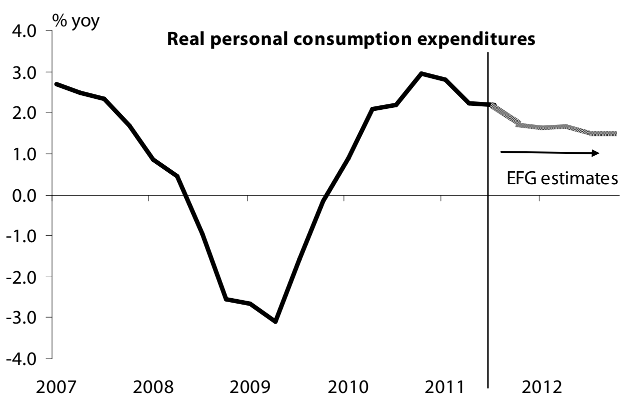
However, the rebound in consumption growth was not accompanied by an increase in personal income, but rather reflected a decline in savings. Real disposable income declined by 0.4% q-o-q in Q3, increasing just 0.4% from a year earlier. Although the weakness in real disposable income partly reflected the strength of consumer price inflation, nominal disposable income trend softened as well, increasing by a mere 0.1% q-o-q in Q3 from 1% in Q2. As a result, households used their savings to offset weak income, with the savings rate falling gradually to 3.6% in September from 5.3% in June 2011 (Figure 2). Continued labor market weakness appears to be restraining disposable income and exerting downward pressure on consumer sentiment. The Conference Board's index of consumer confidence posted another decline in October, reporting the weakest reading since March 2009. In particular, the index plunged to 39.8 from 46.4 in September, reflecting declines in both the present situation and expectations components. The current state of consumer confidence and the underlying weakness in income growth suggests that the jump in personal spending in Q3 will prove to be temporary (Figure 3). The upward trend in the services consumption component and a likely boost to the goods component from auto sales in Q4 will be partially damaged by a softer trend in employees' wages, denting households' disposable income. According to our estimates, real consumption growth will decelerate from 2.4% q-o-q saar in Q3 to about 1.6% in the final quarter of the year, leaving the annual average at 2.2% for 2011. Looking ahead, we believe that further weakness in real disposable income and further drawdown in the savings rate will lead to a deceleration of annual consumption growth to 1.6% in 2012, half the average growth during the post war II period since 1947 (Figure 4).

Figure 3



Source: US Bureau of Economic Analysis (BEA), Conference Board

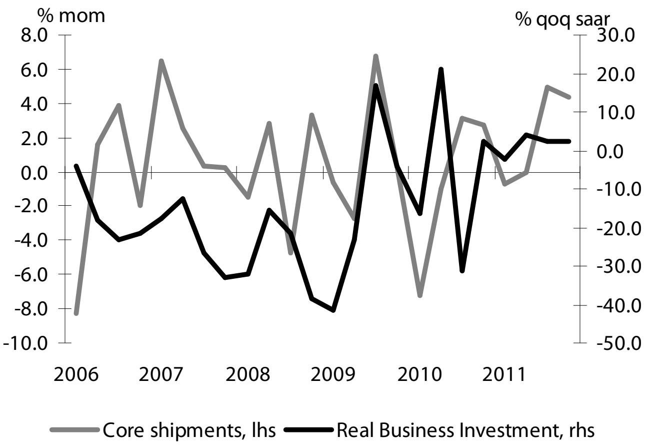
Figure 4



Source: US Bureau of Economic Analysis (BEA), EFG estimates

On the investment front, real business investment surged at a 16.3% pace, on the back of stronger investment in equipment and software which contributed 1.2% to Q3 GDP growth. Supported by solid growth in corporate earnings and accelerated deductions for the cost of certain investments, equipment and software -which accounts for three fourths of business capex- will probably continue to boost growth for the remaining of 2011. However, the recent softness in the pace of core capital goods shipments (Figure 5), the most important input for estimating equipment and software spending, indicates some easing in the pace of spending growth ahead. We expect real non-residential investment growth to gradually decelerate from an annual average of 9.0% in 2011 to 5.0% in 2012, close to levels seen in 2010.

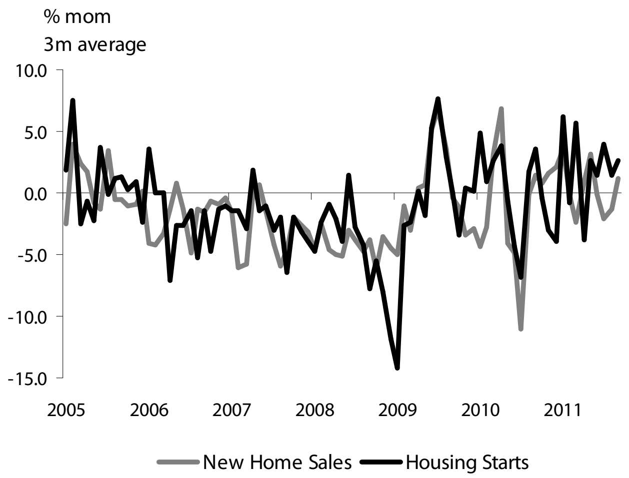
Figure 5



Source: US Bureau of Economic Analysis (BEA), US Census Bureau

Residential investment rose 2.4% q-o-q saar in Q3 after a 4.2% increase in Q2, contributing a mere 0.05% to real economic activity. The housing recovery is being protracted, given the massive overhang of excess supply. Although there are some recent signs of stabilization, with new home sales and housing starts reporting solid monthly increases in September (Figure 6), the recent soft trend in house prices suggests continued weakness in the property market due to the large overhang inventory of foreclosed properties. Our view for a prolonged housing recovery remains intact, with residential investment picking up only gradually from -1.6% y-o-y in 2011 to 3.5% in 2012.

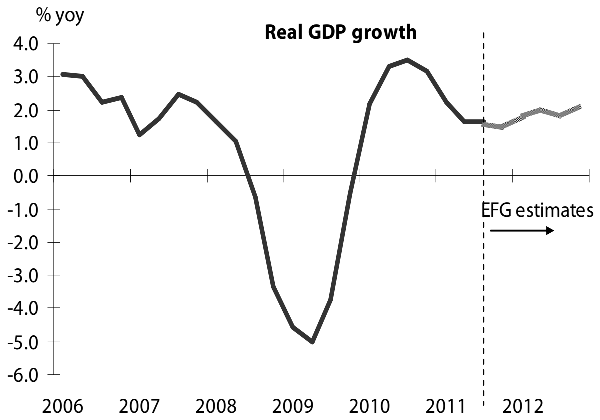
Figure 6



Source: US Census Bureau

Overall, the components of the GDP report were generally favorable, providing reasons for a positive outlook for GDP growth in Q4. The significant contraction in inventories in Q3 should translate into greater stock piling in Q4. In addition, real consumer spending should be supported by a boost from auto spending and an expected easing of headline consumer price inflation, partially offsetting the negative impact from the income side. Meanwhile, the strong pace of core durable orders at the end of Q3 is an encouraging sign for business investment heading into Q4. Capital spending will probably continue to expand at a healthy -albeit slower- rate. Hence, we expect GDP to cruise around 2% q-o-q saar in Q4, with an annual average of 1.8% in 2011. Looking ahead, we expect below-trend growth through next year, averaging at around 2.0%, as weak employment growth and persistent economic slack will probably continue to weigh on personal income (Figure 7).

Figure 7



Source: US Bureau of Economic Analysis (BEA), EFG estimates

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