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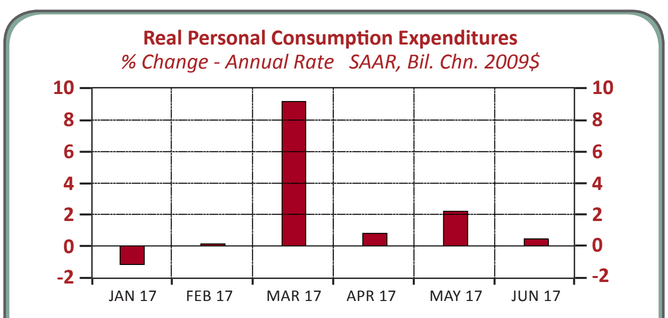
Consumer Spending – I'll Bet that Q3 Real GDP Growth Will Be Closer to Q1's than Q2's

It's too hot to go sailing today, so I thought I'd "unpack", as the kids on cable news say, second quarter real GDP and real personal consumption growth (PCE). I will argue that the quarter-to-quarter acceleration in the growth of both second quarter real GDP and real PCE was due more to arithmetic than a fundamental acceleration in the growth of aggregate demand. To refresh your memory, real GDP annualized growth in the second quarter was 2.6% versus 1.2% in the first quarter. Real PCE growth annualized growth in the second quarter was 2.8% versus 1.9% in the first quarter.

Because the March level of real PCE was so far above the first-quarter average, this biased upward the second-quarter average level of real PCE and thus, second-quarter annualized growth in real PCE

Let's take a look at the month-to-month annualized real PCE growth over the first six months of 2017 (see Chart 1). The median month-to-month annualized real PCE growth during this time period was a paltry 0.6%. The outlier during this period was March, when annualized real PCE growth was a whopping 9.2%. The annualized growth rate of real PCE in April, May and June were 0.20%, 2.20% and 0.45%, respectively. The three-month average of the annualized growth rates of real PCE for April, May and June was 1.15%, a far cry from the 2.8% annualized growth in the quarterly average level of real PCE.

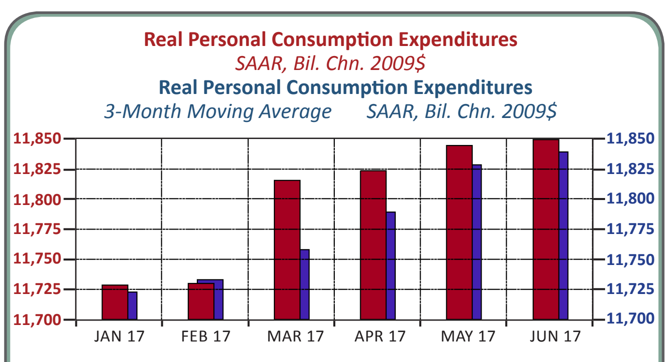
CHART 1



Sources: Bureau of Economic Analysis/Haver Analytics

It was the surge in real PCE growth at the end of the first quarter that boosted second-quarter real PCE growth. Plotted in Chart 2 are the monthly levels of seasonally-adjusted at annual rates of real PCE along with their three-month averages for the first six months of 2017. Let's concentrate on the data points for March and June. The three-month averages of the PCE levels for March and June also are the first and second quarterly averages, respectively, of the levels of real PCE. If you do the arithmetic you will find the March level of real PCE was 0.49% higher than the average level of real PCE for the three months ended March or the first-quarter average level of real PCE. If the level of real PCE had simply remained at its March level in April, May and June, the second-quarter average level of real PCE would have been equal to that of the March level. In this case, annualized growth in second-quarter real PCE would have been 1.97% (1.0049 raised to the fourth power and so on and so forth). **Because the March level of real PCE was so far above the first-quarter average, this biased upward the second-quarter average level of real PCE and thus, second-quarter annualized growth in real PCE**. But what March giveth, June taketh away. The June level of real PCE was only 0.085% above the average level of real PCE for the three months ended June, or the second-quarter average. If the level of real PCE were to remain at the June level in July, August and September, then annualized growth in real PCE in the third quarter would be only 0.3%! So, while second-quarter annualized growth in real PCE started the quarter with a strong tailwind, third-quarter growth is starting with hardly any wind at its back. In order for annualized growth in third-quarter real PCE to match the second quarter's 2.8% growth, the month-to-month annualized changes in real PCE would have to be about 1.2%, **double that of the median month-to-month annualized percentage changes in the second quarter.**

CHART 2



Sources: Bureau of Economic Analysis/Haver Analytics

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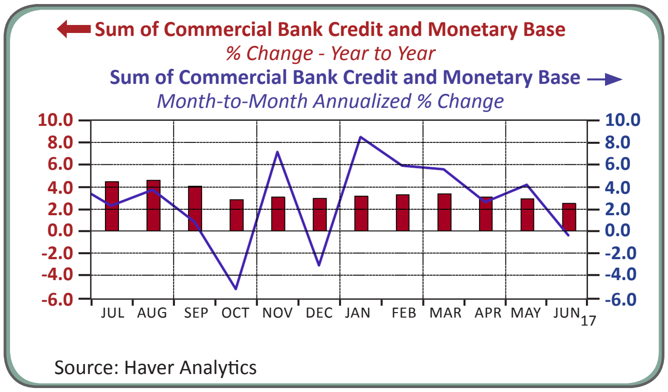
Real PCE contributed 1.9 percentage points to the second quarter's 2.6% annualized growth in real GDP. If growth in real PCE slows in the third quarter, which quarterly-averaging arithmetic suggests it will, then growth in third-quarter real GDP is likely to slow, too. But there also is a fundamental reason why third-quarter real PCE growth is likely to slow – you guessed it, sluggish growth in thin-air credit. Plotted in Chart 3 are monthly observations of the behavior of the sum of bank credit and the monetary base. The bars are the year-over-year percent changes in monthly thin-air credit. The line traces the month-to-month annualized percent changes in thin-air credit. In June, the year-over-year percent change in thin-air credit was 2.6%, the slowest growth in 12 months. In June, thin-air credit contracted at an annualized rate of 0.4% versus May. Sluggish growth in thin-air credit is not the stuff of robust growth in consumer spending.

> *It was the surge in real PCE growth at the end of the first quarter that boosted second-quarter real PCE growth*

If the Fed does, in fact, begin paring its outright holdings of securities in September, then it had better start engaging in repurchase agreements. Otherwise the monetary base will shrink and, all else the same, there will be upward pressure on the federal funds rate. If the monetary base shrinks, thin-air credit growth will slow further unless there is an offsetting increase in bank credit. If thin-air credit growth slows further in the months ahead, investment-grade bond yields will fall more from their already-low levels – barring a Treasury default emanating from a failure to raise the federal government debt ceiling.

CHART 3



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Paul is Legacy's Senior Economic and Investment Advisor and former Senior Vice President and Chief Economist at The Northern Trust Company. Paul works across Legacy's wealth management initiatives, consulting on investment strategies with his innovative research. Considered one of the best economic forecasters as measured by long term accuracy, Paul is a highly regarded, innovative economic researcher whose work has helped form economic policy at national and global levels.