THE WEEKLY U.S. ECONOMIC MONITOR

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IAN SHEPHERDSON, CHIEF ECONOMIST

Second quarter GDP growth likely was close to 5%, but the payback will come in the third quarter.

Productivity growth was dragged up too in the second quarter, and the trend is improving.

Existing home sales probably slipped in June; the trend has been broadly flat for two years.

Brace for Very Strong Q2 GDP Growth, but a Q3 Payback is Coming

Back on May 14, we argued—see here—that the stars were aligned to generate very strong second quarter GDP growth, perhaps even reaching 5%. Our view on the composition of growth in Q2 has changed a bit since that note, with consumption likely to make a bigger contribution than we initially expected, offsetting a smaller boost from net foreign trade. *We'll find out Friday if our view was correct, but right now our forecast is 5.0%.* As always, we've had to fill in some quite big gaps in the data, but we'd be amazed if growth turns out to be less than 4%, and we can't rule out 5½%-plus.

Cue much crowing from the administration, presumably. The strength of the second quarter will be cited as evidence that the tax cuts are working, though ***it's hardly a great revelation that if you borrow enough money from your grandchildren and throw it at the economy all at once, growth will pick up.*** What matters is whether the growth can be sustained and if it will trigger an improvement in the supply-side of economy. Without that, rapid growth will boost inflation.

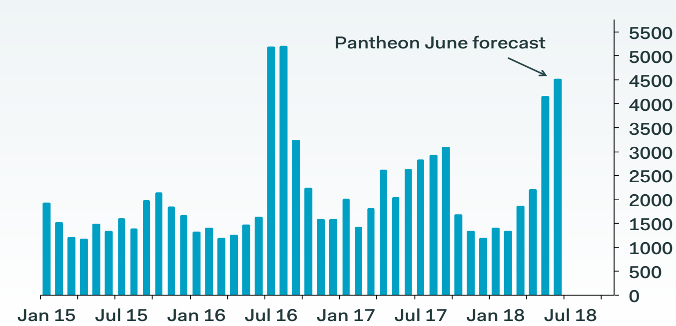
Data for one quarter cannot possibly offer any sort of definitive answer to these longer-term questions. *But we can say with some confidence that growth won't be sustained anywhere near 5% in the third quarter, because the confluence of factors at work in Q2 will not be repeated.* We think business capex will grow about as quickly in the third quarter as in the second, but even here the risk is to the downside, against the backdrop of the tariff wars, and every other component of GDP is likely to make a smaller contribution in Q3.

Consumption will slow, following a likely 3½% second quarter jump. This follows a sluggish 0.9% first quarter, which, in turn, was a correction following the 4.0% jump in Q4, when spending surged in the wake of the hurricanes. Peoples' real after tax incomes jumped at a 3.6% annualized rate in early Q1 as the tax cuts took effect, but the money appears not to have been spent until Q2. *Income growth now has returned to the prior trend, 2% or so, and consumption will follow.*

Government spending appears to have jumped in Q2 as the increases agreed by Congress in March have kicked-in and state and local construction spending has enjoyed one of its periodic surges. But this is very likely to reverse in the third quarter, and it's not clear whether other government spending will accelerate.

The contribution of foreign trade to GDP growth should be about 1.0 percentage points in the second quarter, but it will be a *drag* in Q3. *The mean-reversion of core imports, after their post-hurricane jump, is nearly over.* On the other side of the account, the surge in soybean exports, triggered by Chinese importers seeking to get ahead of tariffs on U.S. farm products, will reverse.

SOYBEAN EXPORTS CAN'T BE SUSTAINED AT THEIR Q2 LEVEL

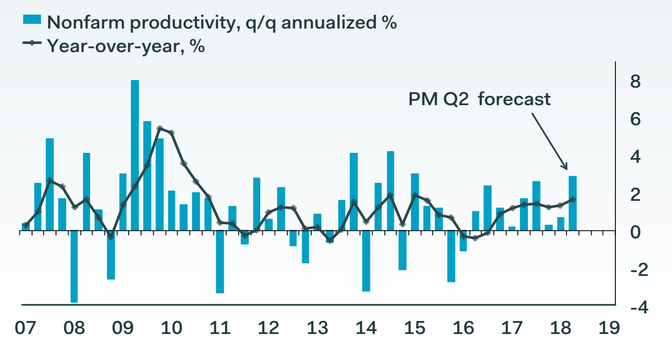


Finally, inventories are now rising at a steady pace, so the pace of inventory accumulation in the third quarter likely will be similar to the $30B or so we expect in the second. In which case, inventories will make no contribution to third quarter growth, after adding some 0.4pp in the second.

Our working assumption, then, is that third quarter growth will slow to 2-to-3%. The trend, we think, is a bit shy of 3%. That's not bad, relative to the 2.1% average from 2010 through 2016, but it's not transformative, either, and it comes at a great cost, in terms of the damage done to the public finances. The productivity picture, though, seems to be improving.

Productivity growth dipped alarmingly during the crash in capital spending in the oil sector, to the extent that it was exactly zero in 2016. Last year was better, with a 1.3% increase, and this year is on course, we think, for a near-2% gain. In the second quarter, our forecast of 5.0% GDP growth should combine with our 2.1% estimate for hours worked to generate a 2.9% productivity gain. That would be the best performance in a single quarter since the first quarter of 2015, but it follows two sub-1% increases and the year-over-year rate will rise only to 1.6%. *Still, the trend is rising, and we're hopeful that the strength in business capex will lift productivity growth further over the course of this year and into 2019.*

Q2 PRODUCTIVITY GROWTH LIKELY REBOUNDED STRONGLY



The administration can't claim this to be all its own work, though; the rate of growth of business capex hit bottom in year-over-year terms back in Q1 2016, when Hillary Clinton was expected to be president, and it has been rising in a straight line, more or less ever since. We detect no positive deviation from the trend either when President Trump was elected—even though surveys of business sentiment rose sharply—or after the tax cuts. *The jury, in other words, is still out, as far as we're concerned.* But we're happy to see stronger productivity growth, whatever caused it.

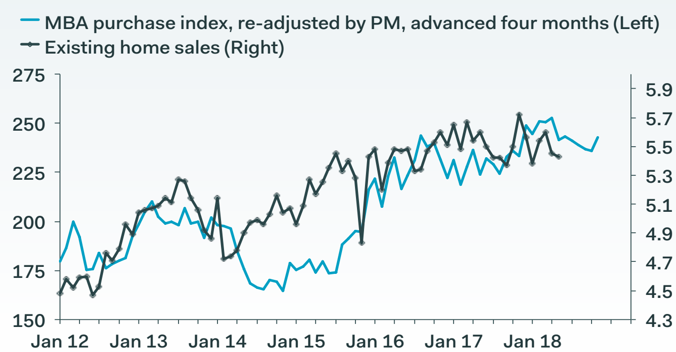
Existing home sales seem to have slipped in June

The pending home sale index points to a modest decline in June new home sales, slipping to about 5.35M from 5.43 in May. For once, the message from the pending sales index is in line with the analysis of regional sales data by Tom Lawler, reported at Calculated Risk, so we're happy to make this our forecast.

The underlying story here is straightforward. *The trends in both mortgage applications and home sales have been flat, net, for the past two years.* And with mortgage rates now some 75bp higher than at their recent low, last September, while lending standards are tightening, a renewed upward trend seems unlikely.

Strong payroll growth is increasing the pool of potential homebuyers. *But big downpayments are needed to access mortgages at the benchmark rates, and that appears to be an insurmountable barrier for many people.* Right now, existing home sales are underperforming relative to mortgage applications, so a modest rebound over the next few months would be unsurprising. But we won't be extrapolating that into a forecast of sustained gains.

EXISTING HOME SALES HAVE BEEN FLAT, NET, FOR TWO YEARS



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THIS WEEK IN BRIEF

Note: "**D**" prefix denotes Datanotes for these releases.

Monday, July 23

• D: Existing Home Sales (6)/10:00 EDT
The pending home sales index points to existing home sales dipping to about **5.35M,** a 21-month low, from 5.43M. Analysis of regional data by Tom Lawler, reported at Calculated Risk, also points to sales falling to 5.35M. **Consensus: 5.45M.**

Tuesday, July 24

• Redbook Chain Store Sales (7/21)/9:00 EDT
We expect a modest rebound after last week's correction to **3.3%,** below the trend, which is running at about 4%.

• Richmond Fed Survey (7)/10:00 EDT
The Richmond Fed index is sensitive to trade war talk, so we look for a drop to about **10** from 20 in June. **Consensus: 18.**

Wednesday, July 25

• Mortgage Applications (7/20)/7:00 EDT
We expect little change in the purchase index from last week's **247.9.** The trend is falling, very slowly.

• D: New Home Sales (6)/10:00 EDT
New home sales overshot in May, relative to the mortgage applications numbers. We look for mean reversion June, with sales falling to about **650K** from 689K. **Consensus: 670K.**

Thursday, July 26

• D: Jobless Claims (7/21)/8:30 EDT
Claims have been unpredictable in recent weeks, distorted by the automakers' retooling shutdowns. We expect a rebound to **230K** from last week's 49-year low, 207K. **Consensus: 215K.**

• D: Durable Goods Orders (6)/8:30 EDT
We think total orders rose **0.7%,** with a small boost from aircraft. Ex-transportation, we expect a **0.5%** increase. **Consensus: Total orders 2.9%, ex-transportation 0.5%.**

• D: Advance Trade in Goods (6)/8:30 EDT
A rebound in core imports, signalled by container data from major ports, seems likely to have pushed the deficit up to **$66.0B** from $64.8B in May. **Consensus: $67.0B.**

• Advance Inventories (6)/10:00 EDT
We expect **0.3%** increases in both wholesale and retail inventories, both a bit less than in May. **Consensus: Wholesale 0.4%, retail N/A.**

Friday, July 27

• D: GDP (Q2 advance)/8:30 EDT
We look for GDP growth of **5.0%.** Consumption likely rose 3.4%, rebounding after a soft Q1, and boosted by tax cuts. Fixed investment probably jumped by 5.0%. Looser fiscal policy means we look for a 3.0% increase in government spending, led by defense and state and local government, and we think rebounding inventories contributed 0.4 percentage points to growth. Net foreign trade likely contributed 1.0pp, partly because imports continued to mean-revert after their post-hurricane surge, and partly because soybean exports soared as Chinese importers sought to get ahead of tariffs on U.S. agricultural products. We think the GDP deflator rose **1.7%,** with the core PCE deflator up **2.2%. Consensus: GDP 4.2%, GDP deflator 2.4%, core PCE deflator 2.2%.**

• D: Univ. of Michigan Consumer Sentiment (7f)/10:00 EDT
We expect little change from the preliminary **97.1**, down slightly from 98.2 in June. **Consensus: 97.1.**

THIS WEEK'S FUNDING

Monday 23	Announcement: four-week bills Auction: $51B 3-month, $45B 6-month bills
Tuesday 24	Auction: four-week bills Auction: $ccB 2-year notes (settles July 31)
Wednesday 25	Auction: $xxB 5-year notes (settles July 31)
Thursday 26	Auction: 3-month, 6-month bills (July 30) Auction: $xxB 7-year notes (settles July 31)
Friday 27	Nothing

PANTHEON'S FINANCIAL FORECASTS

		End-month:			
	4:00pm Fri.	**Sep**	**Dec**	**Mar**	**Jun**
Fed funds target	1¾-to-2	2-to-2¼	2¼-to-2½	2½-to-2¾	2¾-to-3
2-yr	2.59	2.70	3.00	3.20	3.30
10-yr	2.89	3.25	3.50	3.50	3.50
30-yr	3.03	3.30	3.50	3.60	3.60
Curve 10-2	30	55	50	30	20
Curve 30-2	44	60	50	40	30
S&P 500	2,802	2,800	2,850	2,800	2725
Dollar/Yen	111.4	110	110	115	115
Euro/Dollar	1.17	1.15	1.10	1.10	1.10
Sterling/Dollar	1.31	1.38	1.40	1.40	1.40

PANTHEON'S ECONOMIC FORECASTS

GDP	Q3	3.2%	2015 year:	2.6%
	Q4	2.9%	2016 year:	1.6%
	Q1 third	2.0%	2017 year:	2.3%
	Q2	*5.0%*	*2018 year:*	*3.0%*
	Q3	*2½%*	*2019 year:*	*2.0%*
	Q4	*3%*		

CPI Jun 0.1% (2.9% y/y); core 0.2% (2.3% y/y)
Dec. 2018 forecast: 2.5% y/y; core 2.3% y/y
Mar. 2019 forecast: 2.5% y/y; core 2.5% y/y

Unemployment: Dec. 2018: 3.6%; June 2019: 3.3%.

Federal budget: FY 18 forecast: -$750B (3.8% of GDP)