LPL RESEARCH

WEEKLY ECONOMIC COMMENTARY

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SECOND QUARTER GDP PREVIEW

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KEY TAKEAWAYS

The economy may have posted unusually strong growth of near 4% or more in the second quarter.

We expect support across economic sectors, but a rebound in consumer spending will be the key to stronger growth.

Tariffs may actually have helped growth in the second quarter, as business accelerated activity ahead of their implementation.

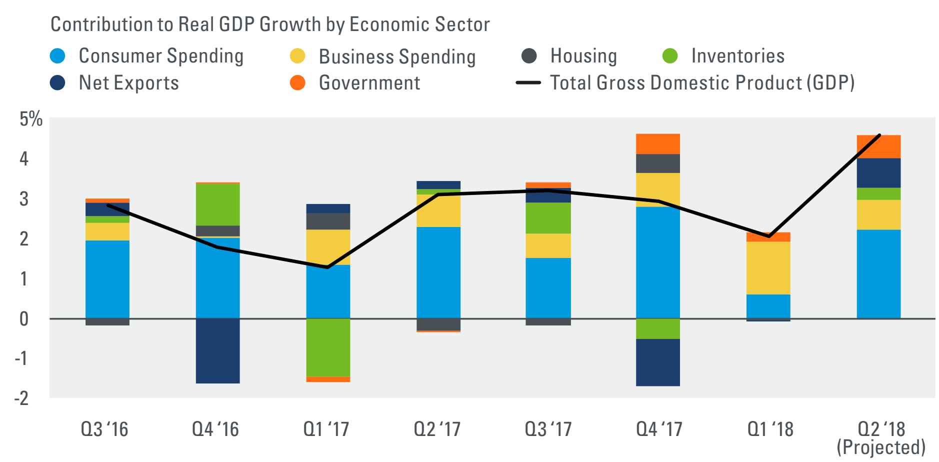
After a seasonally weak first quarter, expectations have been ramping up for the U.S. economy, which is now in the midst of its longest expansion since World War II. The first look at real gross domestic product (GDP) for the second quarter will be released Friday, July 27, and economists are expecting it to be the strongest reading in years. The median Bloomberg-surveyed economist forecast is for GDP growth is 4.0%, which, if realized, would be the largest quarterly increase since 5.2% growth in the third quarter of 2014.

FISCAL STIMULUS: A TAILWIND FOR GROWTH

The domestic economy has begun to reap the benefits of supportive fiscal policy, which includes lower tax rates for individuals and corporations, deregulation, and increased government spending. A key driver of the pickup in growth, if realized, would be a rebound in consumer spending, which accounts for about 70% of the economy. First quarter consumer spending was weak after a strong fourth quarter last year, but recent numbers for the second quarter have been upbeat. Retail sales rose for a fifth straight month in June, coming in near expectations but with a large upward revision to May data, while already strong consumer confidence has steadily improved.

We can see stronger consumer spending data reflected in the Federal Reserve (Fed) Bank of Atlanta's GDPNow forecast of second quarter growth [Figure 1]. While we

1 REBOUND IN CONSUMER SPENDING MAY SUPPORT ACCELERATED GDP GROWTH



Source: LPL Research, Federal Reserve Bank of Atlanta as of 07/18/18

Q2 '18 represents forecast of Federal Reserve Bank of Atlanta's GDPNow model.

Illustration is historical and no guarantee of future results.

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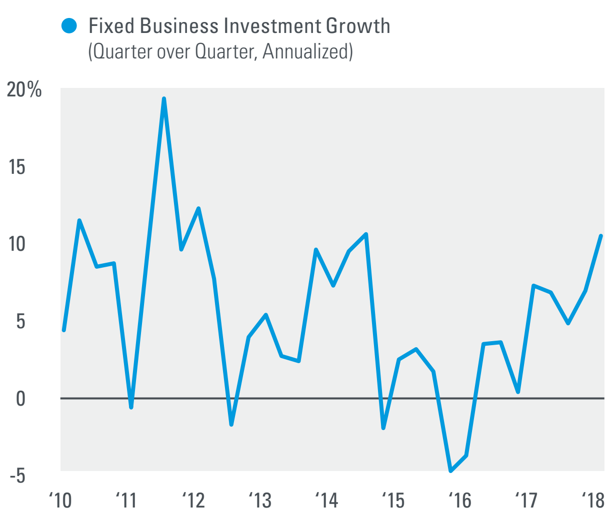
don't put too much faith in a single forecast and the model's projection of 4.5% growth for the quarter is above consensus, the model does provide a helpful picture of how different economic sectors may contribute to second quarter growth based on data received to date. The forecast shows considerable improvement in the contribution from consumer spending, which would be needed even to meet the 4% consensus target.

We also anticipate continued strength in business spending to contribute to a healthy picture of the economy in the second quarter, as incentives for increased capital investment in the new tax law encourage companies to build out their infrastructure. Business spending has been accelerating since an oil-related slowdown in 2015 and early 2016, and posted some of its strongest growth in the cycle in the first quarter [Figure 2]. While we expect the momentum to continue, the contribution to GDP growth in the second quarter may decline after strong first quarter growth helped offset weakness in consumer spending.

2 BUSINESS SPENDING HAS BEEN ACCELERATING



Sources: LPL Research, Bureau of Economic Analysis 07/23/18

EXPORTS RISE AMID TARIFF TENSIONS

Trade tensions have dominated headlines recently. Tariffs on $49 billion in goods have already been implemented and tariffs on $200 billion or more of additional Chinese goods have been discussed, along with tariffs on automobiles.

Anxiety around a global trade war has fueled a jump in U.S. exports ahead of tariffs, which, in turn, has closed the trade deficit to its smallest point since 2016. Net exports averaged $144 billion in March, April, and May, the highest three-month rolling average of the current expansion. The increase in exports is primarily from increased demand as purchasers try to beat retaliatory tariffs, evidenced by soybeans and civilian aircrafts comprising almost all of the jump in exported goods in May. The Atlanta Fed's NowCast model estimates that net exports may account for 0.7% of their 4.5% GDP growth forecast for the second quarter, which would be its strongest contribution since 2013 if realized.

However, the positive impact on GDP from the increase in exports may just be borrowing growth from future quarters, as the effect reverses and the negative economic impact of tariffs makes itself felt. A strong dollar may compound the difficulty. A strong dollar can weigh on exports, because it makes U.S. goods more expensive abroad. On the other hand, consumers can benefit from a strong dollar, though, as it allows U.S. consumers to purchase imports more cheaply. The U.S. dollar rallied to a 12-month high relative to its peers recently, reflecting the strength of the economy.

Tariffs over time are likely to raise price levels and there's already anecdotal evidence that uncertainty around tariffs may be delaying business spending as companies await greater clarity. Nevertheless, we estimate that tariffs would cause only a 0.1% to 0.2% drag on U.S. GDP annually if they do not extend meaningfully beyond current concrete proposals. Such an impact would be small when compared with the overall effect of fiscal stimulus, but nevertheless may still add unnecessary friction to the economy.

CONCLUSION

As we noted in our *Midyear Outlook 2018* publication, we expect U.S. GDP growth of up to 3% in 2018. Year-over-year GDP growth was 2.8% in the first quarter, so our target range implies a modest lift from current levels. Although we are watching the impact of tariffs closely, we expect that the benefits of fiscal stimulus may outweigh any negative implications and the economy should be able to maintain a solid growth trajectory over the remainder of the year. ■

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