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TRENDMACRO LIVE!

What to Make of Q1-2022 GDP?

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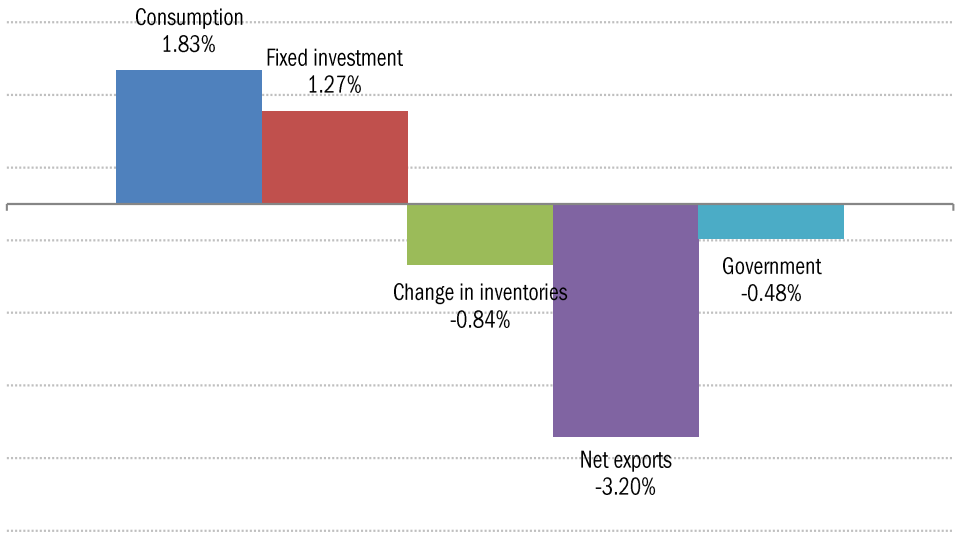
Donald Luskin

OK, Chair Pro Tempore Powell – tell us about rate hikes in the face of stagflation.

We have some explaining to do. We've been saying we're in a post-pandemic productivity-led boom (see, among many, "Boom On..." January 4, 2022). And now we have a Q1-2022 GDP report at negative 1.4%, even worse than the soggy consensus expectations for positive 1.0%. We're not the only ones with some explaining to do – *we have to assume that both President Joseph R. Biden, Jr. and Fed chair pro tempore Jerome Powell are wondering how they are going to spin this*. Hopefully this note won't come off as spin, but we have to say *we find this report to be a little inexplicable*.

- *It's all quite remarkable to have had a negative quarter at the same time as the unemployment rate has fallen to within basis points of its pre-pandemic lows, which were themselves the best in two generations. And it seems to us like most of what has gone wrong this quarter is, well, transitory.*
- The Bureau of Economic analysis cites "a resurgence of COVID-19 cases from the Omicron variant and decreases in government pandemic assistance payments" as the culprits.
- We agree on the first part. In January, and lingering into February,

Contributions to -1.4% Q1-2022 real GDP growth SAAR



Source: BEA, TrendMacro calculations

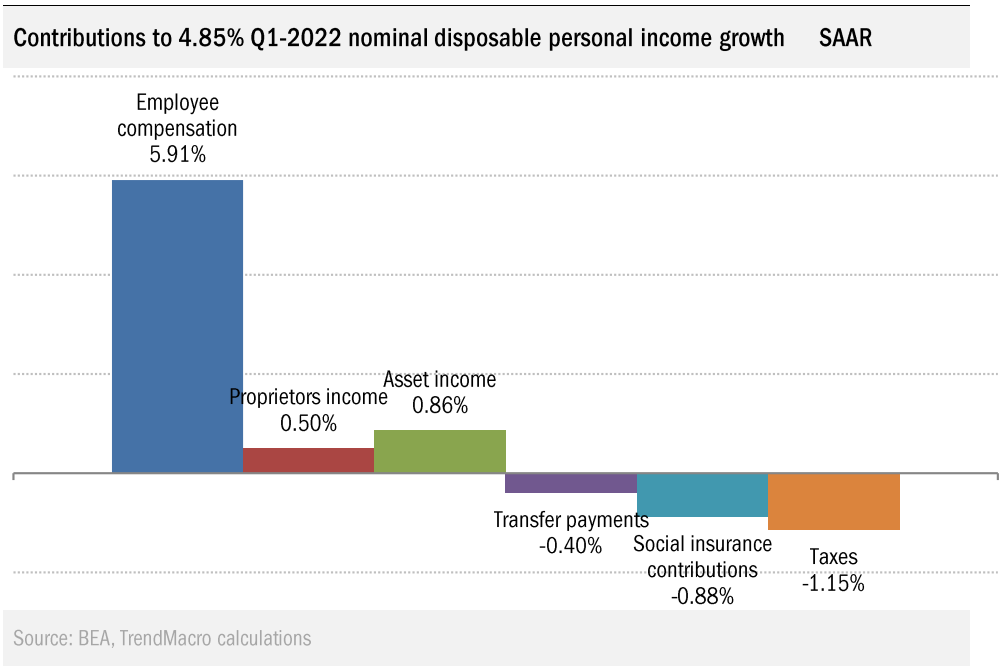
Update to strategic view

US MACRO, FEDERAL RESERVE: A 1.4% GDP contraction in the midst of a post-pandemic productivity-led boom. In January and February, as much as 7.5 million were out sick from Omicron, so some weakness is expectable. BEA points to the discontinuation of transfer payments, yet personal incomes rose sharply – after the prior quarter's stagnation – on the back of employee compensation. Personal spending growth was robust, the best in three quarters. Change in inventories fell, despite the rise of the absolute level of inventories to above the pre-pandemic trend for the first time. Falling exports of goods was the single largest issue. Housing growth was small, but better than the prior quarter's small contraction. PCE inflation rose sharply, which sets next week's FOMC to deal with the specter of stagflation. The 50 bp rate hike is a sure thing, but this will likely cool the rhetoric, which would be a positive surprise.

[Strategy dashboard]

there were as many as 1.5 million new confirmed cases daily – meaning that in any five-day period, something like 7.5 million people, or 5% of workers on payrolls, were in some form of isolation, and outside of full economic participation. That wouldn't have shown up in labor statistics, because they were home sick, not laid off.

- But as to the second part, about the decrease in government payments, we don't get it. Disposable personal income grew by 4.85% in the quarter at an annual rate, compared to a nearly flat 0.31% in Q4-2021 (please see the chart below). The negative contribution from decreased transfer payments and discontinued tax credits was minor, and far smaller than they had been in the previous quarter – and overwhelmed by strong growth in employee compensation.



- You can rightly complain that the personal income growth is only nominal, and that it is overwhelmed by the quarter's inflation. Fair enough, but neither the wrongly purported hit to incomes nor the rise in inflation deflected spending. Personal consumption expenditures grew at 2.7% at an annual rate, in real terms, the fastest pace since Q2-2021. It was the largest single contribution to net growth in the quarter – or, more accurately, the largest positive offset to contraction – at 1.83% at an annual rate (please see the chart on the first page).
- *So we continue to see very little argument for "fiscal drag" – rather, we are seeing the hand-off of the source of household income growth from the public sector to the private sector. That is purely a good thing.*
- *Net exports subtracted 3.20% at an annual rate, having contributed zero in Q4-2021 – this is seemingly the largest explanatory factor*, computationally. It's not because American consumers bought fewer imports – that growth rate was the same as the prior quarter,

a brisk 17.7% at an annual rate (computationally, import growth is a subtraction from GDP, because the imports are consumed domestically bur produced externally). The problem is that exports (which add to GDP, because they are produced domestically) contracted 5.9% at an annual rate, explained entirely by exports of goods. Why the export drop? War on the European continent? Lockdowns in China? Not sure about the former, but the latter will surely be resolved in the present quarter.

- *Some commentators this morning are pointing, as another explanation of the quarter's contraction, to possible cooling in the housing market thanks to higher mortgage rates. But residential investment was a small positive contributor in Q1-2022, at 0.10% – having actually been a negative one in Q4-2021 at -0.03%.* That said, while we don't see housing as a credible culprit for contraction in the quarter, of all the elements in play here its weak growth is not likely to be transitory.
- *We are disappointed by the reported decline of the change in inventories*, contributing 0.84% to the quarter's net contraction. We have been relieved – indeed delighted – to see the level of inventories finally grow above the pre-pandemic trend, having lagged it for almost two years, reflecting supply-change stress that has been contributing to statistical inflation (see "Data Insights: Supply Chain Stress Monitor" April 14, 2022).
- But in the GDP framework, what gets reported is not the change in the level of inventories quarter over quarter – thankfully, that level grew. Rather, what is reported is the double-derivative of that – the change in the rate of change of the level (that's the necessary logic to convert the level of inventories, a stock, into the flow terms that the rest of the GDP categories measure). *This means simply that the rate of growth in inventories decelerated slightly – not that the level fell. Inventories still lag sales, with the ratio at about historic lows – much faster inventory growth is inevitable.*
- *The Fed's particular conundrum here is that while real GDP contracted, the price index for personal consumption expenditures grew at an 8.0% annual rate, following Q4-2021's 7.1%. The core index grew 5.5%, up from 5.0%. These are the Fed's preferred inflation indicators, in which they express their target of 2.0%. At next week's FOMC meeting, Powell is going to have to do some fancy footwork to explain his aggressive hiking program in the face of what, at least in one quarter's GDP numbers, looks on the surface exactly like stagflation*. We're not at all saying that's what it really is – but some enterprising reporter or three will ask Powell about it at the post-FOMC press conference, for sure.
- *We're sure he'll come up with something, and that the expected 50 bp hike in the funds rate will arrive on schedule. But if this serves only to cool the Fed's over-the-top inflation-fighting rhetoric, which itself might be inflaming inflation expectations* (see "Video: What you're not hearing about inflation's dead canary in the coal mine" April 25, 2022), *that alone would be a positive surprise.*

Bottom line

A 1.4% GDP contraction in the midst of a post-pandemic productivity-led boom. In January and February, as much as 7.5 million were out sick from Omicron, so some weakness is expectable. BEA points to the discontinuation of transfer payments, yet personal incomes rose sharply – after the prior quarter's stagnation – on the back of employee compensation. Personal spending growth was robust, the best in three quarters. Change in inventories fell, despite the rise of the absolute level of inventories to above the pre-pandemic trend for the first time. Falling exports of goods was the single largest issue. Housing growth was small, but better than the prior quarter's small contraction. PCE inflation rose sharply, which sets next week's FOMC to deal with the specter of stagflation. The 50 bp rate hike is a sure thing, but this will likely cool the rhetoric, which would be a positive surprise.