October 27, 2022

U.S. GDP bounced back in Q3 but outlook weakening

- U.S. GDP rebounded by an annualized 2.6% after contracting in the first half of 2022
- Big add to growth from net trade offset further softening in domestic demand, led by weaker goods consumption and sharply lower residential investment
- Growth headwinds building with the Fed hiking interest rates aggressively – GDP growth to slow in Q4 and a recession to follow next year

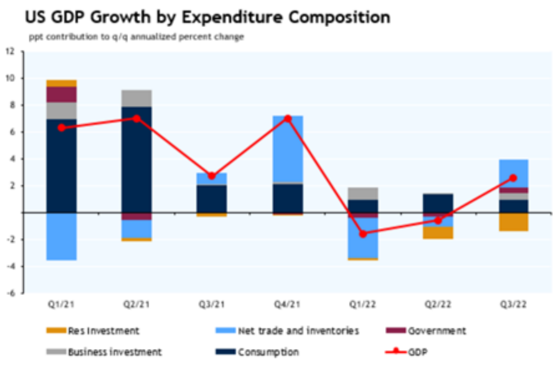
The 2.6% (annualized) increase in U.S. GDP in Q3 was the first in three quarters and fully retraced the decline over the first half of this year. But the details from today's report are softer than the headline growth rate would suggest, with all of the growth accounted for by a huge increase in net trade – something unlikely to be repeated given the sharply appreciating U.S. dollar. Similar to the second quarter, consumer spending was again propped up by resilience in services consumption (+2.8%), offsetting another decline in spending on goods (-1.2%). To-date, spending on services is still being supported by residual pandemic pent-up demand for leisure and travel. But even that should start to lose steam as rising borrowing costs and elevated inflation increasingly bite into households' buying power. Another 150 bps hike to the Fed Funds rate in the third quarter also meant more cooling in home resale markets. Residential investment fell by an annualized 26.4%, the largest decline in over a decade outside of the pandemic. Net trade added a bigger 2.8 percentage points to GDP growth, as ongoing moderation in supply chain bottlenecks supported a jump in exports all while lower demand for consumer goods suppressed imports.

Despite weaknesses in GDP data year-to-date, parts of the economy continued to show resilience. Those include more robust industrial output – which increased 3.0% annualized in Q3 to build on a 5.3% Q2 gain, and over a million jobs added in the same quarter. But growth momentum is starting to wane for pockets of the economy. Housing markets were among the first to soften with the Federal Reserve hiking rates aggressively to cap inflation pressures. Retail sales have weakened as well with demand, especially for household goods softening. That's contributing to a large inventory build-up at general merchandise stores and lower inventory investment among retailers. Demand for workers remained elevated but the number of job openings has also been slowing since spring. Meanwhile still-elevated price pressures mean the Fed is still a ways away from calling an end to its inflation battle. We expect another 150 bps of interest rate hikes from the Fed, with the terminal rate reaching 4.5% and 4.75% range by early 2023. That should be enough to drive a bigger pullback in consumer spending, lowering inflation persistently but also pushing the economy into a mild recession early next year.

US Quarterly GDP Summary

	Q4-21	Q1-22	Q2-22	Q3-22	Q3-22
		q/q annualized %			y/y %
GDP	**7.0**	**-1.6**	**-0.6**	**2.6**	**1.8**
Consumer spending	3.1	1.3	2.0	1.4	2.0
Business investment	1.1	7.9	0.1	3.7	3.2
Structures	-12.7	-4.4	-12.7	-15.4	-11.4
Machinery/equipment	1.6	11.4	-2.1	10.8	5.3
Intellectual property	8.1	10.8	8.9	6.9	8.7
Residential investment	-1.1	-3.1	-17.8	-26.4	-12.7
Exports	23.5	-4.6	13.8	14.4	11.3
Imports	18.6	18.4	2.3	-6.9	7.5
Net exports (q/q annl contribution)	-0.2	-3.1	1.2	2.8	
Inventories (q/q annl contribution)	5.0	0.2	-1.9	-0.7	
Household disposable income (q/q %)	0.2	-1.0	1.4	1.5	2.1
Saving rate (%)	7.3	4.3	3.4	3.3	

Source: Bureau of Economic Analysis, RBC Economics



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