Economic commentary from the Investment Advisory Group

The “I’s” have it – Inflation, imports, and inventories punched down first quarter growth

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Executive summary: The U.S. economy unexpectedly fell 1.4% on an annualized basis in the first quarter, missing the consensus expectations for an increase of 1.0%, and was well below the fourth quarter pace of 6.9%. On a nominal basis, first quarter growth was 6.5%.

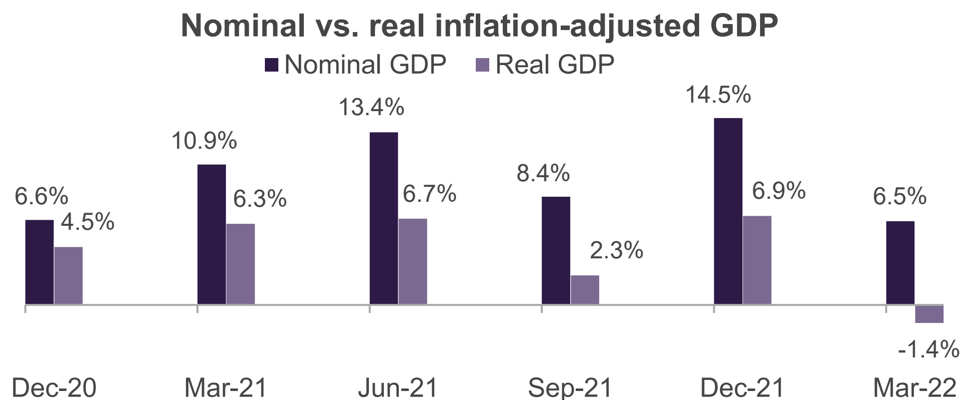
Additionally, net exports carved off 3.2 percentage points from real, or inflation-adjusted, gross domestic product (GDP) as imported goods surged (think backordered goods). Excluding net exports, real GDP rose a respectable 1.8%. Also, business inventories shrank, slicing off another 0.8 percentage points, since those backordered goods were simply delivered rather than accumulated for future sales.

More importantly, overall demand remained strong. Consumer and business spending reaccelerated, which are among the reasons we believe that the U.S. economy will avoid a recession. Unfortunately, we expect hotter inflation will persist, which means it will continue gouging real GDP for the next few quarters, though not as badly as the first quarter.

Inflation gouged real GDP

We typically only discuss inflation-adjusted or real GDP, which fell 1.4% on an annualized basis during the first quarter. Yet, with significantly higher inflation, it is fitting to also show the nominal figures, which grew 6.5% during the first quarter.

Higher inflation readings dramatically dented real first quarter GDP.



Data Source: Truist IAG, Bureau of Economic Analysis. Nominal GDP shown is unadjusted quarter over quarter change on a seasonally adjusted annual rate. Real GDP is inflation-adjusted based on chained (2012) dollars on a seasonally adjusted annual rate.

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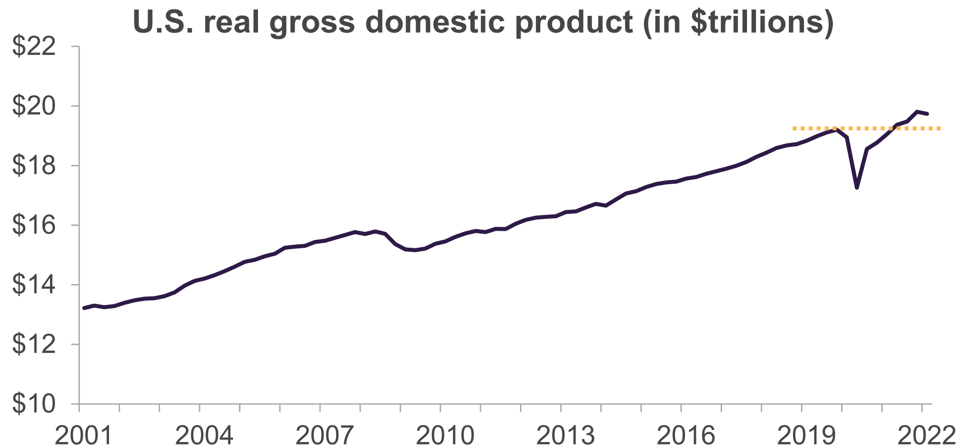
TRUIST

Wealth

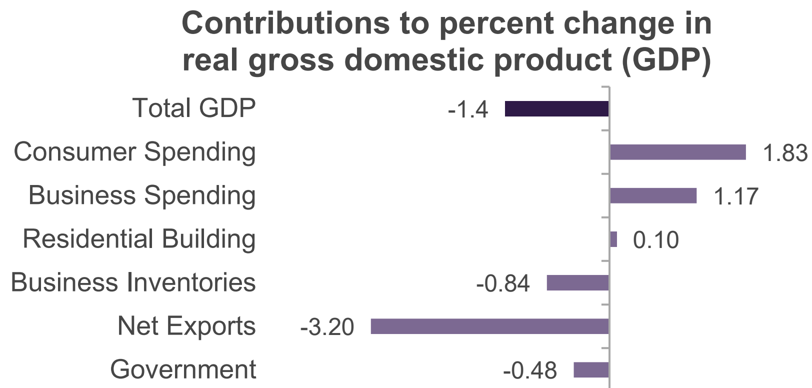
The U.S. economy slipped to $19.7 trillion in real GDP terms in the first quarter. Still, that's 2.8% higher than the pre-pandemic level. On a nominal basis, the economy expanded to $24.4 trillion.



Data Source: Truist IAG, Bureau of Economic Analysis;
Figures shown are inflation-adjusted (real) chained (2012) dollars on a seasonally adjusted annual rate.

A review of the major categories

Consumer and business spending reaccelerated during the quarter, but net exports, inventories, and government spending decreased.



Data Source: Truist IAG, Bureau of Economic Analysis;
Figures shown are inflation-adjusted (real) chained (2012) dollars on a seasonally adjusted annual rate.

Consumer spending reaccelerated as the overall pace grew 2.7%, the fastest pace in three quarters. Total consumer spending rose to $13.9 trillion, an increase of $93.1 billion quarter over quarter, and added 1.83 percentage points to overall GDP. Most of the reacceleration was services, which rose 4.3% compared to the 3.3% pace during the fourth quarter. Spending on goods ticked down 0.1 percentage point due to a variety of factors, including a 15.1% decline in gasoline and energy spending.

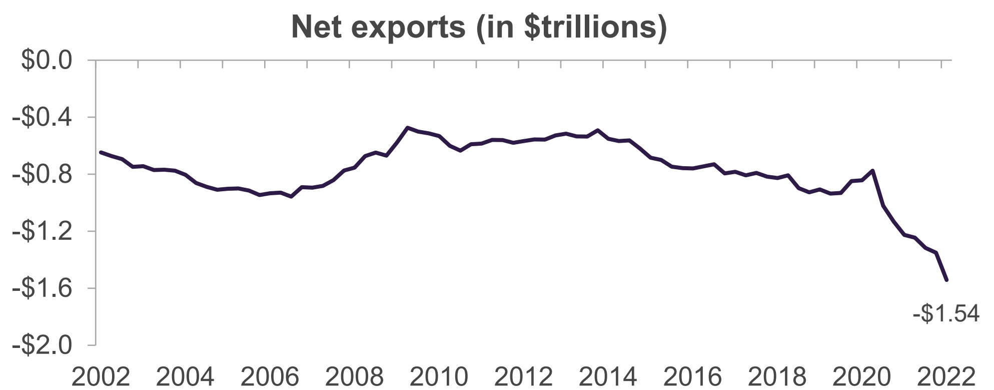
Spending on services has finally recovered to pre-pandemic levels. Still, spending remains more tilted towards goods rather than services compared to pre-pandemic trends, accounting for 39.3% and 60.7%, respectively. Typically, services comprise roughly 65% of consumer spending.

Residential construction rose 2.1% in the first quarter, the second quarterly increase in a row after two straight negative quarters (2Q21 and 3Q21). That added 0.10 percentage points to overall GDP. Given extremely tight housing supply in many areas, we expect that housing construction activity will continue to march higher in the coming quarters – even with higher mortgage rates.

The change in business inventories fell by $34.5 billion from the prior quarter, carving off 0.84 percentage points from overall GDP in the first quarter compared to the massive 5.32 addition during the fourth quarter. Although unusual, such large swings happen and will likely continue until the pandemic-related supply chain issues are fully repaired. Our read is that the inventory decline was related to backordered goods that were simply delivered rather than accumulated for future sales.

Outside of inventories, overall business spending reaccelerated to 9.2%—matching the fastest pace in four quarters—and added a hefty 1.17 percentage points to overall GDP. Commercial construction dipped 0.9% during the quarter, which was an improvement from a drop of 8.3% during the fourth quarter. The subcategories of commercial construction remained mixed with the exception of mining, which includes oil & gas exploration-related structures. Mining investment jumped 25.4% from the prior quarter, the sixth consecutive quarterly increase. Business spending on equipment jumped 15.3%, driven by tech and industrial equipment, while transportation equipment fell for the third quarter in a row.

Net exports fell to $1.54 trillion in the first quarter as imported goods surged and exports dropped.



Data Source: Truist IAG, Bureau of Economic Analysis;
Figures shown are inflation-adjusted (real) chained (2012) dollars on a seasonally adjusted annual rate.

Net exports dropped dramatically during the first quarter. Imports increased 17.7%, while exports fell 5.9%. Importantly, imports are the larger of the two categories by nearly three-to-one. Our read is the surge in imports was directly related to the aforementioned inventory decline. More specifically, it was the resolution of the huge backup at West coast ports, which was mostly corrected during the first quarter. Lastly, as we regularly note, the net export figures are based on incomplete data at this stage of the quarterly reporting process and are frequently revised.

Government spending fell 2.7%, slicing 0.48 percentage points from overall GDP. Spending on all three levels of government declined. Federal spending fell 5.9% as military spending dropped 8.5% from the prior quarter. Federal non-defense spending slipped 2.2%, its fourth straight quarterly decline. State and local spending fell 2.2% during the quarter.

Our take – Updated economic outlook

The first quarter was certainly weak. January was hurt by a series of unusually strong winter storms, which strafed much of the U.S., as well as the hangover of the omicron variant that was carried in from December and delayed some activities. Much of the economic data began to improve early in February as omicron faded, only to be upended by the Russian invasion of Ukraine.

The Russian military action aggravates the inflation situation globally for commodities (energy, agricultural, and industrial metals). Given a slim possibility that the conflict will be resolved quickly, we expect hotter inflation readings will linger for longer, especially with higher energy prices. That means inflation will continue gouging real GDP for the next few quarters.

Aside from energy, other upward inflationary pressures have generally cooled compared to 2021 and early 2022. For example, rents appear to be cooling from red-hot ’21, when effective rents jumped 12.7% year over year. Similarly, used car prices—which accounted for a roughly a quarter of the year-over-year increase in overall consumer prices—have declined for two months (February and March), and the mid-April reading was down as well. Wage pressures have also begun to abate, albeit slightly.

Ultimately, despite the negative headline GDP figure, this report validates our view that overall demand is strong, and consumers remain on solid footing, supported by strong wage and income growth. It is also supported by a wide range of solid economic data, including housing, retail sales, employment, and manufacturing gauges. For instance, the U.S. created 1.69 million jobs during the first quarter, while the unemployment rate has dropped to 3.6%, the same pace as December 2019.

Furthermore, business spending has also reaccelerated. For example, corporate travel bookings jumped 47% month over month in March, while remaining 30% below the pre-pandemic average. We expect the rebound in corporate travel to continue throughout 2022, along with overall business spending.

Our outlook for U.S. GDP growth in 2022 is 2.2% year over year. However, given the weaker-than-expected first quarter and stronger incoming April data, we suspect that our 2.2% figure may prove to be overly conservative and will be revised upward.

We reiterate our view that the U.S. is currently struggling with supply issues, not demand issues. We aren’t hearing complaints about a lack of demand. On the contrary, many companies are talking about “too much” demand for their capacity, which is being constrained by supply chain bottlenecks or insufficient labor, or both. Either way, that’s not a recipe for stagnant growth. Also, European demand for U.S. energy just started and should be reflected in upcoming quarters, particularly within mining investment and exports.

Lastly, the hot inflation readings within this report will keep the Federal Reserve (Fed) laser focused on inflation. We anticipate the Fed will follow through with a 0.50% increase in the Federal funds rate at their meeting next week and most likely another 0.50% at the mid-June meeting, which is also what markets appear to be expecting.

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