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REGIONS
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## Q3 2022 GDP: It Wasn't That Bad Then, It's Not That Good Now

- The BEA's initial estimate shows real GDP grew at an annualized rate of 2.6 percent in Q3
- A narrower trade deficit was the primary support for Q3 growth; a sharp contraction in residential fixed investment was a material drag

We like to think that we're equal opportunity pointer outers of noise in the economic data. For instance, when the BEA reported quarterly contractions in real GDP in each of the first two quarters of this year, our saying that underlying economic conditions were not as bad as implied by the headline numbers wasn't us being unable to admit that the economy was in a recession. Instead, we were simply pointing out that large swings in inventories and trade, as treated in GDP accounting, were resulting in quarterly changes in real GDP that were painting a misleading picture of underlying economic conditions, a point we've made often over the years regardless of whether real GDP was reported to be rising or falling. By the same token, us now pointing out that underlying economic conditions are not as good as implied by the reported increase – an annualized rate of 2.6 percent – in real GDP in Q3 isn't us unleashing our inner doom and gloom. It is, instead, simply a nod to the outsized impact of a smaller trade deficit in Q3 and the deterioration in real private domestic demand over the past few quarters. It is the latter that, at present, tells the much more meaningful story of where the U.S. economy is, not the headline Q3 real GDP growth number.

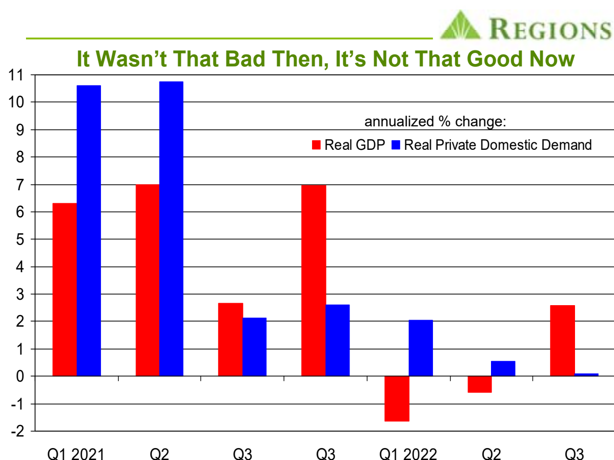
The 2.6 percent annualized growth in Q3 was between what we (2.9 percent) and the consensus (2.3 percent) expected. To our earlier point, real private domestic demand, comprised of consumer spending, business fixed investment, and residential fixed investment, was basically flat in Q3, logging just a 0.1 percent annualized increase. Real consumer spending rose at a 1.4 percent rate, an increase entirely driven by growth in services spending as real consumer spending on goods contracted for a third consecutive quarter. Services spending, which accounts for roughly two-thirds of all consumer spending, continued to grow in Q3 but did so at a slower pace than in Q2.

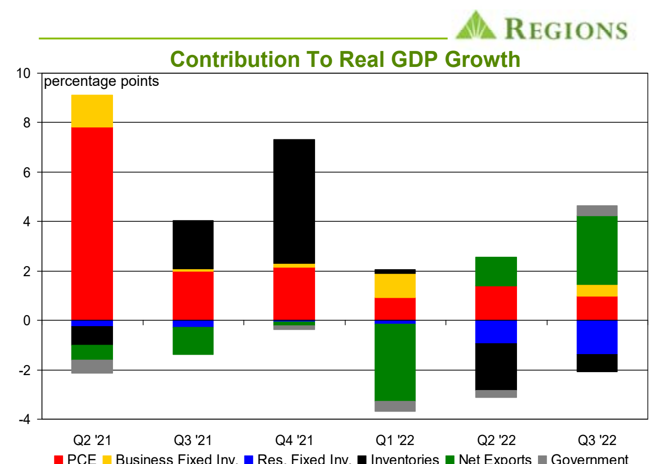
Real business fixed investment in equipment and machinery advanced at an annual rate of 10.8 percent in Q3, while real outlays on intellectual property products, the bulk of which is spending on computer software and research and development, posted annualized growth of 6.9 percent. A double-digit annualized decline, the third in the past four quarters, in real spending on business structures was a drag on total business fixed investment, which on net contributed 0.49 percentage points to top-line real GDP growth. Though business inventories rose further in Q3, that they did so at a slower rate than in Q2 meant inventories knocked 0.70 percentage points off top-line growth. Real residential fixed investment contracted at an annual rate of 26.4 percent, knocking 1.37 percentage points off of top-line growth, a testament to how higher mortgage interest rates have staggered construction and sales of single family homes.

A much narrower trade deficit added 2.77 percentage points to top-line real GDP growth. Real exports logged a second consecutive double-digit annualized growth, while real imports fell sharply. Trade flows have been significantly distorted since the onset of the pandemic, reflecting clogged global supply chains, shipping backlogs, and uneven demand.

As we do each quarter, we'll note that the BEA's initial estimate of GDP in any quarter is based on highly incomplete source data, particularly for inventories and trade. As such, BEA's estimates fill in the blanks and the estimate of GDP is refined as new source data come in and prior data are revised. The biggest surprise to us in the initial estimate is that business inventories are reported to have risen by much less than we anticipated, which accounts for most of our miss on our forecast of top-line growth.

The more relevant question isn't what the Q3 GDP report means for the FOMC – little to nothing – or whether it proves that the economy isn't in a recession – it doesn't, just as the 1H 2022 data did not prove that the economy was in a recession. Instead, the relevant question is what the Q3 GDP report tells us about the state of the U.S. economy heading into the year's final quarter. As we've made clear, we see the meager gain, just 0.079 percent unrounded, in real private domestic demand as being the most telling number. Real consumer spending on goods will fall further, services spending will slow, there are signs that business investment is wavering, and the housing market is reeling under the weight of higher mortgage interest rates. Moreover, the full impact of higher interest rates has yet to make its way through the economy. As such, we expect real GDP growth to hover around zero for the next few quarters.

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