



MORNING BRIEFING

January 31, 2018

Looking Under GDP's Hood

See the [collection](#) of the individual charts linked below.

(1) Growth is good and getting better. (2) The Q1 curse hitting Citigroup Economic Surprise Index. (3) Year-over-year growth in real GDP still more like 2.5% than 3.0%. (4) Will Trump's tax cuts boost economy's cruise speed? (5) Capital spending rebounding smartly, led by equipment spending. (6) Information processing equipment and software among the strongest components of capital spending. (7) Transportation equipment spending recovering from recent dip. (8) R&D at record high. (9) Inflationary pressures remain subdued in GDP.

GDP I: Still Cruising, Not Speeding. Last week's Q4 GDP report showed a gain of 2.6% (saar), following gains of 3.2% and 3.1% the prior two quarters—which was the first time in three years that GDP posted two consecutive quarters of 3.0%-plus growth. Debbie notes that “recent history suggests it will likely be revised higher.” The Atlanta Fed's [GDPNow](#) forecasting model had 3.4% for Q4 the day before the official number was released. Meanwhile, this forecasting model's handlers have moved on to Q1-2018 with a jaw-dropping gain of 4.2%.

That would be quite a change from the pattern of weak Q1 GDP growth rates reported since 2010, as we noted previously ([Fig. 1](#)). To eliminate this seasonal distortion in the seasonally adjusted data, Debbie and I prefer to track the yearly percentage change in real GDP ([Fig. 2](#)). This growth rate has been hovering around 2.0% since 2010. A few years ago, pessimistically inclined economists warned that in the past this rate had been the economy's “stall speed,” always preceding recessions. Instead, the economy continued to cruise at the stall speed without stalling.

Notwithstanding the strength of the last three quarters of 2017, real GDP remained near this speed, clocking in at 2.5% during the four quarters through the end of the year. If Trump's tax cuts boost economic growth to let's say 3.0% per quarter this year, then the y/y growth rate for 2018 would be 3.0%.

While the GDPNow model is starting the year bucking the Q1 curse, the same cannot be said for the daily Citigroup Economic Surprise Index (CESI), which has been surprisingly predictable since 2010 ([Fig. 3](#)). That's because it is still tracking the Q1 curse closely. It most recently peaked at 84.5 on December 22, and fell to a 1/29 reading of 35.5. By the way, the CESI is highly correlated with the 13-week change in the 10-year US Treasury bond yield ([Fig. 4](#)). This suggests that some of the upward pressure on the bond yield might dissipate for a while.

GDP II: Capital Spending Rebounding. The energy-led growth recession during the second half of 2014 through early 2016 was most visible in capital spending. This component of real GDP rose just 0.4% from Q3-2014 through Q4-2016 ([Fig. 5](#)). Since then through Q4-2017, it is up 6.3%. This may be partly attributable to the animal spirits unleashed by Trump's election. There is a good correlation between the CEO Outlook Index compiled by the Business Roundtable and the y/y growth rate in real capital spending ([Fig. 6](#)). Both rebounded simultaneously last year. Also contributing to the rebound in capital spending was that the energy sector had stopped slashing such spending at the end of 2016

and increased it as oil prices recovered ([Fig. 7](#)).

While the news is still full of articles about the sad state of America's infrastructure, now there is much less chatter claiming that US corporations aren't spending enough on their plant and equipment to remain competitive in global markets. That's because the data suggest that notion has been wrong all along, and particularly now. Let's have a closer look at which sectors are driving capital spending:

(1) *Equipment: IT*. Capital spending on equipment in real GDP stalled during 2015 and 2016, but rose to a new record high during Q4-2017 ([Fig. 8](#)). Leading the way higher through thick and thin has been information processing equipment, which soared 9.7% y/y last year to a new record high ([Fig. 9](#)). Interestingly, it has been setting new record highs consistently during the current expansion despite the flat trend in capital spending on computers ([Fig. 10](#)). This flat trend must be due to the cloud, which allows companies to rent the computing and storage services they need from cloud providers, which are able to operate servers much more productively than their customers ever could.

(2) *Equipment: Industrial and transportation*. Capital outlays on industrial equipment in real GDP rebounded sharply during 2010-2012 from the previous recession ([Fig. 11](#)). Such spending stalled near the previous cyclical high through 2016. It soared during 2017, rising 7.4% y/y through Q4 to a new record high.

Spending on transportation equipment also soared coming out of the previous recession ([Fig. 12](#)). However, it has continued to do so since, rising into record territory from Q4-2012 through Q3-2015. Then it dipped during the energy-led growth recession, and has been slowly recovering since the second half of 2017.

(3) *Software and R&D*. Software spending in real capital spending has been soaring in lock-step with IT equipment to record highs ([Fig. 13](#)). Lagging behind, but still managing to climb into record territory, is spending on R&D.

(4) *Structures*. Far less awe inspiring is capital spending on structures ([Fig. 14](#)). It remains below the two previous cyclical peaks. That seems to support the notion that companies aren't spending enough on their infrastructure. More likely is that they are using more industrial and information processing equipment more productively in refurbished facilities.

GDP III: Inflation Remains Subdued. The quarterly GDP price deflators don't get as much press as do the monthly CPI and PCED. Nevertheless, Debbie and I glance at the quarterly inflation data, though they are largely determined by the monthly inflation indicators, which focus on consumer inflation rather than economy-wide inflation. Of course, since the consumer accounts for so much of GDP, consumer inflation has a big weight in the GDP deflator.

The bottom line on the broadest inflation measure for our economy is that inflation remains subdued at 1.9% (y/y through Q4) for the overall GDP deflator ([Fig. 15](#)). Excluding food and energy, the figure is 1.8%. The PCED in the quarterly GDP shows inflation of 1.7% total and 1.5% core ([Fig. 16](#)). The market-based core PCED inflation rate was notably subdued at 1.2% last year.

CALENDARS

US. Wed: ADP Employment 195k, Employment Cost Index 0.6%, Pending Home Sales Index 0.4%, Chicago PMI 64.0, MBA Mortgage Applications, EIA Petroleum Status Report, FOMC Meeting Announcement 1.375%. **Thurs:** Total & Domestic Motor Vehicle Sales 17.3mu/13.1mu, Construction Spending 0.5%, Jobless Claims 235k, Productivity & Unit Labor Costs 1.1%/0.9%, ISM & Markit M-PMI

58.7/55.5, Weekly Consumer Comfort Index, Challenger Job-Cut Report, EIA Natural Gas Report. (*Wall Street Journal* estimates)

Global. Wed: Eurozone Headline & Core CPI 1.3%/1.0% y/y, Eurozone Unemployment Rate 8.7%, Germany Unemployment Change & Unemployment Claims Rate -17k/5.4%, Germany Retail Sales -0.4% m/m/2.8% y/y, UK GfK Consumer Confidence -13, Canada GDP 0.4% m/m/3.4% y/y, Australia CPI 2.0% y/y, Japan Consumer Confidence 44.9, Japan Housing Starts 1.1% y/y, China M-PMI & NM-PMI 51.5/55.0. **Thurs:** Eurozone, Germany, France, and Italy M-PMIs 59.6/61.2/58.1/57.3, UK M-PMI 56.5, Japan M-PMI. (DailyFX estimates)

STRATEGY INDICATORS

YRI Weekly Leading Index ([link](#)): Our Weekly Leading Index (WLI)—a good coincident indicator that can confirm or raise doubts about stock market swings—climbed 3.8% during the two weeks ending January 20 to a new record high. Our WLI is the average of our Boom-Bust Barometer (BBB) and Bloomberg's Weekly Consumer Comfort Index (WCCI). Our BBB also reached a new record high, jumping 6.7% over the two-week period, as jobless claims—one of the components of our BBB—fell from 250,750 to 240,000 (4-wa) over the time span, back near its cyclical low. The CRB raw industrial spot price index, another BBB component, climbed to its highest reading since September 2014. Meanwhile, the WCCI remains on a steep uptrend.

S&P 500 Q4 Earnings Season Monitor ([link](#)): With over 32% of S&P 500 companies finished reporting earnings and revenues for Q4-2017, their revenue and earnings surprise metrics are better compared to the same point during the Q3 earnings season. Of the 157 companies in the S&P 500 that have reported, 80% exceeded industry analysts' earnings estimates by an average of 4.9%; they have averaged a y/y earnings gain of 15.5%. At the same point during the Q3-2017 reporting period, a lower percentage of companies (74%) in the S&P 500 had beaten consensus earnings estimates by a lower 2.7%, and earnings were up a lower 10.1% y/y. On the revenue side, 82% beat sales estimates so far, with results coming in 1.1% above forecast and 7.9% higher than a year earlier. At this point in the Q3 season, a lower 72% had exceeded revenue forecasts by a slightly higher 1.2%, and sales had risen by a lower 5.5% y/y. Q4 earnings results are higher y/y for 82% of companies vs a lower 78% at the same point in Q3, and revenues are higher y/y for 68% during Q4 vs a higher 84% a quarter ago. These figures will change markedly as more Q4-2017 results are reported in the coming weeks. Q4's earnings surprise is typically smaller relative to Q3 because Financials typically clear their books at the end of the year, so we're pleased to see these metrics improving q/q. Despite the potential negative impact of write-offs related to the TCJA, Q4-2017 should mark the sixth straight quarter of positive y/y earnings growth and the seventh quarter of positive revenue growth.

US ECONOMIC INDICATORS

Consumer Confidence ([link](#)): "Consumers remain quite confident that the solid pace of growth seen in late 2017 will continue into 2018," according to The Conference Board's Director of Economic Indicators Lynn Franco. Consumer confidence in January was better than expected, climbing to 125.4, after falling from 128.6 to 123.1 in December—back to within 3.2 points of November's 17-year high. The expectations component drove this month's gain, jumping 4.7 points to 105.5, remaining in a volatile flat trend around recent highs. The Conference Board report noted that while expectations improved, "consumers were somewhat ambivalent about their income prospects over the coming months, perhaps the result of some uncertainty regarding the impact of the tax plan." The present situation component dipped a bit, from 156.5 to 155.3, remaining at historically strong levels. The six-month jobs' outlook showed the percentage expecting more jobs (19.0%) continued to surpass those expecting fewer jobs (11.8), with the spread widening from 3.0ppts to 7.2ppts this month, near recent

highs. Consumers' view of the current job market held around 16.5-year highs—with those saying jobs are plentiful (37.6%) at the highest percentage since June 2001, while those saying jobs are hard to get (16.4) was just above its cyclical low of 16.0% posted in December.

GLOBAL ECONOMIC INDICATORS

Eurozone Economic Sentiment Indicators ([link](#)): The January Economic Sentiment Indexes (ESI) for the Eurozone (-0.6 points to 114.7) and the EU (-0.4 points to 114.7) both eased slightly from December's 17-year highs. This month, ESIs for three of the five largest Eurozone economies improved—Spain (+0.9 to 110.9), the Netherlands (+0.9 to 112.9), and Germany (+0.6 to 116.0), while ESIs for France (-2.4 to 111.5) and Italy (-1.7 to 110.1) declined markedly, though remained at relatively high levels. At the sector level, confidence was mixed: construction (+1.5 to 4.6) and consumer (+0.8 to 1.3) confidence rose to new cyclical highs, while services (-1.3 to 16.7) and retail trade (-1.0 to 5.0) confidence fell from their recent highs; industry confidence was unchanged at its record high of 8.8.

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