SILVERCREST
ASSET MANAGEMENT GROUP

THIRD QUARTER GDP REPORT

Overall, this was a positive GDP report. After all the nit-picking and second-guessing is over, I expect the strong headline number, combined with the absence of any glaring weaknesses, will be supportive of the US stock market recovery. The low PCE inflation numbers that accompanied it should temper the upward pull on bond yields and downward pull on stocks from fears of an impending Fed rate hike.

An unusual fiscal year-end surge in defense spending added a bit more than half a percentage point (ppt) to the growth number, which will probably be given back next quarter. That caveat aside, the main takeaway should be that, contrary to the fears that drove the stock market sell-off earlier this month, the slowdowns in Europe and China – amid a multitude of other worries – have not pulled down the US economy. Growth in consumption and business investment moderated a bit from their sharp Q2 rebound, but remain in healthy territory. The housing market is weaker than we might like, but it is recovering from its winter downturn. Government spending levels have come down, but that's no longer a big drag on the economy. Inventory levels are being kept in check. Inflation remains below the level where the Fed would feel pressure to raise interest rates. Most importantly, perhaps, the US trade deficit is shrinking, and the US has returned to a "rebalancing" path in which growing exports and reduced dependency on oil imports is contributing to growth.

US real GDP rose 3.5% (on an annualized basis) in Q3, higher than the expected 3.1%. This compared to a decline of -2.1% in Q1 and a buoyant rebound of 4.6% in Q2. Over the past 12 months, real GDP has grown by 2.3%, while nominal GDP has risen at a rate of 3.9%.

The biggest driver of real GDP growth in Q3 was a fall in the US trade deficit, which contributed 1.3 ppts to growth. Exports rose by 11.0% (down slightly from 14.3% in Q2), but the real change was in imports, which fell -1.7% (compared to rising 11.3% in Q2). Given the strength of the other growth categories, this fall in imports does not appear to be due to shrinking domestic demand. More likely, it was due to expanding US domestic oil output (and reduced quantity of oil imports), as well as the impact of a stronger US dollar on the price of oil and other imports. In any event, it signifies the first positive contribution by net exports this year, and a return to the "rebalancing" trend of improving US trade balances we were seeing for the past several years.

The next biggest driver was personal consumption, which contributed 1.2 ppts to growth. Consumption rose 1.8% in Q3, which was a decline from 2.5% in Q2, but in line with the 2.0% average we've seen for the past 3 years. Personal consumption was led, in large part, by a 7.2% increase in spending on durables, extending a surge we saw in Q2.

The third biggest driver was government spending, which contributed 0.8 ppts to growth. For several years now, cuts in federal spending (under sequestration) have been a big drag on GDP, while spending by state and local governments has been weak. In Q3, state and local spending was up 1.3%, but the main contribution came from a 10.0% rise in federal spending, driven primarily by a 16.0% surge in defense spending. Without this unusual spike, overall GDP growth would have come in closer to 2.8%.

Business investment (nonresidential fixed investment) contributed 0.7 ppts to GDP growth (down from 1.2 ppts in Q2). It grew at a more moderate 5.5% pace in Q3, compared to 9.7% in Q2 (but still a big improvement on 1.2% in Q1). Business investment has been highly erratic for the past several years, and bears watching as a critical swing factor (in contrast to consumption, which has been remarkably steady, if sluggish).

Housing (residential fixed investment) grew by an unimpressive 1.8% in Q3 (down from 8.8% in Q2) and barely registered a positive contribution. However, this still signifies a marked improvement from this past winter (4Q13 and 1Q14), when a slowdown in the housing market was pulling down GDP.

The only "negative" contributor to GDP in Q3 came from a drawdown in business inventories, which subtracted 0.6 ppts from growth. Given the big surge in inventories that added 1.4 ppts to GDP growth in Q2, this drawdown is only to be expected. A reduction in that inventory build-up, sooner rather than later, is probably healthy.

PCE, the Fed's preferred inflation measure, fell to 1.2% in Q3, down from 2.3% in Q2. Core PCE, excluding volatile food and energy prices, rose 1.4% in Q3, down from 2.0% in Q2. Both are below the Fed's target inflation rate of 2.0%. While some may ring the alarm bell over "deflation", I would argue that these readings, combined with the strong GDP growth numbers (including resilient consumption and investment) do NOT imply that demand is collapsing, but that despite growing, the US economy has yet to encounter significant capacity constraints. This means the economy can continue growing for some time yet without the Fed having to raise interest rates to counter inflation.

Some are arguing that much of Q3's surprise GDP growth was "stolen" from next quarter, and that Q4 growth will come in lower as a result. I agree with this, but only in part. The surge in defense spending that added 0.7 ppts this quarter cannot be sustained, and will likely subtract the same amount from the Q4 figure. But I disagree with the argument that the strong dollar will damage the real growth outlook for Q4. The improvement in the US trade position is driven by real competitive advantages, such as cheaper energy costs, that will be only partly mitigated by an unfavorable exchange rate, and cheaper oil imports should free up more consumer dollars and boost consumption.

So should we worry about a potential reduction in Q4 GDP growth? In one sense, yes: the artificial "bump" to Q3 GDP growth from defense spending may have set the market up for a disappointment in Q4. When markets are disappointed, however unreasonably, they drop. But from the perspective of a longer-term investor, no, it really doesn't matter. Saying we should

downgrade our GDP growth projections for Q4 sounds terrible. In fact, given that Q3 came in above expectation, the real question is whether we should raise our growth expectations for the year as a whole. We are not raising them, because we recognize that some of the activity that showed up in Q3 was lumpy, and could easily have fallen into other quarters. But the spending was still real, and will contribute to annual GDP growth for 2014 coming in around 2.2%, which is what we were projecting before the latest numbers came out.

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