Rodney's Take

May 11, 2022

Checking on Growth Halfway Through the Second Quarter

The Federal Reserve is doing its best to destroy demand through higher interest rates. The bankers want to cool economic growth and thereby ease inflation, but it's not like the economy is zooming to the moon. Real first-quarter GDP growth fell far short of expectations, down 1.4% instead of up 1%, and so far, the second quarter isn't shaping up to be anything special, which might put annual growth back in the low range of the 2010s.

The Federal Reserve, which in December expected the economy to grow by 4% this year, lowered its estimate to 2.8% in March. Goldman Sachs has walked down its annual growth estimate four times since December, from 3.8% to 2.4%. With first-quarter growth negative, these estimates imply that the U.S. economy will pick up during the rest of the year to pull the average higher, but don't expect that sort of help in the second quarter.

The average real second-quarter GDP growth from the Blue Chip Economic Indicators survey is 2.8%, while the Atlanta Federal Reserve's GDPNow model estimates growth at just 1.8%. The estimates can and likely will change before the end of the quarter, but if the Blue Chip survey is correct, then the U.S. economy will have expanded at a 0.7% annualized pace in the first half of the year. If the Atlanta Fed's GDPNow model is correct, the average first-half growth rate will have been 0.2%.

Inventory numbers, exports, and weak government spending held down first-quarter GDP, while residential investment and consumer spending stayed up. Economists expect inventories and government spending to pick up significantly by the end of the year as consumer spending and residential investment remain steady.

I've got questions.

Weak auto production due to the parts shortage held down inventory numbers. There's no sign that this will change during 2022. Higher government spending estimates are based on greater infrastructure outlays funded by the recent stimulus bills. Some of that money will be spent as intended, but I wonder how much will be held up due to legal challenges and red tape. Then there are questions about continued residential investment and consumer spending.

The Fed's singular goal is to destroy demand, and they're just starting to do that. They've raised rates by 0.75% but won't start shrinking their balance sheet until next month. The effects of their actions are just starting to filter into the economy outside of the financial markets. I covered residential real estate in the current issue of the *Rodney Johnson Report*. Real estate might not crash, but it's hard to see how doubling mortgage rates will keep the good times rolling. Already, inflation is curbing demand, with consumers pushing back on high used-car prices and switching from expensive brands to store brands.

If the Fed successfully destroys demand and thereby lowers consumer spending and if the government can't push through significant infrastructure outlays, then it's hard to see how economic growth in the second half of the year will be strong enough to pull us up even to the modest level of the 2020s, say 1.5% to 2%. If the Fed has pressed too hard on the economic brakes, then we're likely to end up with near-zero growth, or worse. At that point, we'll be suffering through two of the three markers of stagflation, high inflation and weak or falling economic growth. Let's hope that doesn't lead to the third marker, rising unemployment.

The good news is that weak second-quarter growth could give both the equity and bond markets a bounce if investors expect the Fed to pause in its tightening cycle. The harder the economic landing, the more dramatic the rebound might be. While we wait for more data, conserve your cash and make a wish list of stocks and bonds you'd like to own. In the financial markets, we might get Christmas in July.

Rodney

Got a question or comment? You can contact us at info@hsdent.com.