

What's Behind the Q1 Slowdown?

The two most important questions for financial markets at present: what's behind the US Q1 slowdown and will economic growth rebound later in the year?

First quarter US GDP came in slow—much slower than expected. According to government estimates, the US economy grew just 0.2% annualized during the first three months of the year. Consumer spending slowed in Q1, adding just 1.3 percentage points to growth compared to 3 percentage points in Q4. Meanwhile, a decline in goods exports detracted a percentage point from topline growth, followed by nonresidential structures, which subtracted 0.75 percentage points.

The Q1 slowdown in structures investment may be attributed to weather and the West Coast port shutdown undoubtedly cut into goods exports. Further, Q1 GDP data has been weak throughout this recovery (see chart below). Since 2010, on average, Q1 GDP has grown at just 0.5% at a quarter-to-quarter annualized rate. In comparison, Q2s have averaged 3.0%, Q3s 3.1% and Q4s 2.6%. Will 2015 shape up the same way?

We think so. And, if we're right, the weaker Q1 figures won't change that much for the Federal Reserve. Policymakers will still be on track to hike rates later this year. Here is why.

The first reason the Fed hikes sooner rather than later: the labor market looks good. Job openings are at post-recession highs, initial claims for unemployment are near historic lows, the unemployment rate in 2014 recorded its biggest one-year drop since the recovery began and nonfarm payrolls expanded by over 3 million workers in the last year. We expect the April jobs report (to be released next

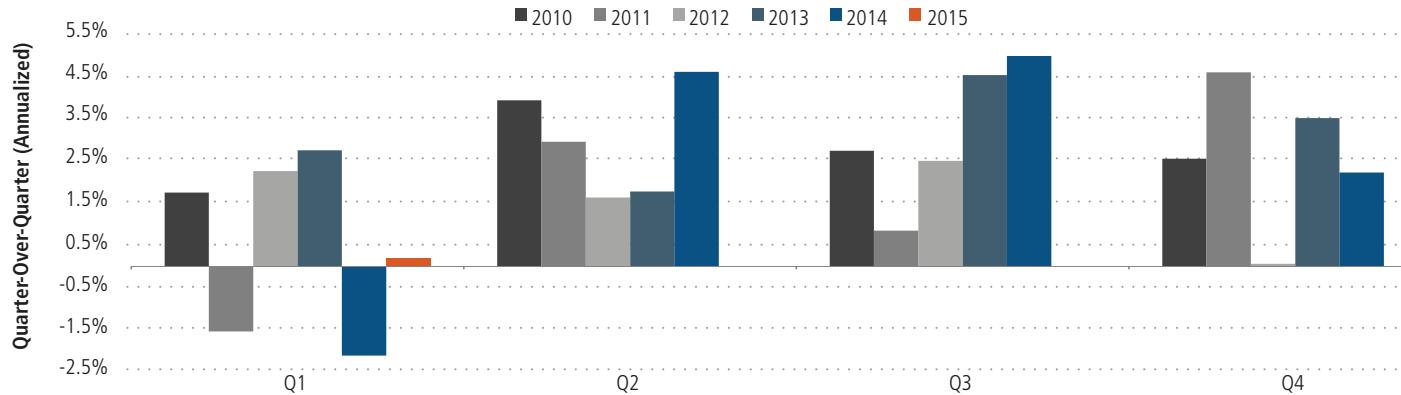
Friday, May 8th) to show a rebound in jobs added, up from April's underwhelming 126,000. Continued employment gains will bolster consumer income and spending in 2015.

The second reason the Fed hikes sooner rather than later: after a nasty shock last year, when oil prices were chopped in half, we think inflation has bottomed in the US. If we look sequentially, headline inflation jumped by an average of 0.23% in each of the past two months. What is more, a good predictor of future inflation, the Cleveland Fed's median CPI has been running consistently at around 2.2% year-over-year for the past 2 years.

In short, today's GDP report was disappointing. No doubt the stronger dollar and energy sector weakness pose risks to our more rosy outlook. But we think the first quarter data contain more noise than signal. The Fed seems to agree, saying in its policy statement released at the conclusion of Wednesday's April meeting that slower economic growth "in part reflect[s] transitory factors." The FOMC is making policy decisions based on a rebound in the data as well, not focusing on the weak Q1 GDP. If GDP growth rebounds to average 3% over the balance of 2015 as we expect, growth will achieve the Fed's expectations for the year, 2.4%.

If we are correct and the US data bounces back to life—April payrolls, we're looking at you!—we feel comfortable envisioning the Fed's first move before the market anticipates (as of this writing the market does not see the first rate hike until December). While the March FOMC statement contained the phrase that a hike was "unlikely" at the April meeting, no such phrase appeared in the April statement. As a result, each meeting going forward presents a live option.

Comparison of Gross Domestic Product (GDP) Growth Rate By Quarter, 2010-2015



Source: Bureau of Economic Analysis