

August 7 2017

THE 411 ON Q2 GDP

Matthew E. Peterson *Chief Wealth Strategist, LPL Financial*
Shawn Doty *Senior Analyst, LPL Financial*

KEY TAKEAWAYS

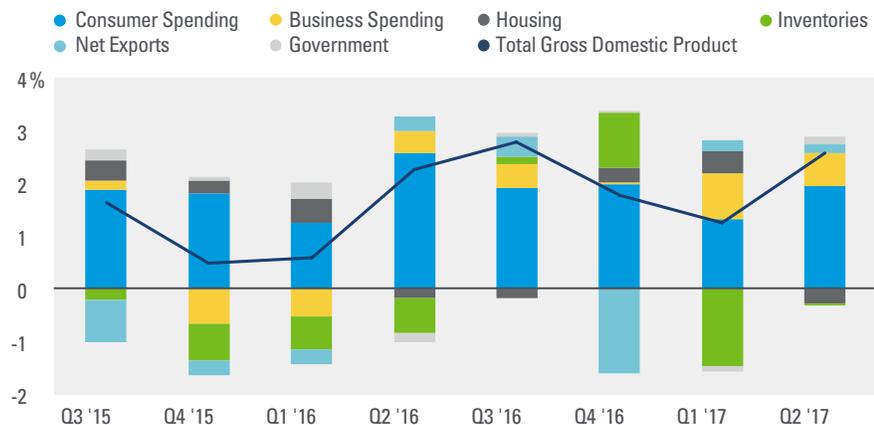
The advance estimate of Q2 GDP on July 28 showed growth at 2.6%.

Advance estimates of GDP are subject to several revisions over time.

The July GDP release also included revisions of data going back to 2014, which can help us understand how estimates can change.

The advance estimate of real GDP (GDP adjusted for inflation), released on July 28, showed the U.S. economy grew at an annualized rate of 2.6% in the second quarter, slightly missing consensus expectations of 2.7%, but accelerating from a downwardly revised 1.2% in the first quarter. Diving into the numbers, the data showed that consumer spending rebounded after a weak first quarter and business spending on equipment grew at an annualized rate of 8.2%, the highest growth in almost two years. The two disappointments were residential construction, which slowed after a strong first quarter, and inventories, which were expected to bounce after a sharp contraction in the first quarter but were basically flat [Figure 1].

1 CONTRIBUTIONS TO REAL GDP GROWTH BY ECONOMIC SECTOR



Source: LPL Research, Bureau of Economic Analysis 08/04/17

Gross Domestic Product (GDP) is a broad representation of economic output, and one of the most closely watched economic releases each quarter. Rather than measuring the end price of all goods and services sold, GDP measures the difference between input prices and output prices, making it a broad representation of the value an economy adds over time. The famous equation, $GDP = C + I + G + X$, may bring back (potentially bad) memories of economics classes, but indicates that the major inputs of GDP are consumer spending (C), business investment (I), government spending (G), and the net value of exports (X).

REVISIONS AND MORE REVISIONS

Those who read the [actual GDP report](#) released by the Bureau of Economic Analysis (BEA) may be confused to see a disclaimer that states, “The Bureau emphasized that the second-quarter advance estimate released today is based on source data that are incomplete or subject to further revision by the source agency. The second estimate for the second quarter, based on more complete data, will be released on August 30, 2017.” It may seem strange at first glance that market participants place so much importance on a report that is based on estimates and subject to revision. However, markets are forward looking, and investors are constantly creating their own estimates of GDP based on available economic data anyway, so the advance estimate can at least give an indication of whether the market’s own estimates are realistic.

As time goes on and more data is reported, the BEA updates the advance estimate. About a month after the advance estimate, a second revision comes out, which is then followed by a third revision about a month after that. Data revisions then continue annually each July for a period of three years, and a comprehensive review of GDP data back to 1929 is done every five years, with the next one due in 2018.

THE IMPACT OF REVISIONS

Though a lot of work goes into finding an accurate measure of GDP, the forward-looking nature of markets means that advance estimates receive the most attention. Markets would generally rather see less accurate data early on than wait for potentially more accurate data down the line. Given this preference, the annual revised data released in July of each year is not likely to drive markets, but remains important because it can give us a gauge of how accurate past advance estimates have been versus later revisions. If the BEA’s advance estimates are consistently good, markets are likely to put more importance on them.

This year’s July revisions show that the BEA’s estimation process, though far from perfect, is pretty good overall. Though the accuracy of individual quarters varies, the average difference between advance and third estimates over the past three years has been 0.3% [Figure 2]. The average difference between the third estimate and the final numbers in the July 2017 revision was another 0.1%.

THE PATH OF REVISIONS OVER TIME

While most of the BEA’s advance estimates have ended up being at least reasonably close to later

2 DIFFERENCE BETWEEN ADVANCE, THIRD, AND JULY 2017 ESTIMATES OF GDP BY QUARTER



Source: LPL Research, Bureau of Economic Analysis 08/04/17

revisions, a few outliers do exist, with the first quarter of 2015 sticking out as one of the largest. The advance estimate, released on April 29, 2015, showed one of the lower GDP growth numbers of the three years, at 0.2%. After falling even further for the third estimate to -0.2% (on June 24, 2015), the number was subsequently revised higher each July, until reaching its most recent estimate of 3.2% [Figure 3].

Thankfully, this kind of move is rare, but why did it occur? One explanation that some market participants have offered in recent years is that there may be a problem with the seasonal adjustment process used for the first quarter. Holidays, production schedules, and weather can cause GDP growth to increase or decrease seasonally, in fairly predictable patterns. Given that the purpose of the GDP report is to show changes in the underlying economy, the BEA adjusts the GDP number for these seasonal variations. However, we can also notice in Figure 2 that first quarter numbers seem to have more volatility in revisions than other quarters, indicating there may be a problem with the first quarter adjustment process. This volatility abated somewhat in 2016 and 2017, which may show that progress has been

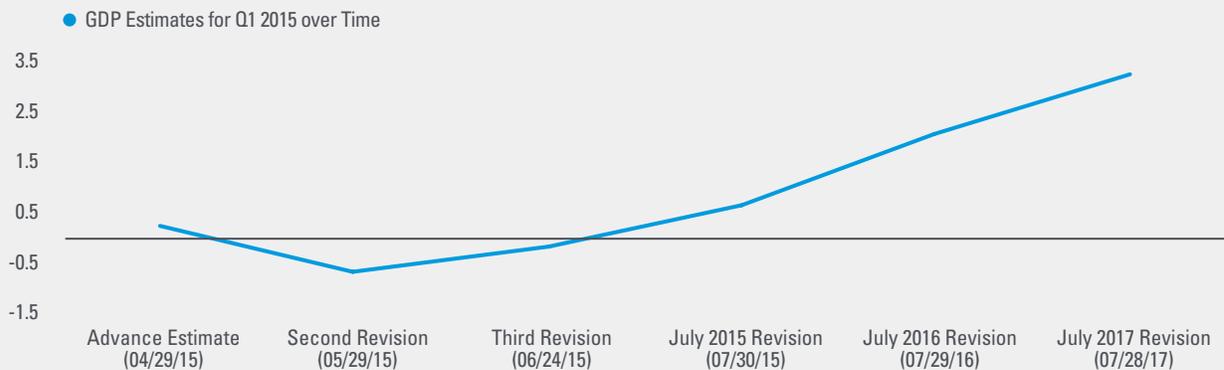
made on this issue, though the 2018 and 2019 annual revisions remain to be seen.

Looking at the underlying data, revisions in first quarter 2015 private domestic investment, which was increased from 2% growth in the advance estimate to 11.1% in the July 2017 revision, had the largest impact. Gains in business spending (structures moved from -23.1% to -2%) and residential investment (which moved from a 1.3% to 11.4% growth rate), were the biggest drivers of this change. Consumer spending and government spending also saw large upward revisions.

CONCLUSION

The advance estimate of GDP growth in the second quarter of 2017 was in line with economists' expectations, though a series of revisions in the coming months and years will provide a more accurate picture of growth. Outliers do exist, but past experience has shown that the BEA's advance estimates are generally fairly accurate. Strong consumer and business sentiment, prospects of fiscal stimulus, and continued support from business investment all

3 THE BEA'S ESTIMATION PROCESS IS GENERALLY GOOD, BUT OUTLIERS DO EXIST



Source: LPL Research, Bureau of Economic Analysis 08/04/17

increase the likelihood that the second quarter's growth rate is reasonable and sustainable. We continue to see GDP growth for the full year in the 2.5% range, as communicated in our [Midyear Outlook 2017: A Shift In Market Control](#). ■

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indexes are unmanaged and cannot be invested into directly.

Any economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

This research material has been prepared by LPL Financial LLC.

To the extent you are receiving investment advice from a separately registered independent investment advisor, please note that LPL Financial LLC is not an affiliate of and makes no representation with respect to such entity.

Not FDIC or NCUA/NCUSIF Insured | No Bank or Credit Union Guarantee | May Lose Value | Not Guaranteed by Any Government Agency | Not a Bank/Credit Union Deposit

RES 6007 0817 | Tracking #1-631709 (Exp. 08/18)