Core GDP in 2015:Q1

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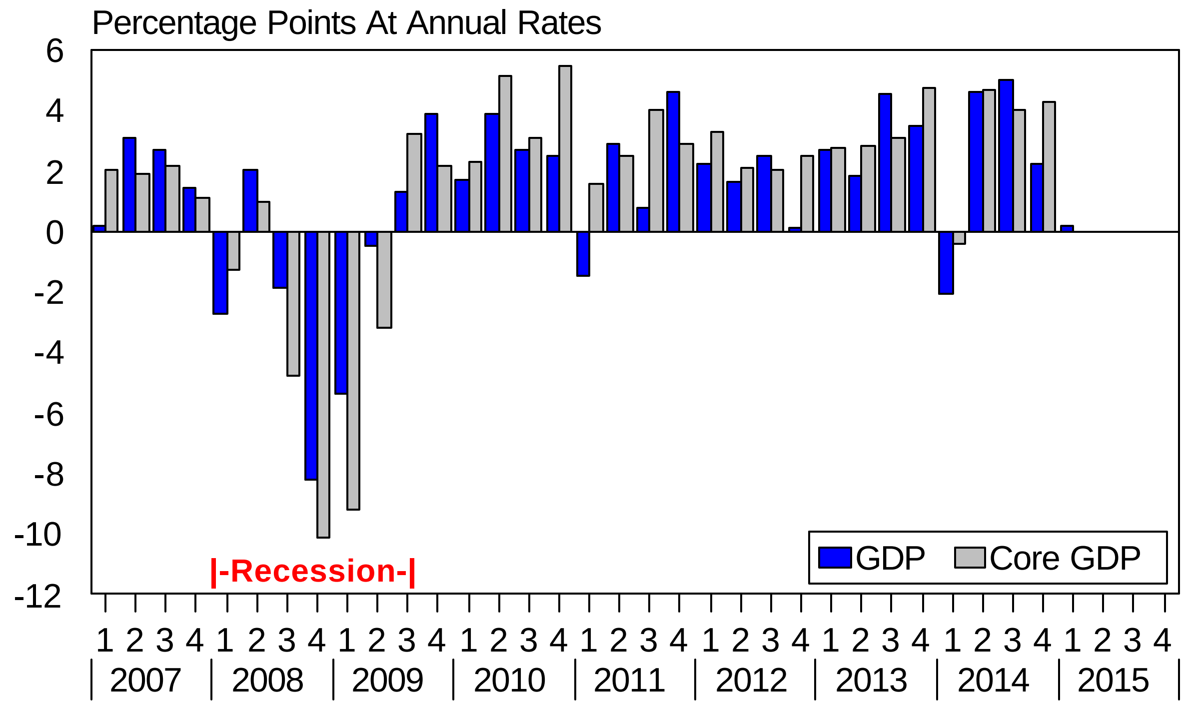
Chart 1
Selected Measures of Aggregate Economic Activity
Core GDP = PCE+BFI+Exports

The release this morning of the first quarter GDP figures has touched off yet another round of "we are all going to freeze in the dark". As I read through the report, however, another bit of advice, this from a baseball player, also a catcher, turned sage, about how to handle complicated situations came to mind.

No, I am not referring to my main man Yogi Berra. This time we turn to "Mr. Baseball" Bob Uecker, who said: "The way to catch a knuckleball is to wait until it stops rolling and then pick it up." This morning's report was certainly a knuckleball.

As you know, my preferred measure of aggregate economic activity is Core GDP, the definition of which appears in the caption of this chart. Because I think it is a better representation of what is going on in the domestic economy, I show it to you every time it gets updated. Today is just such an occasion. The fact that the latest reading, which is going to be revised several times, was negative was the proximate cause of your getting this report.



PCE = Personal Consumption Expenditures
BFI = Business Fixed Investment

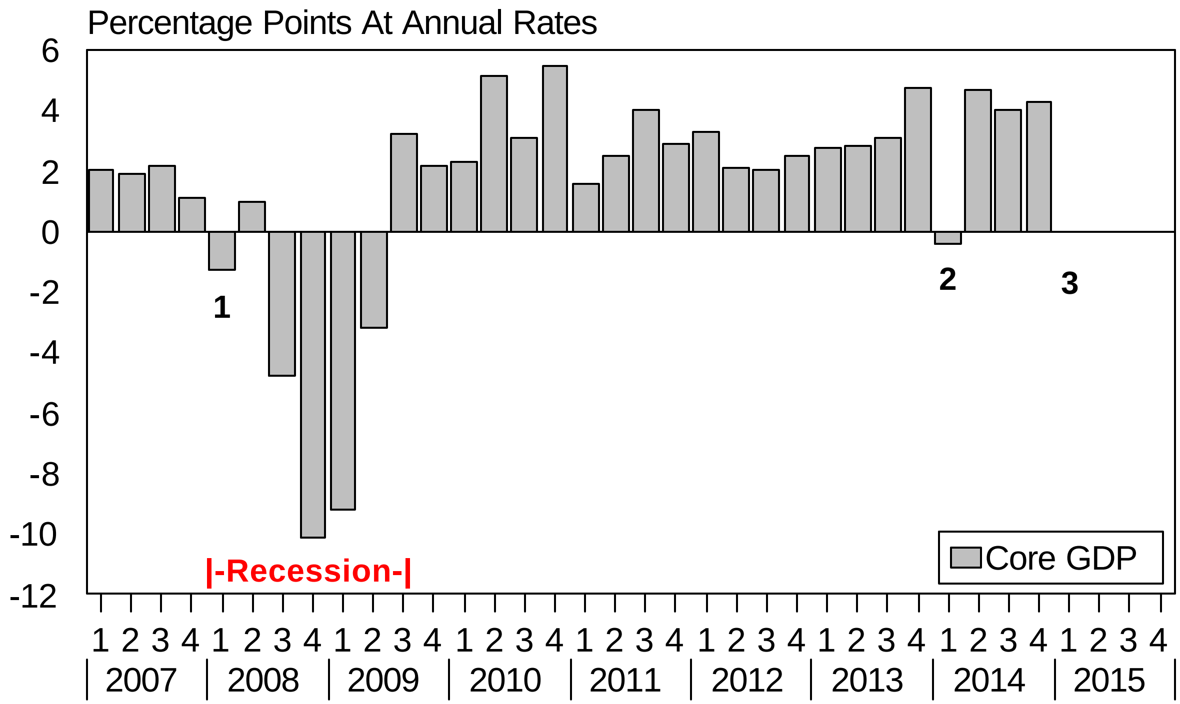
Date	GDP	Core
2014:2	4.6	4.63
2014:3	5.0	4.03
2014:4	2.2	4.29
2015:1	**0.2**	**-0.05**

Chart 2
Selected Measures of Aggregate Economic Activity

Core GDP = PCE+BFI+Exports

Under most circumstances, I limit the comments on Core GDP to the comparison between its performance and that of headline GDP you saw on Chart 1. This time, because it is a special report, I am going to take you through the behavior of Core GDP and each of its components. We will be paying special attention to the episodes you see here numbered 1 through 3. In each of those cases the Core reading was negative. How and why this was so is the first part of the analysis. What those readings mean is the second part of the analysis.

The first thing you will note is that all three episodes occurred in the first calendar quarter of the year. Episode 1 also happens to be in the first full calendar quarter of the last recession. The other two episodes are, respectively, the first quarter of 2014 and the first quarter of 2015.



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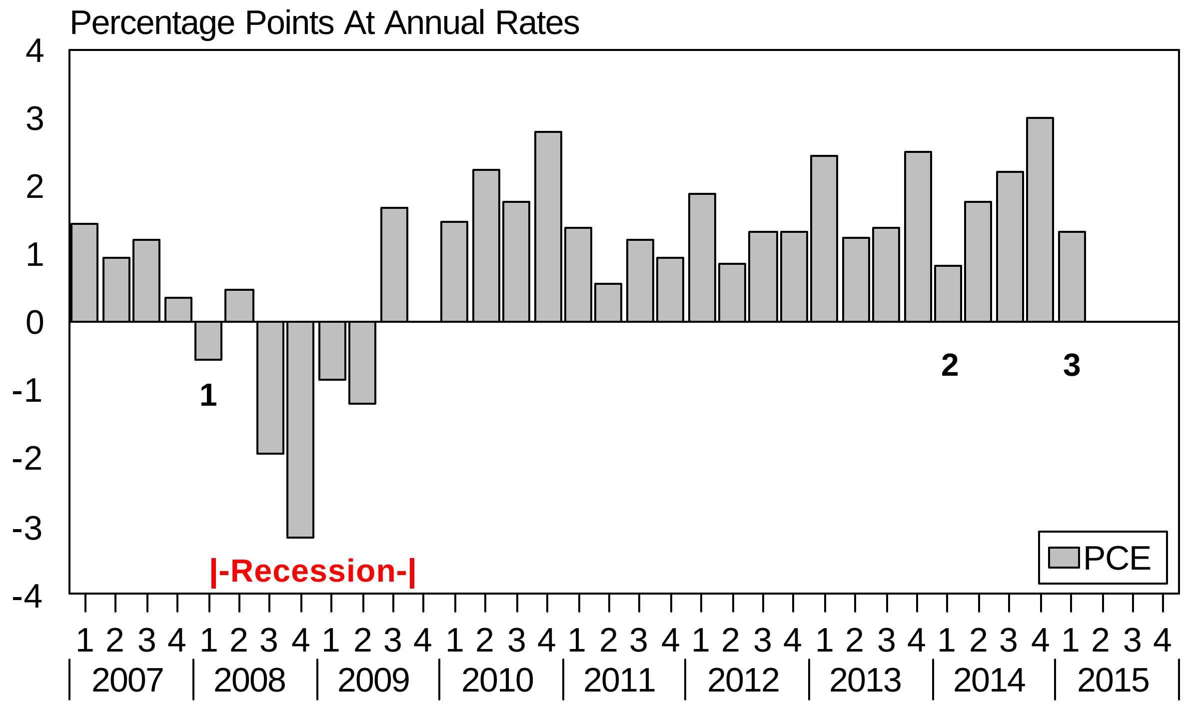
2015:1	**0.2**	**-0.05**

Chart 3
Selected Measures of Aggregate Economic Activity
PCE = Personal Consumption Expenditures

Let's start with PCE, which represents about 70% of the Core. As you see here, we had a negative reading in episode 1 and positive readings in episodes 2 and 3. The negative reading in episode 1 was the prelude to several more negative readings we would get during the recession. That move into positive territory you see in the second quarter of 2008 was largely the result of efforts by both the Federal Reserve and the Bush administration to deal with the weakening economy. As we know, those efforts failed.

But, the key takeaway from this chart is that PCE turning negative and staying negative is one of the hallmarks of recessions. Episodes 2 and 3 were not negative. And, for those of you saying, because you just looked at the inset table "consumer spending is slowing down", I say "did you go to the mall in January?"

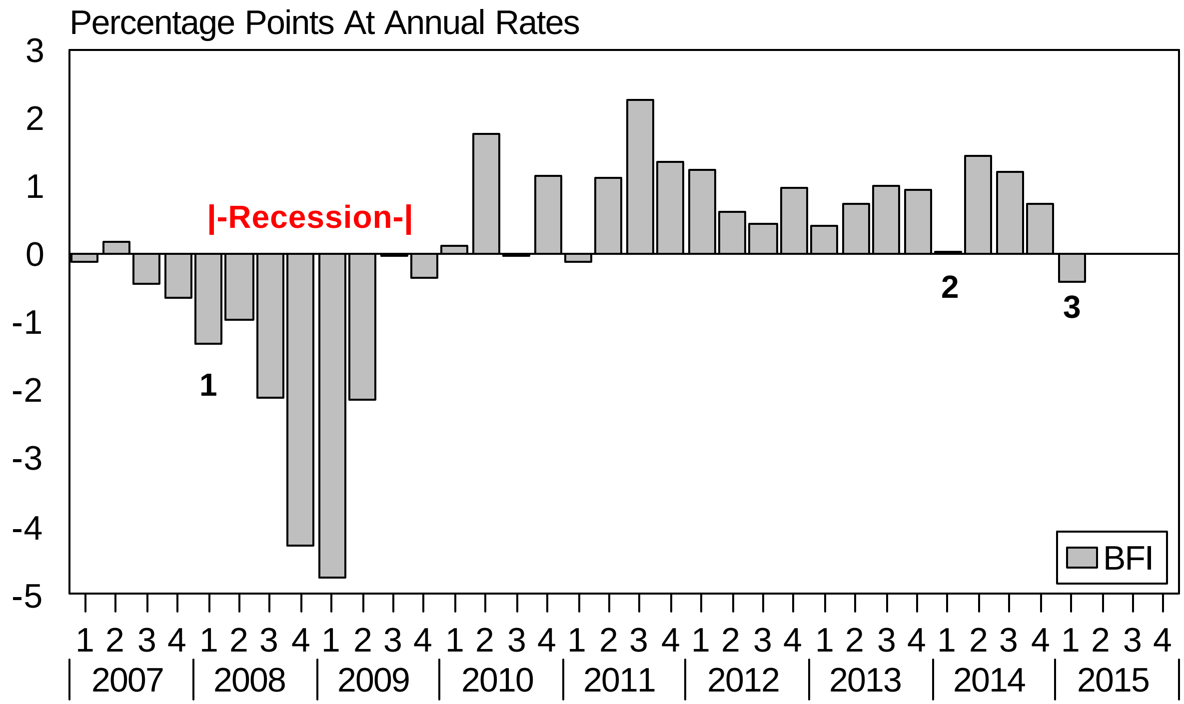


Date	GDP	PCE
2014:2	4.6	1.75
2014:3	5.0	2.21
2014:4	2.2	2.98
2015:1	**0.2**	**1.31**

Chart 4
Selected Measures of Aggregate Economic Activity
BFI = Business Fixed Investment

Next up, at about 17% of the Core, is BFI. As you see here, episode 1 was just one of many declines that took place before and during the last recession. As you also see, the recovery in BFI did not begin in earnest until 2011. Since that time we have been getting steady positive contributions from this component,

It is probably worth mentioning here that this series does not include the change in business inventories. Those get counted in what we call Gross Private Domestic Investment. Both because of their volatility, and the fact that one cannot interpret changes in inventory levels in isolation, we exclude inventories from the Core.



For the record, there was an inventory build during the first quarter of 2015. But we don't know how much of it was voluntary, because businesses wanted more stock on hand, and how much was involuntary, because businesses could not move the goods. More about this in a moment. But before we get into that, it is worth pointing out that the slower pace of BFI over the last several quarters could be associated with the normal shifting of gears that comes about over the course of the business cycle as firms who have made planned expenditures reduce their pace of spending.

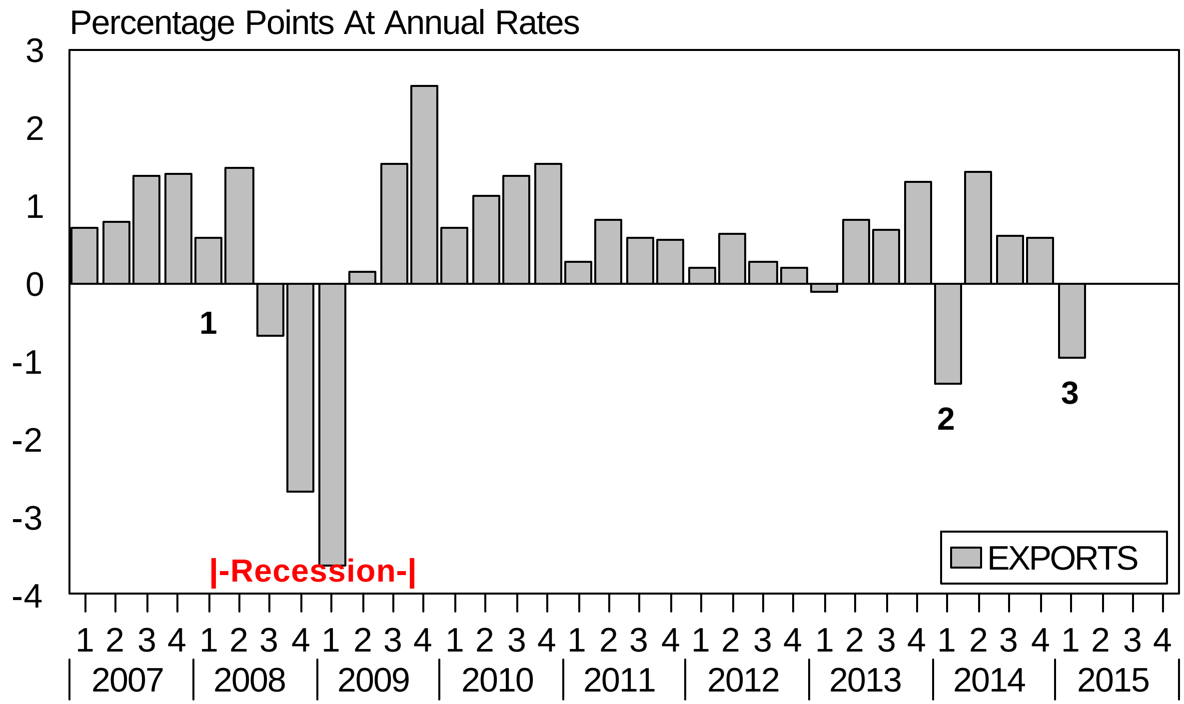
Date	GDP	BFI
2014:2	4.6	1.45
2014:3	5.0	1.21
2014:4	2.2	0.72
2015:1	**0.2**	**-0.40**

Chart 5
Selected Measures of Aggregate Economic Activity

Last up, at approximately 13% of the Core are exports. And this is where voluntary and involuntary movements of goods come into prominence. Both this year and last, there have been physical impediments to the movement of goods through the ports. In 2014 these had mostly to do with the effects of the Polar Vortex on roads and railroads. In 2015 we had those problems, although to a lesser degree, as well as the near shutdown of the ports of Long Beach and Los Angeles because of a prolonged labor dispute. Additionally, in 2015, we also see the effects of a slower pace of economic activity in Europe, which had already contributed to the smaller positive contributions made by exports in the second half of 2014.

These factors are part of the reason for our remarks about the inventory build made on the previous chart. Goods that are stacked up at a port waiting to get on a ship get counted in inventory until they get on the ship. The latest reports from the west coast suggest that it will be several months before the backlog of containers finally clears the docks.

Exports



PCE = Personal Consumption Expenditures
BFI = Business Fixed Investment

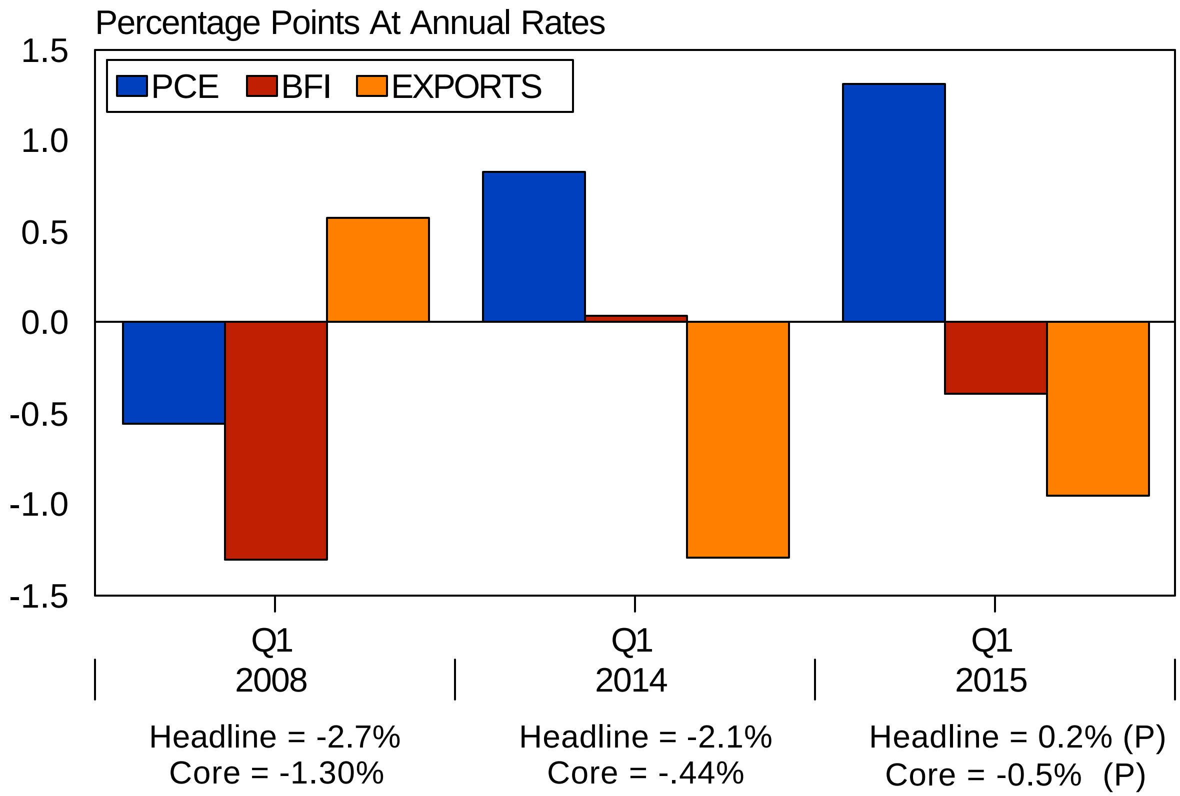
Date	GDP	Exports
2014:2	4.6	1.43
2014:3	5.0	0.61
2014:4	2.2	0.59
2015:1	**0.2**	**-0.96**

Chart 6
Selected Measures of Aggregate Economic Activity

Components of Core GDP

This chart, and the one that follows, bring together the information on the three components of Core GDP in two different ways.

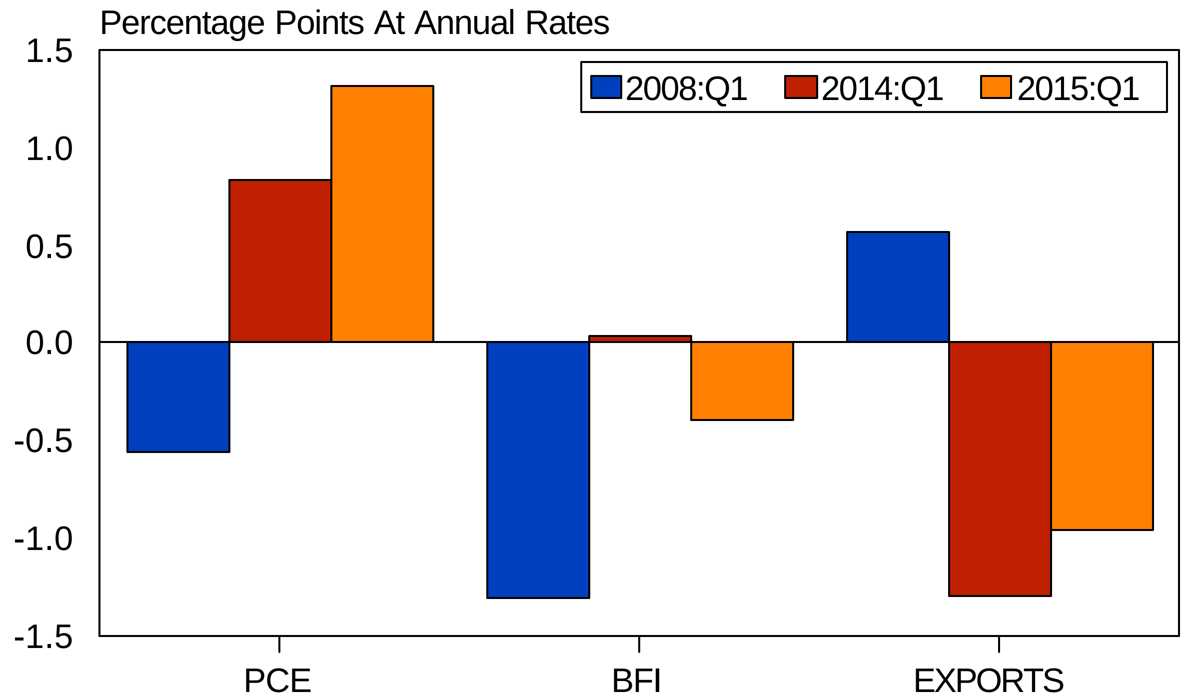
Here we display the three components in each of the three episodes so that you can see their combined effects. The numbers that appear below each of the dates are the rates of change of headline and Core GDP in each quarter. We put (P) after the latest readings as a reminder that they are preliminary and subject to revision.



PCE = Personal Consumption Expenditures
BFI = Business Fixed Investment

Chart 7
Selected Measures of Aggregate Economic Activity
Components of Core GDP

The other way to group these data was to grab each component's bar in each episode and put them together. As I had mentioned earlier, all three episodes that we examined happened in the first calendar quarter of the year. From the looks of this chart it appears that there could be some calendar effects at work with BFI. Which would not be entirely surprising as I have noted that there tends to be some clustering of capital spending in the fourth quarters of most years, most likely because of the way budgets are managed. For example, a lot of trucks are purchased in December and very few are purchased in January. Similarly, not a lot of construction activity takes place during the winter months. While the seasonal adjustment process is supposed to take care of the bulk of those effects, that process is far from perfect.

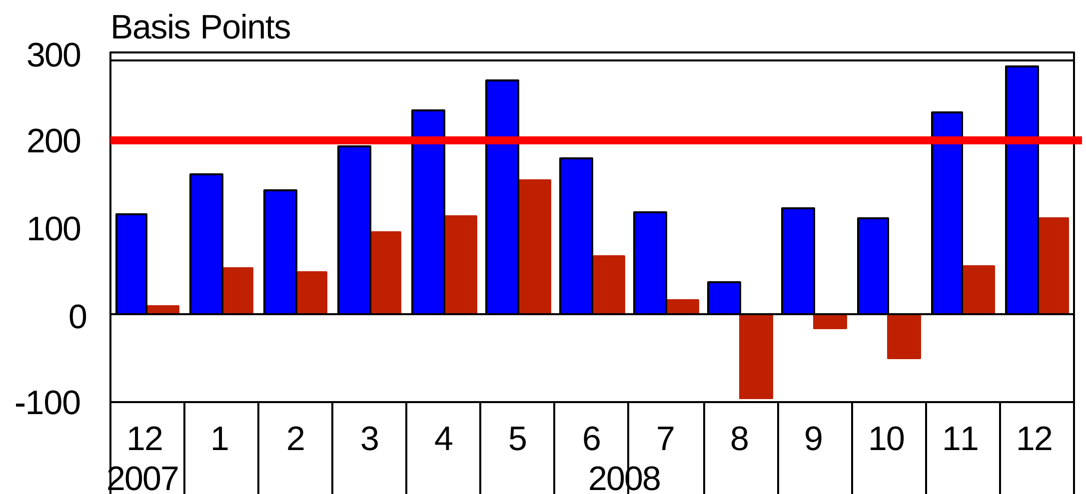


PCE = Personal Consumption Expenditures
BFI = Business Fixed Investment

Chart 8
Aggregate Spreads -- Forecast Summary

The last aspect I wanted to address is what the latest readings on Core GDP might be telling us about the overall state of the economy. To do that I am going to show you what our forecast summary page looked like in episodes 1 and 2. We will conclude with the current forecast summary as part our discussion of episode 3.

This is what the forecast looked like in April of 2008. We had the data for the first three months in hand, and the values of the Aggregate Spreads for the rest of 2008. As you see here both of the Aggregate Spreads were either in the Danger Zone, or negative. What's more, by February, all three of the coincident indicators had turned red. Which means we would have taken the Core GDP news as further confirmation that either a recession had already started or soon would.



	12	1	2	3	4	5	6	7	8	9	10	11	12
Traditional	**115**	**160**	**143**	**194**	**233**	**268**	**180**	**117**	**37**	**123**	**111**	**231**	**285**
Enhanced	**10**	**54**	**50**	**95**	**114**	**155**	**68**	**17**	**-94**	**-14**	**-50**	**56**	**110**
Pvt. Payrolls	**0.74**	**0.54**	**0.4**	**0.16**									
Ind Prod	**2.14**	**2.37**	**0.99**	**0.59**									
DeltaDelta	**-10.11**	**-12.85**	**-14.3**	**-22.82**									

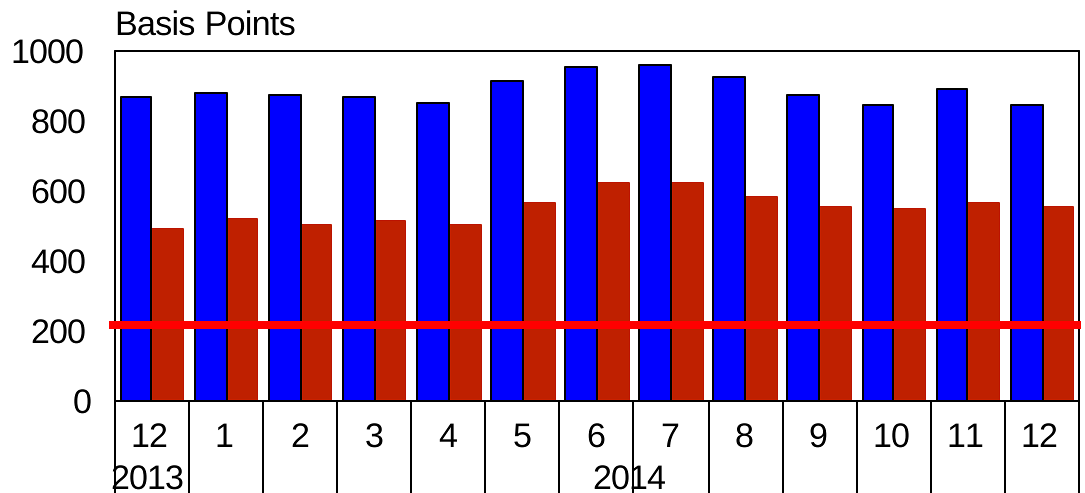
Recession Associated Level
Private Payrolls <1.00% and falling
Industrial Production <1.00% and falling
DeltaDelta <0.0% and falling

Keep in mind that the announcement of the actual peak date of December 2007 did not happen until December of 2008. So, we would have been forecasting the official start date when we were putting this chart together. While we would have already known about Bear Stearns, Lehman was still six months away. But the warning signs were there, as the track of the Aggregate Spreads was telling us that it would be a while before we saw improving economic conditions.

Chart 9
Aggregate Spreads -- Forecast Summary

This is the chart from April of last year. Here, the board is green and the track of the spreads is well above the Danger Zone. This was the chart with which I told you that all of the forecasts of a recession in 2014 were likely to be wrong. And so it turned out.

Once the Polar Vortex receded and goods began to move again, the pace of aggregate activity picked up. As you know from having seen this chart progress over the course of the year, the rest of the entries for the coincident indicators were green.

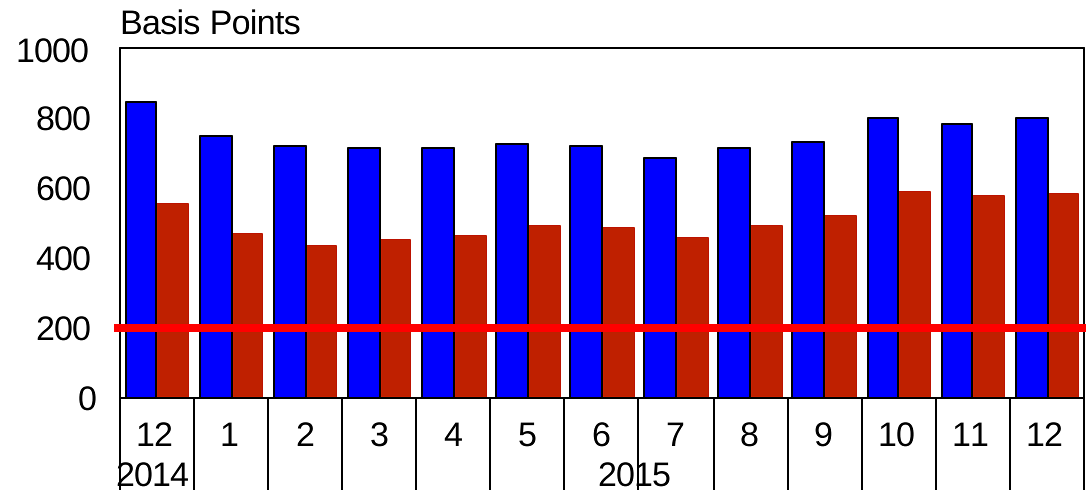


	12 (2013)	1 (2014)	2	3	4	5	6	7	8	9	10	11	12
Traditional	**870**	**880**	**872**	**868**	**852**	**911**	**955**	**959**	**922**	**874**	**845**	**891**	**847**
Enhanced	**488**	**521**	**502**	**511**	**499**	**566**	**623**	**623**	**584**	**551**	**549**	**564**	**554**
Pvt. Payrolls	**2.17**	**2.13**	**2.02**	**2.09**									
Ind Prod	**3.25**	**2.94**	**3.24**	**3.64**									
DeltaDelta	**44.79**	**35.44**	**35.75**	**29.99**									

Recession Associated Level
Private Payrolls <1.00% and falling
Industrial Production <1.00% and falling
DeltaDelta <0.0% and falling

Chart 10
Aggregate Spreads -- Forecast Summary

This is the chart that ran in last month's report. And it is another opportunity for me to mention the “what did they know and when did they know it” process that underlies the work we do. As of right now we know that the model is saying the economy should continue to move forward in 2015, and the track of the coincident indicators has been fully supportive of that notion. The arrival of a piece of information such as Core GDP that seems to be out of pattern is a reminder that we have to be always vigilant for something that might be indicative of a different course. That vigilance includes close examination of the particulars of what caused the out of pattern event. We saw, in the review of the components of Core GDP that there could be calendar issues as well as special factors at work.



	12	1	2	3	4	5	6	7	8	9	10	11	12
Traditional	**847**	**748**	**723**	**715**	**718**	**725**	**722**	**688**	**717**	**733**	**799**	**783**	**802**
Enhanced	**554**	**472**	**437**	**450**	**465**	**493**	**484**	**461**	**494**	**519**	**587**	**577**	**583**
Pvt. Payrolls	**2.63**	**2.64**	**2.72**	**2.63**									
Ind Prod	**4.59**	**4.42**	**3.56**	**2.05**									
DeltaDelta	**27.81**	**25.55**	**31.09**	**28.35**									

<u>Recession Associated Level</u>
Private Payrolls <1.00% and falling
Industrial Production <1.00% and falling
DeltaDelta <0.0% and falling

As I said at the outset, the first quarter GDP report is a “knuckleball”. And, I think we would be well served by Mr. Baseball's advice to let it stop rolling (in other words wait for the revisions and any other explanatory information) before we pick it up. Next week we get the employment report for April. With any luck, and the good graces of Saint Offset, there will be some information that will allow us to gain more clarity on the course of economic activity over the balance of 2015.

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