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CHG Economic Report – 3rd Quarter GDP Update

Key Takeaways

- *Improving consumer sentiment and recent wage gains appear to be driving increased personal consumption.*
- *Net investment is anticipated to grow given uptick in investments in rolling stock, aircraft deliveries, and manufacturing.*
- *Residential investment continues to underperform and is concerning given housing shortage.*
- *Despite a slight positive for GDP, advanced Census Bureau data suggests Americans continue to leverage foreign companies; annualized trade deficit continues close to $1 trillion.*
- *Market pricing in another 25BPS cut in December.*

Economy Grade

B+

Consumers are spending but preliminary data suggests an increasing reliance on foreign goods.

Rate Cut Probability

97% (95% 25 / 2% 50)

Recession Probability

19%

Initial round of data from the BEA and Census Bureau point to continued consumer spending strength; however, there are lingering concerns around the trade deficit, negative residential structural investment, and the continued increase in consumer debt. Despite these concerns, with the East-Gulf Coast strikes in the rearview mirror for now and expected monetary loosening, we have raised our grade of the U.S. economy.

Solid Core GDP Growth

As illustrated below, the CHG model shows GDP growth tracking at 3.2% versus the Atlanta Fed at 3.3%:

Component	CHG	Atlanta Fed	Prior Qtr.
Personal Consumption	2.753%	2.430%	2.120%
Residential Investment - Structures	-0.180%	-0.380%	-0.097%
Non-Residential Investment - Structures	-0.059%	-0.030%	0.005%
Non-Residential Investment - Equipment	0.134%	0.540%	0.534%
Intellectual Property Investment	0.385%	0.300%	0.277%
Net Exports	0.041%	0.040%	-1.127%
"Core GDP"	3.075%	2.900%	1.711%
Change in Inventory	-0.128%	0.060%	0.830%
Government Spending	0.281%	0.380%	0.268%
Total	3.228%	3.340%	2.809%

As illustrated above, CHG is forecasting greater Personal Consumption and a lower drop in Residential Investment vis-à-vis the Atlanta Fed offset by a steeper drop in the inventory growth rate and lower level of equipment investment. Further analysis on each GDP component follows.

Personal Consumption

Real Income Growth / Lower Rates Buttress Spending

Easing inflation, rising incomes, and improving consumer confidence have Americans spending more: personal consumer spending is on pace to contribute 2.8% to 3rd quarter GDP; the highest level this year (**Chart 1**). While Americans' purchases of new cars appears to be cooling, purchases of non-automotive related goods remains robust, tracking at 5.9% annualized growth. Similarly, spending on services is tracking at 2.9% annually.

The increase in consumer spending is somewhat surprising given that consumers continue to struggle with a heavy debt load (see **Chart 2**). American debt service to real income remains at a record high, 20% of American take home income is used to service debt, and is reflected by consumer credit card >90 delinquent balances exceeding 10%, the highest since the Great Recession. On a more positive note, inflation has moderated to 2.6% from September '23 through September '24 and at an annualized rate of 2.4% for the latest quarter. Though the annual rate remains above the Fed's target rate of 2%, the slowdown in price increases over the last several months and a cooling job market give the Fed plenty of impetus to continue with their rate cuts. Without continued rate cuts, we believe this level of consumer spending to be unsustainable.

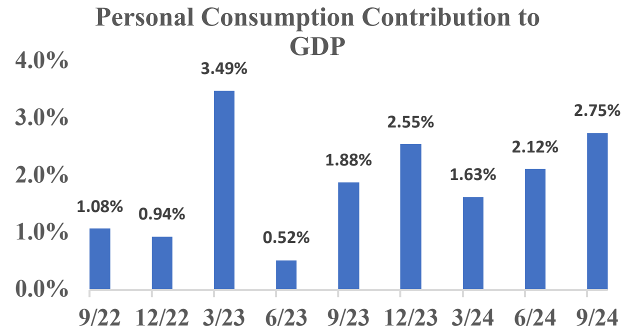


Chart 1

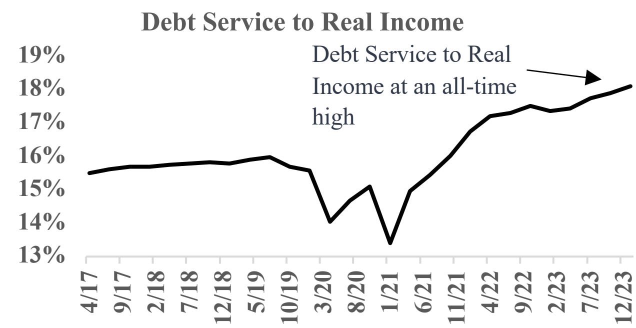


Chart 2

Residential Investment – Structures

Homebuilders Continue to Pull Back

Residential investment appears headed for a second straight decline in the 3rd quarter (See **Chart 3**). Through August, annualized multi-family and single-family home construction declined approximately 1.3% and 3.8%, respectively. Further, broker commissions will likely be dampened as a decline in existing home sales volume (-3.6%) outpaced increases in new home construction and rising residential prices. This decline was partially offset by increases in advanced retail sales of home improvement and building materials, the first notable increase in 3 quarters.

That said, the Home Builder Confidence Index, as measured by the Wells Fargo Housing Market Index reversed several months of decline, hitting 43 in October. As we suggested in our previous update, homebuilder confidence is closely tied to Fed interest rate policy and appears set to improve given the Fed's stated plan of monetary loosening.

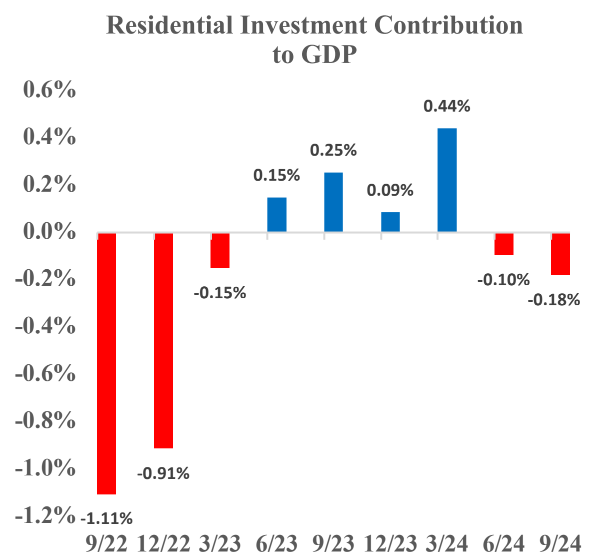


Chart 3

Non-Residential Investment – Structures

Trend Continues

Like residential investment, non-residential structural investment seems likely to register negative growth in the 3rd quarter (see **Chart 4**). Advanced data on deflated non-residential construction spending suggests a -0.9% decline quarter over quarter. Further, both oil / gas and mining industrial production each suggested deepening investment contractions in their respective industries.

The two largest components of structural non-residential investment, commercial building and utilities, have pulled back 1.4% and 0.4%, respectively. Hospitals and churches also appear to have declined in the 3rd quarter.

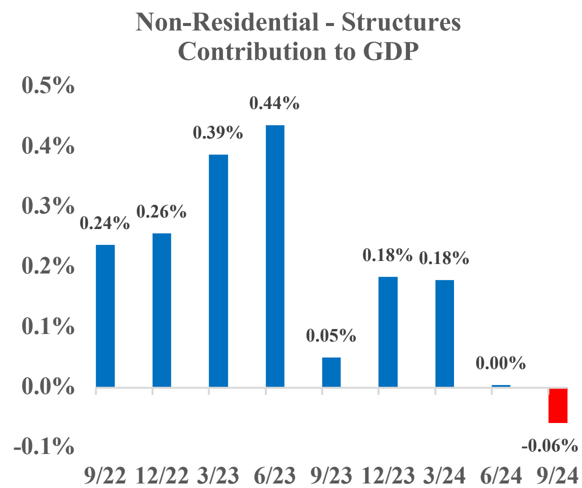


Chart 4

Non-Residential Investment – Equipment

Strong Truck and Aircraft Investments Stimulate Positive Growth

Despite another decline in core capex shipments (-1.2%) and a pullback in truck investment (-1.0%), non-residential equipment investment is on pace to eke out a slight quarter over quarter gain (see **Chart 5**). Delivery of aircrafts in July and August were the highest for the year and 10% greater than the first and second quarter average as Boeing continues to increase throughput of its 737 Max.

We continue to anticipate core capex orders will struggle considering weakness in the agricultural sector where farmer income and farming equipment orders continues to be challenged prompting John Deere into layoffs and seeking of a lower cost footprint. Further, labor unrest at Boeing could derail a reduction in the aircraft backlog.

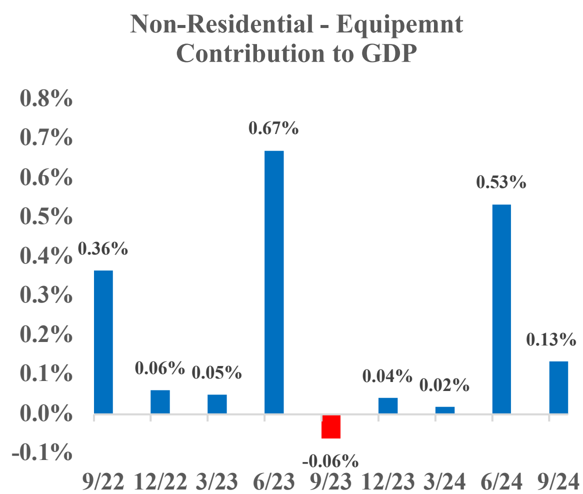


Chart 5

Net Exports

A Glimmer of Hope? Not Likely

Since, 2014, the U.S. trade deficit has consistently trended up, with the trend taking brief respites immediately after tariffs before returning to form as (i) foreign nations develop mechanisms for circumventing the tariffs and (ii) domestic prices rise rendering the tariffs ineffective. Biden's tariff extensions have proven no different with the annualized trade deficit approximating $1.1 trillion. That said, the deficit appears to have eased somewhat in the 3rd quarter with exports of airplanes and semi-conductors driving the improvement. We do not expect this to be the start of a positive trend given the volatility of aircraft deliveries, labor unrest at Boeing, and a lack of U.S. competitiveness in key manufacturing industries.

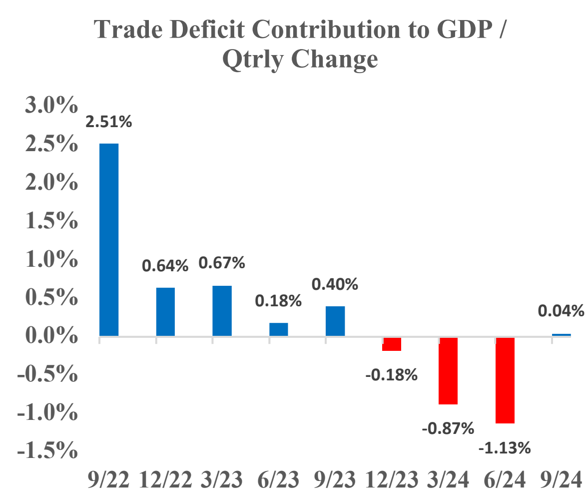
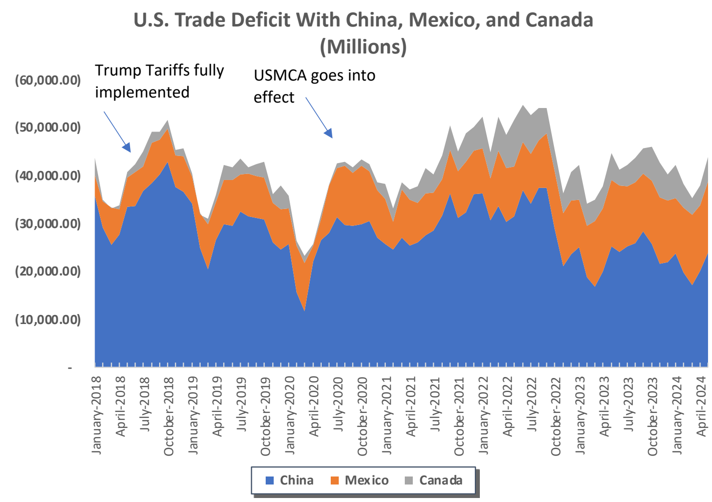


Chart 6

Net Exports (Continued)

A Glimmer of Hope? Not Likely

CHG has been very critical of tariffs, suggesting they are a tax on the middle class, and consistently rejected them as a useful mechanism in managing trade imbalances. Further, after implementation of NAFTA 2.0, CHG declared Mexico and Canada the winners: this has proven true as the trade imbalance has increased $66 billion and $42 billion with Mexico and Canada, respectively, since 2020 (much of this is due to Chinese investment in these regions), while the Chinese trade deficit has only shrunk $23 billion. We expect these imbalances to continue in the foreseeable future.



Other: Intellectual Property Investment, Governmental Spending, Change in Inventory

Historically, investment in IP has been tied to overall economic activity which is measured by the Chicago National Activity Index (CNAI) as well as the lagged activity in other components of GDP. CHG has modeled quarterly changes in IP investment vis-à-vis the CNAI and historical components of GDP; based on our model, despite recent softening in the CNAI, strength in U.S. investment over the past four quarters suggests another uptick in IP investments. Our projected 0.39% increase in quarter over quarter change in IP investment is consistent with that projected by the Atlanta Fed.

Similarly, both CHG (0.337%) and the Atlanta Fed are predicting an increase in governmental spending; a second straight quarter of increased governmental spending. Seasonally adjusted outlays by the Treasury Department are trending toward a 4.8% seasonal increase in the third quarter versus the second and non-military government hiring increased at an annual rate of 1.6%.

Conversely, while the Atlanta Fed is suggesting the growth rate of U.S. inventories will continue climbing (albeit slower than previous quarters), contributing about 0.06% to GDP, CHG is currently forecasting a slight decline in the inventory growth rate as we are yet to see advanced data supporting a more significant build.

Synopsis

Given interest rates and election uncertainty, the U.S. economy has held up surprisingly well and much to our surprise; while we expected tepid growth, the American consumer and the Fed, with a 50 bp interest rate cut, had different plans. Frankly, while there are several areas of concern (most notably consumer debt, the continued trade imbalance, and slow commercial investment), there isn't much to dislike about the trajectory of the economy given continued monetary loosening. While inflation remains above the Fed's target rate of 2%, it has fallen significantly portending additional rate cuts prior to year-end; the market has priced in a 25 bps cut at the December meeting. Using our market proprietary model, we have assessed the market probability of a recession within the next 4 quarters at only 19%, the lowest in the last 3 years.

Obviously, the outcome of the election and a significant shift in fiscal policy could change the recession probability dramatically. Specifically, neither candidate appears to be addressing the fiscal deficit while the potential for increased protectionism and a prolonged trade war is increasing the prospects of future inflation. Further, several countries have joined the BRICS in initial discussions to decouple their international trade from the dollar, the success of which would greatly reduce the value of the greenback and generate additional inflationary pressure. While any decoupling solution is likely a way off, these discussions appear to be the first serious attempt to develop a scalable trading mechanism not backed by U.S. currency. Collectively, these events appear to be spooking investors with the market responding with a 50 bps increase on longer term treasury and mortgage yields since the Fed rate cut in September.