DOWNWARD REVISION TO Q4 GDP GROWTH IS ACTUALLY GOOD NEWS FOR 2015

SUMMARY

- Real GDP growth in the fourth quarter of 2014 was revised down to 2.2 percent, from the initially reported 2.6 percent.
- All of the revision came from a downward revision to inventory investment; this is actually a positive for growth in early 2015. Final demand in the fourth quarter was revised higher.
- There were upward revisions to personal income in the third and fourth quarters, and the saving rate was revised higher as well. These are positives for near-term consumer spending.
- Inflation remained very low at the end of 2014.
- Consumer sentiment fell slightly in February, but remains near its cyclical high.
- The U.S. economy will continue to expand at an above-trend pace in 2015.

GDP growth in the fourth quarter, adjusted for inflation, was revised down to 2.2 percent at an annual rate in the second estimate, down from 2.6 percent growth in the advance estimate. This was the weakest quarter since a contraction in the economy in the first quarter of 2014, when bad winter weather weighed on activity. But with 5.0 percent growth in the third quarter, growth in the second half of 2014 was a very good 3.6 percent per annum. On a year-ago basis, real GDP growth was 2.4 percent in the fourth quarter.

All of the downward revision came from inventories; their contribution to growth was revised down to 0.1 percentage point, from 0.8 percentage point. There was also an upward revision to imports (higher imports reduce GDP). These were somewhat offset by upward revisions to business fixed investment and state and local government spending. With the downward revision to inventories growth in final sales of domestic product—purchases of U.S.-produced goods and services, a measure of final demand—was revised higher, to 2.2 percent in the fourth quarter, from 1.8 percent in the advance estimate.

There were also upward revisions to personal income, including after-tax income, in the third and fourth quarters. As a result the saving rate was revised up slightly in both quarters. This better income growth, and higher saving, will allow for stronger consumer spending growth in 2015. At the same time, falling gasoline prices boosted after-inflation income. Adjusted for inflation, disposable personal income rose 3.8 percent at an annual rate in the fourth quarter, the best growth since late 2012, when tax changes boosted incomes. That strong real income growth continued into January when workers’ wages rose while sharply lower gasoline prices pushed down consumer prices by a near-record 0.7 percent.

Inflation remained low at the end of 2014 as energy prices continued to plunge. The GDP price deflator rose a scant 0.1 percent at an annual rate, revised up from no change in the advance estimate. This was the lowest inflation since prices fell in mid-2009 during the Great Recession.

Although growth in the fourth quarter was revised lower, the downward revision came from inventories, which is a positive for near-term economic growth. With demand increasing and fewer unsold inventories in the fourth quarter, firms will need to increase output in the first half of 2015 to keep up with stronger demand. Demand was also stronger in the fourth quarter than initially thought, and that will carry over into 2015 (see Chart).
Economic growth will remain solid in the first quarter, 2.8 percent at an annual rate, held back somewhat by worse-than-usual weather. But compared to the contraction in the first quarter of 2014, year-over-year growth will accelerate to near a recent high of 3.5 percent. This is above the economy’s trend, and thus is leading to a reduction in the economic slack still remaining after the Great Recession.

The University of Michigan’s consumer sentiment index fell slightly in February to 95.4. This was still just below January’s eleven-year high of 98.1, however. Both the current conditions and expectations components dropped in February.

An uptick in gasoline prices in February after huge declines over the previous seven months weighed on consumer sentiment in February. But gasoline prices are still $1.00 per gallon lower than at this time last year. Thus confidence remains at a high level, and will continue to increase over 2015 as the economy continues to add more than 200,000 jobs per month, the unemployment rate declines, and wage growth accelerates with the stronger labor market.

The U.S. economy continues to expand at a solid pace in early 2015, despite a temporary drag from severe weather. Consumers are spending more thanks to solid job growth and moderate income growth, and lower energy prices are freeing up cash to spend on other goods and services. Business investment will increase thanks to rising profitability and low borrowing costs. The drag from government has faded with less emphasis on deficit reduction. The major headwind will be trade, with weak overseas growth and the strong U.S. dollar a drag on exports. PNC is forecasting real GDP growth of 3.2 percent from the fourth quarter of 2014 to the fourth quarter of 2015, compared to 2.4 percent over the same period of 2014.

Chart source: BEA

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