Srinivas Thiruvadanthai
Director of Research

Markets Brush Off Weak Q1 GDP

Analysts Argue Q2 Will Be Better—Don't Buy It

*Based on an April 29, 2016 client bulletin. .

- ***Consensus thinks Q1 numbers "misleadingly weak" but have that backwards***
- ***Entering transitional period in which consensus expects better economy and in all probability will get worse***
- ***The weak first-quarter GDP and profit sources may well be revised up substantially, but by then expect disappointing reports on April and early May***

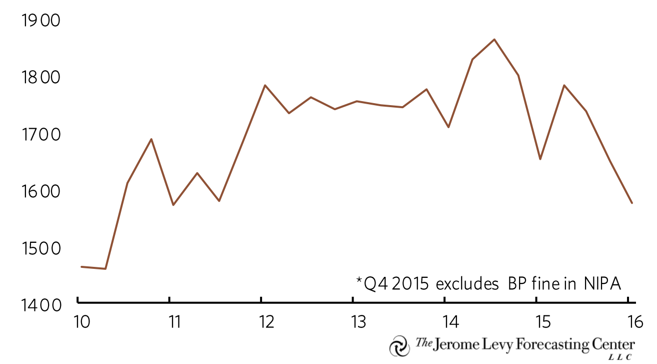
Yesterday's advance national income and product accounts (NIPA) report showed that real GDP grew 0.5%, annual rate, in the first quarter. Without the boost from the extremely mild winter, real GDP almost surely would have contracted in the first quarter. Meanwhile, corporate profits, based on incomplete NIPA data, appear to have declined on a year-over-year basis for the sixth consecutive quarter (chart 1), in line with our expectations. Given the payback from the warm weather, the elevated level of inventories, and the continued deterioration of capital outlays, we expect the economy to look much worse in the second quarter.

A few observations on the NIPA data:

- ***The "faulty data" argument is faulty.*** Many analysts have downplayed the weak first-quarter performance, attributing it to flawed seasonal adjustments. Indeed, first-quarter real GDP growth has averaged significantly less than the growth of the other three quarters over the past two decades, so there may well be an issue with the seasonal adjustments as the economy evolves and changes. Nevertheless, in recent years a bigger factor has been in play: extreme winters, either cold and stormy or mild and calm. This past winter, growth was weak despite arguably the mildest winter weather in U.S. history. Since about 90% of the first quarter is during winter, first-quarter activity is, of course, much more heavily affected by weather variations than any other quarter. During the previous three years, fluctuations in weather and first-quarter GDP growth have gone hand-in-hand —growth has been stronger than the trend whenever the weather has been warmer and vice versa (chart 2). The winters of

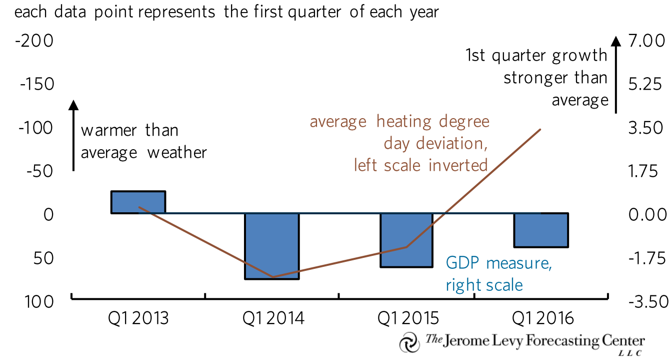
NIPA Profits Continued Falling in First Quarter CHART 1

Domestic Profits Before Tax, adj. for tax law distortions to depreciation
$ billions, seasonally adjusted, annual rate, last data point Q1 2016 estimated



Q1 2016 Breaks Winter Growth Pattern CHART 2

BEA: Real GDP, quarter-over-quarter % change minus annual % change
NOAA: U.S. Pop.-Weighted Heating Degree Days Deviation from Normal
each data point represents the first quarter of each year



'13-'14 (an extremely severe December-March period) and '14-'15 (featuring an extremely severe February) markedly depressed Q1 performance. However, '15-'16 broke the pattern. Even if there are some countervailing seasonal issues, the first quarter should have been at least solid.

- ***Declining capital spending.*** Business fixed investment fell in the first quarter for the second consecutive period. Declining earnings, capital goods orders, business executive surveys, and regional Fed manufacturing surveys all point to further weakness in capital spending in the second quarter.
- ***Inventory levels remain high.*** The real inventory-to-final-sales ratio surged to its highest level since 2011 (chart 3)—a level consistent with pressures to cut inventory investment. (We prefer to use the nominal inventory-to-final-sales ratio, but it has been vitiated by the huge swing in commodity prices. With some crude adjustments for commodity price swings, the nominal inventory-to-final-sales ratio paints a picture that looks similar to the chart of the real ratio.)
- ***Export decline has a long way to go.*** Exports continued to trend down—the decline is already one of the worst in history (chart 4), but probably only half way through.

The global economy has received a brief respite from a renewed credit binge in China and unusually warm weather not only in North America but throughout most of the northern hemisphere. Both influences are likely to prove fleeting. Expect worsening economic news in the months ahead as the weather influence fades and reported data fall back to trend.

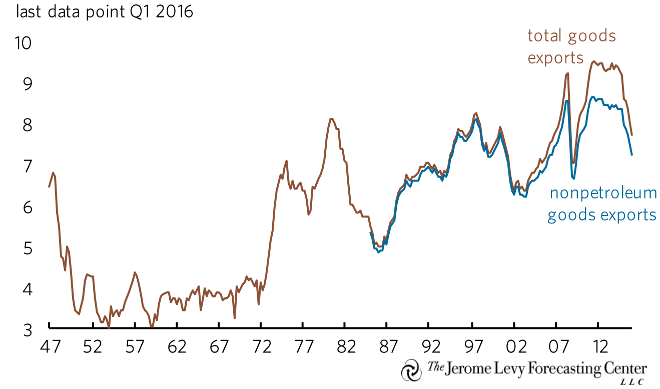
Risk asset markets have continued to rally in the face of mixed data, and apparently they have chosen to look optimistically beyond the first quarter GDP figures, sliding car sales, falling capital goods orders, and unsettled problems around the world. We think this has provided an excellent entry point for shorting global equities, currencies, commodities, and various other positions we have previously discussed. Markets could surprise us and swim upstream a while longer, but the current is strengthening.

Real I/S Ratio Continues to Climb CHART 3

Ratio of Real Nonfarm Inventories to Final Sales of Goods & Structures
seasonally adjusted, quarterly total, last data point Q1 2016

2014-2016 Export Decline One of Largest CHART 4

Goods Exports as % of GDP
last data point Q1 2016



macroeconomic insights for business and investment strategy

Improving risk management and providing a fuller understanding of economic trends with unique framework "The Profits Perspective"

Visit www.levyforecast.com

Contact Douglas Williams: DWilliams@levyforecast.com (914) 666-0641