

United States

Economy set for rebound after contracting for first time in three years

- **First quarter GDP revised to show 1.0% annualised fall, likely weather related**
- **Survey data and improving jobless claims point to strong rebound in second quarter**
- **FOMC will need to wait until the Fall for true steer on economic growth momentum**

The US recovery took a backward step in the first quarter, most likely the result of many parts of the country having been battered by extreme weather at the start of the year. Current indicators also suggest this was merely a temporary set-back in an otherwise ongoing robust recovery, pointing to a strong rebound in the second quarter. Frustratingly, policymakers will therefore have to wait until the second half of the year to get a true reading of the underlying growth momentum and, most importantly, an idea of when the economy will be able to cope with higher interest rates.

Worse than expected

Gross domestic product fell for the first time in three years in the first quarter, dropping at an annualised rate of 1.0%. Final sales (which strip out inventories) rose at a rate of just 0.6%.

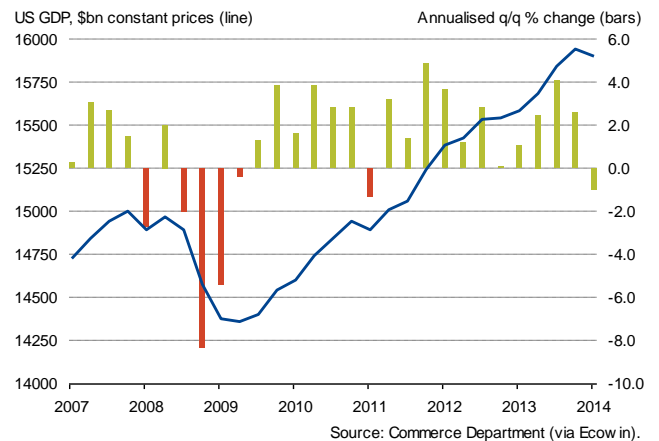
The revised number was worse than the initial estimate, which had shown an annualised 0.1% expansion, and below expectations. Analysts polled by Reuters had anticipated a 0.5% annualised rate of contraction, with final sales expected to rise at a rate of 0.7%.

Of concern was a 1.6% fall in business investment, and in particular a 7.5% drop in business spending on non-residential structures, which was previously thought to have risen slightly.

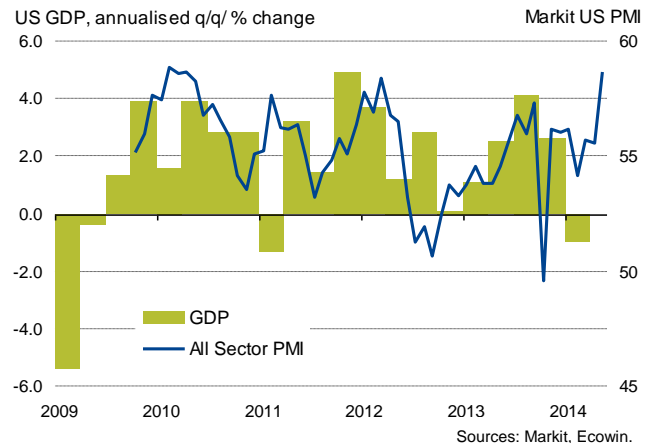
Exports fell at a 6.0% rate; not as bad as previously thought but still a worrying set-back to the trade position.

Corporate profits meanwhile sank at an annualised rate of some 13.7%, the largest decline since the height of the financial crisis in late-2008.

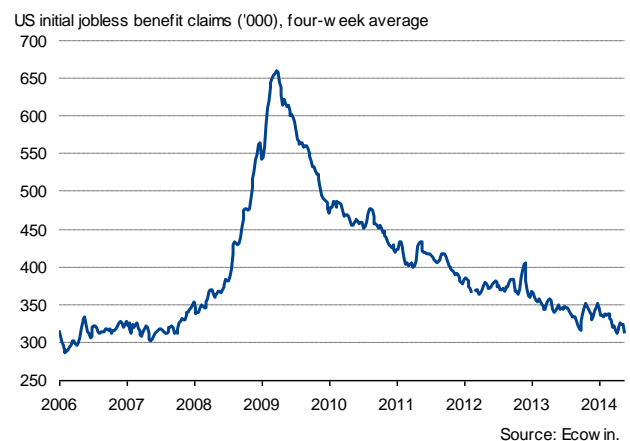
Gross domestic product



GDP and the PMI™ compared



Jobless claims



What's more, the GDP decline would have also been even worse had it not been for increased spending on 'Obamacare', which contributed to an overall rise of 3.1% in consumer spending. Spending on durable goods – which tends to provide a more reliable guide to underlying household spending – rose a more modest 1.4%.

Get ready for the second quarter rebound

However, it was not all bad news. As well as the weather impact, the weak number also reflected a smaller than previously thought inventory accumulation, which bodes well for a pick up in the second quarter.

Policymakers are of course also already looking beyond these weak weather-hit numbers for the first few months of the year. Fed Chair Yellen's belief that the economy remains in good health has been given increased credence by the recent data flow, which suggests that the economy is enjoying a strong rebound in the second quarter.

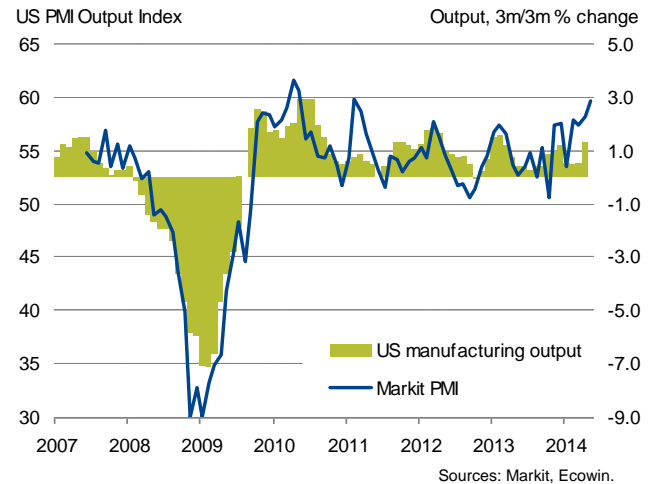
Markit's flash PMI survey data pointed to the strongest expansion of business activity for just over four years in May, with companies reporting that demand continued to recover after the weather-related disruptions of the first quarter. The surveys showed manufacturers enjoyed the largest monthly increase in production since February 2011 alongside a service sector that was growing at the fastest pace since March 2012.

The improving survey data have been followed by signs of stronger growth in the official statistics. Retail sales have strengthened, surging 1.5% in April to register the largest monthly rise for four years. Durable goods orders have also picked up in each of the three months to April.

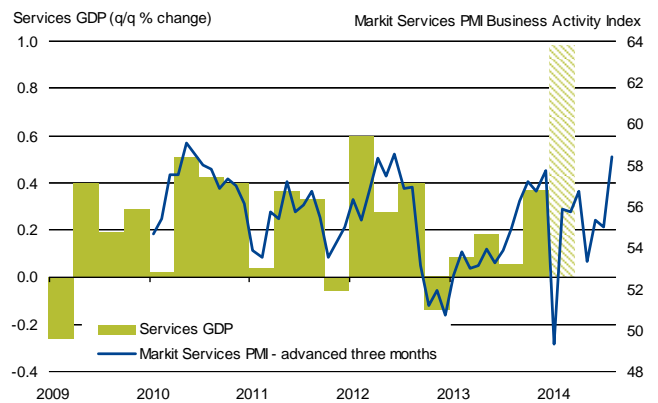
Hiring has meanwhile gathered pace, with the job market showing further signs of improving in May. Initial jobless claims were just 311.5k in the latest four weeks, the lowest recorded since August 2007.

The likely rebound in the economy in the second quarter will fuel expectations that the Fed may start to raise interest rates earlier than the current widespread expectation of a June-July hike. However, the true acid test of the resilience of the economy to the taper so far, and its ability to cope with higher interest rates, will be how the economic data flow settles after the second quarter rebound. That's something which won't become clear until the Fall.

US manufacturing output



US service sector*



* shaded bar represents Q1 distortion from increased spending on Affordable Health Care.

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