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Very Poor GDP Growth May Nix Any Fed Increase

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Forget about a September rate hike – and maybe even December (although that is a long way off). Today's disappointing GDP data highlight a theme that I have been harping on for two years. How can we be adding 200,000 or more jobs per month with GDP barely growing? Or more to the point, how can productivity growth, which until the financial crisis increased at 2.2% per year for more than 60 years, turn persistently negative? Several weeks ago, when economists predicted Q2 GDP growth to be about 2.5% and a very poor May labor report implied a sharp slowdown in the number of hours worked, productivity looked like it bounced back to positive territory. No longer. With the robust June labor report and actual GDP remaining stuck in the 1% range, it looks like another negative quarter for productivity growth.

This is the biggest macroeconomic problem today. Is slow growth caused by over-regulation? Are we undercounting the digital economy? Since most of the source of the low GDP is in the investment category, should R&D be categorized as investment? Will this fix the problem? We don't know, but we need to find out to better understand which direction policymakers should go.

I thought that the Fed meeting turned out as expected. They set the stage for a post-election rate hike. I strongly doubt September was in the cards; the report would be much more hawkish than it was. But I expected that by September the Fed would say the economy has grown sufficiently to resume the "normalization" of interest rate policy. This morning's GDP report throws that conclusion in doubt. It seems very unlikely that second half growth can average 3% + to reach the 2% GDP range that the Fed regards as a minimum for a well-functioning economy. To be sure, the composition of today's disappointing GDP data did support faster growth in the future – the drawdown in inventories subtracted more than one percentage point from the data. But at this time, most of the best forecasters are still predicting only 2% to 2.5% growth in this quarter, nowhere near enough to reach the 2% level for the year.

Stocks are marking time. To be sure a high percentage of firms are beating lowered Q2 estimates, but forward guidance has been lukewarm. In truth, tight ranges of the market near all-time highs, combined with a low VIX have not been favorable to stocks on a short term basis. Absent very favorable news, I would not be surprised to see a 5% correction in equities.
