US GDP edged lower in Q1/2022

- US Q1 GDP fell 1.4% (annualized) from Q4
- Consumer spending and business investment rose further, but net trade subtracted more than 3 percentage points from growth.
- Wage growth increased from 3.1% to 3.4% in March year-over-year
- Slower GDP growth reflects strong demand bumping up against long-run production capacity limits; Fed still under pressure to hike rates

The decline in GDP in Q1 is not a result of a deteriorating economic backdrop as much as it is a sign that still very strong household (and business) demand is bumping up firmly against long-run domestic production constraints.

Government spending declined by 2.7%, led by an 8.5% drop in defense spending. But consumer spending rose another 2.7%. Spending on physical merchandise was little-changed from Q4, but was still almost 16% above pre-pandemic levels, and spending on services rose 4.3% to get back above February 2020 levels. Business investment jumped by 9.2%, led by a 15% surge in equipment and software purchases, and businesses continued to rebuild inventory stocks from declines, albeit at a slower pace than the huge Q4 build.

But additional domestic production capacity is limited, so those increased purchases came largely from abroad via an 18% surge in imports. And exports to the rest of the world declined. Indeed, excluding net trade, GDP would have been up by 1.8% in Q1. The industrial capacity utilization rate was 78.3% in March - 2 percentage points higher than pre-pandemic. The unemployment rate is back close to pre-pandemic lows, and wage growth has accelerated alongside widespread reports of labour shortages. Strong demand bumping up against limited supply will only add to the strongest inflation pressures in decades.

Against that backdrop, a softer Q1 GDP reading isn’t likely to do anything to deter the Federal Reserve from continuing to hike rates off of exceptionally low levels, and we continue to look for a 50 bp hike to the fed funds target range next week.