July 23, 2019

Economics Group

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Parade Forecast: Rain

When Q2 GDP prints on Friday, we expect to see the first sub-2% growth rate in two years. A key swing factor is that private inventories will likely build at a slower pace and pull GDP growth lower.

It Don't Mean a Thing if It Ain't Got that Swing

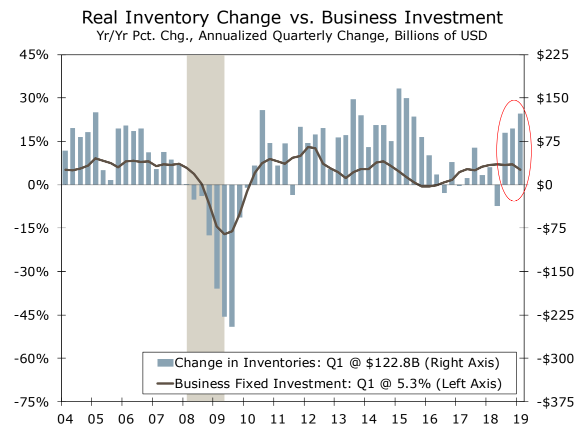
The rate at which businesses add-to or draw-down inventories factors into GDP. It's a question of current quarter change compared to prior quarter change, making it notoriously difficult to forecast private inventories, especially since inventories are subject to large revisions. On Friday when we get our first look at Q2 GDP, we expect to see that the economy grew at a 1.8% annualized pace and that inventories were a decent size drag on headline growth.

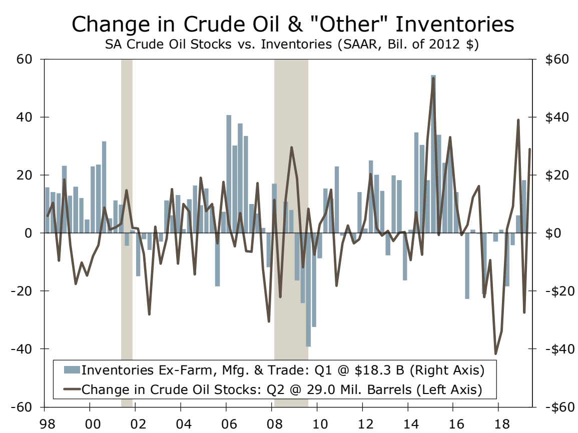
The largest quarterly inventory changes of the past three years occurred in each of the past three quarters (top chart). There's a case to be made that the recent build is at least in part intended, as the escalating trade war over the past year may have led businesses to stockpile in anticipation of supply chain disruptions or higher input prices. The slowdown in manufacturing and retail sales in the first quarter, however, likely led to some unintended inventory building. But, data suggest businesses took note in Q2. The Commerce Department reported slower growth in inventories in April and May, while the ISM manufacturing inventories index contracted for the first time since December 2017 in June. The table is set for inventories to be a drag on growth, and slice 0.9 percentage points from headline GDP growth.

Yet, there are some risks to this estimate caused by some unique circumstances. First, domestic crude oil stocks moved higher in Q2. In April, the United States ended exemptions from sanctions for countries importing Iranian oil. That may have encouraged domestic production and could contribute to a larger-than-expected inventory build in Q2 (middle chart). Second, Boeing's 737 MAX issues remain front and center. The company is still producing 42 737's each month, some of which are MAX models. With MAX plane shipments on hold, that means upward pressure on inventories. Further, tariffs remain a concern among manufactures, and with proposed tariffs on an additional $325 billion of Chinese goods still on the table, businesses may have continued to stockpile in Q2.

Our baseline assumption is that inventories will slow to an $82 billion build in the second quarter, resulting in a 0.9 percentage points drag on GDP growth (bottom table). A larger slowdown, say just a $74 billion build, could drag GDP down a full percentage point. Conversely, a greater-than-expected build will create a more muted impact and a smaller drag on overall growth. In order for inventories to have no impact on headline GDP, we would need to see a build of $123 billion, yet inventories have not grown by more than $100 billion in consecutive quarters since 2015.

The fundamentals signal that private inventories will likely build at a slower pace and pull GDP growth lower in the second quarter. Barring a massive surge of $123 billion or more, the question isn't *if* inventories will be a drag, but by *how much*.





Q2-2019 Inventory Changes

Inventory Change	Pct. Point Contribution to GDP
$82.0 B *	**-0.86 ***
$0.0 B	**-2.57**
$90.2 B	**-0.69**
$73.8 B	**-1.03**
$123.0 B	**0.00**
$41.0 B	**-1.72**

**Current Forecast*

Source: U.S. Department of Commerce and Wells Fargo Securities

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