Economic Indicator — November 30, 2022

Second Estimate of Q3 GDP Overstates Strength of U.S. Economy

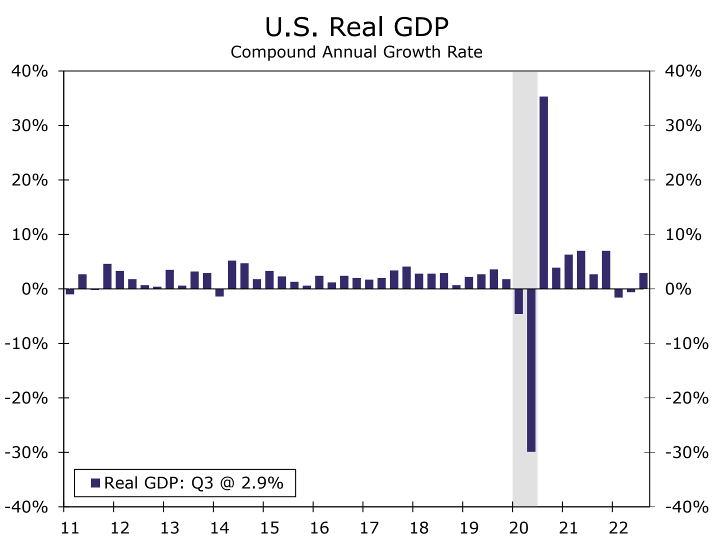
Summary

- Revised data show the U.S. economy expanded at a 2.9% annualized pace in the third quarter, which is slightly stronger than the advance estimate of 2.8%. But still modest growth in the core areas of the economy and weakness in real gross domestic income more clearly demonstrates the slowdown in Q3 economic growth.
- Real gross domestic income suggests the economy expanded at just a 0.3% annualized pace in the third quarter after downward revisions to Q2. Though the two measures (GDP and GDI) narrowed on a year-ago basis, they remain far apart in terms of quarterly rates and the weaker outturn in GDI depicts a slowing economy.
- Pre-tax profits also slipped in the third quarter, but remain near a historically high level. There was evidence of margin compression, which we expect to continue ahead as businesses find it increasingly difficult to pass costs onto consumers. Slowing demand and higher borrowing costs will make it more difficult to retain workers and invest in capital expenditures while maintaining the bottom line. Something's got to give.

Economist(s)

Tim Quinlan
Senior Economist | Wells Fargo Economics
Tim.Quinlan@wellsfargo.com | 704-410-3283

Shannon Seery
Economist | Wells Fargo Economics
Shannon.Seery@wellsfargo.com | 332-204-0693



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

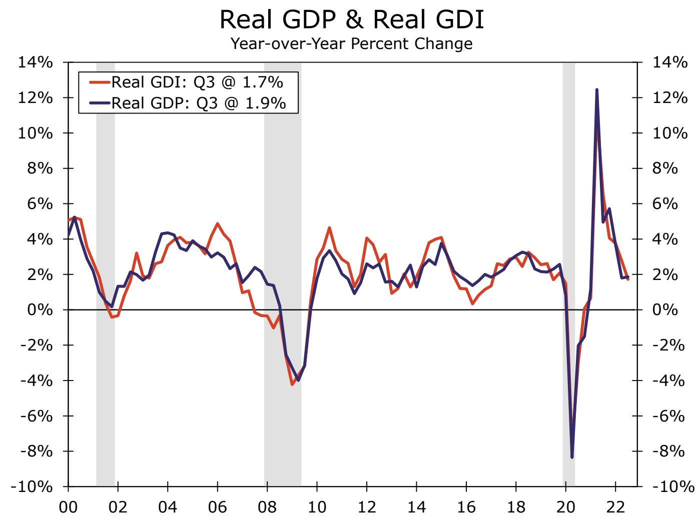
All estimates/forecasts are as of 11/30/2022 unless otherwise stated. 11/30/2022 9:41:01 EST. **This report is available on Bloomberg WFRE**

GDP Overstating Strength, Look at GDI

The U.S. economy expanded at a 2.9% annualized pace in the third quarter according to the second estimate of GDP, which was slightly stronger than the initial advance estimate of 2.8%. The headline continued to be flattered by a sizable gain in net exports due to an unsustainable gain in exports and decline in import activity.

The largest upward revision, however, came from nonresidential structures investment, where the originally reported 15.3% annualized decline was more than halved to a 6.9% drop. Structures is a relatively small component of overall GDP, representing just around 3% of total U.S. output, but the upward gain here flattered the headline. Beyond that, there was also a modest upward revision to real personal consumption expenditures, which now look to have risen at a 1.7% annualized pace in Q3 amid upward revisions to goods consumption specifically. Real final sales to domestic purchasers were thus revised modestly higher to nearly a 1% gain in Q3, demonstrating a still-slow but better pace of growth for the core of the U.S. economy.

This release also included the first look at Gross Domestic Income (GDI), which in theory should be equivalent to GDP. The two have diverged recently, but the gap in the year-ago pace of the two narrowed to just 0.4% in Q2, from 1.1% in Q2 (chart). Still, the more modest 0.3% gain in the annualized rate of real GDI for Q3 and downward revisions to Q2 which flipped a 0.1% gain to a 0.8% decline provide further evidence the economy is slowing. The headline GDP growth rate continues to overstate strength in Q3, in our view.

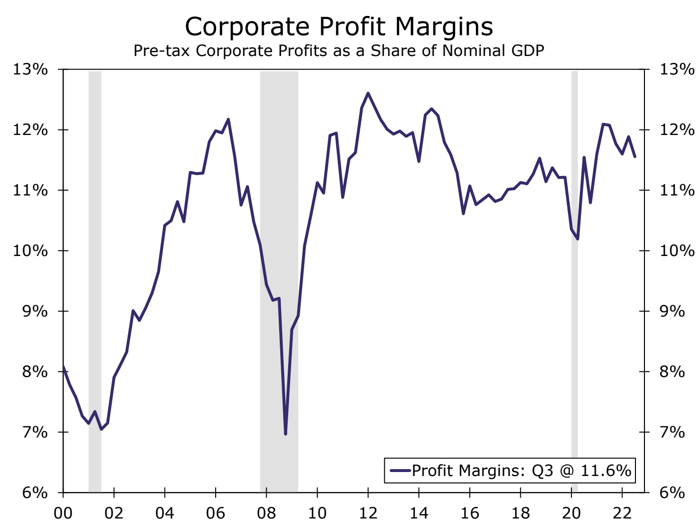


Source: U.S. Department of Commerce and Wells Fargo Economics

Profits Slip, Margins Compress

Pre-tax profits slipped a modest 1.1% (not annualized) in Q3, or by just $31.6 billion, which keeps the overall level of nominal profits near a record high. In fact, on a year-ago basis, profits were still up 4.4%. Third quarter weakness can be traced to domestic financial profits and international profits specifically. Growth in profits of domestic nonfinancial industries, a bulk of overall profits, slowed from the robust Q2 pace but remained positive.

Profits continue to be supported by underlying demand in the United States and the staying power of consumers more specifically. Consumers have largely been price takers this year, continuing to spend in the face of higher inflation, and that gives businesses little incentive to forgo further price increases. Firms have thus been able to maintain elevated profit margins, but there's evidence of compression in the third quarter. Economy-wide corporate profit margins are running at a 11.6% pace, a touch above the average that prevailed over the past cycle (chart).



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

We continue to expect further margin compression going forward. A more pronounced pullback in demand next year, as consumers become more thinly stretched, will dent businesses' ability to continue to pass costs on to consumers. Inventory dynamics are also a challenge with big-box retailers cautioning a hit to revenues from a need to move undesired inventory through discounting. Some reprieve in input prices, particularly of goods, may help counteract these headwinds, but it's likely not enough to keep overall margins at such elevated levels. Slowing demand and higher borrowing costs will make it more difficult to retain workers and invest in capital expenditures while maintaining the bottom line. Something's got to give.

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Economics Group

Jay H. Bryson, Ph.D.	Chief Economist	704-410-3274	Jay.Bryson@wellsfargo.com
Sam Bullard	Senior Economist	704-410-3280	Sam.Bullard@wellsfargo.com
Nick Bennenbroek	International Economist	212-214-5636	Nicholas.Bennenbroek@wellsfargo.com
Tim Quinlan	Senior Economist	704-410-3283	Tim.Quinlan@wellsfargo.com
Sarah House	Senior Economist	704-410-3282	Sarah.House@wellsfargo.com
Azhar Iqbal	Econometrician	212-214-2029	Azhar.Iqbal@wellsfargo.com
Charlie Dougherty	Economist	212-214-8984	Charles.Dougherty@wellsfargo.com
Michael Pugliese	Economist	212-214-5058	Michael.D.Pugliese@wellsfargo.com
Brendan McKenna	International Economist	212-214-5637	Brendan.Mckenna@wellsfargo.com
Jackie Benson	Economist	704-410-4468	Jackie.Benson@wellsfargo.com
Shannon Seery	Economist	332-204-0693	Shannon.Seery@wellsfargo.com
Nicole Cervi	Economic Analyst	704-410-3059	Nicole.Cervi@wellsfargo.com
Jessica Guo	Economic Analyst	212-214-1063	Jessica.Guo@wellsfargo.com
Karl Vesely	Economic Analyst	704-410-2911	Karl.Vesely@wellsfargo.com
Patrick Barley	Economic Analyst	704-410-1232	Patrick.Barley@wellsfargo.com
Jeremiah Kohl	Economic Analyst	704-410-1437	Jeremiah.J.Kohl@wellsfargo.com
Coren Burton	Administrative Assistant	704-410-6010	Coren.Burton@wellsfargo.com

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