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Healthy expansion in Q3

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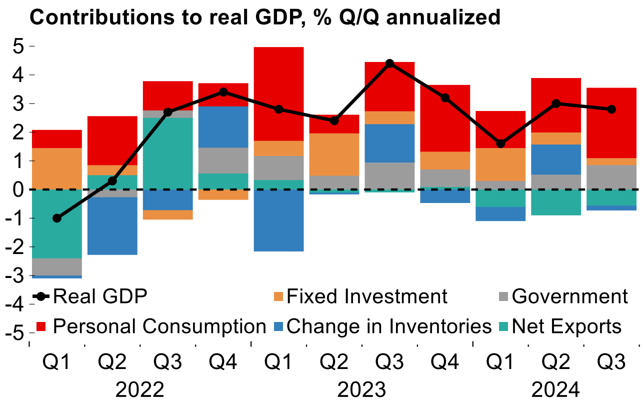
- Real GDP expanded strongly in Q3, driven by accelerated consumption of both durable and nondurable goods, along with elevated services spending. Stronger growth in personal consumption and slower growth in wages and salaries, from relatively weak private sector employment figures over the summer, has resulted in a slight drop in the personal savings rate. Despite this, the level appears far more sustainable than previously thought (apparent after the large upward revision to Q1 real incomes). Though spending growth may slow, households are positioned to continue spending heading into the holiday season.
- Fixed investment growth slowed in Q3 due to a pronounced drop in single-family housing, along with negative growth in multifamily housing and nonresidential structures. Investments in equipment, however, accelerated with strong growth in information processing and transportation equipment. Going forward, Fed rate cuts will support some recovery in residential construction, but mortgage rates are destined to remain elevated in the near-term.

Acceleration in personal consumption

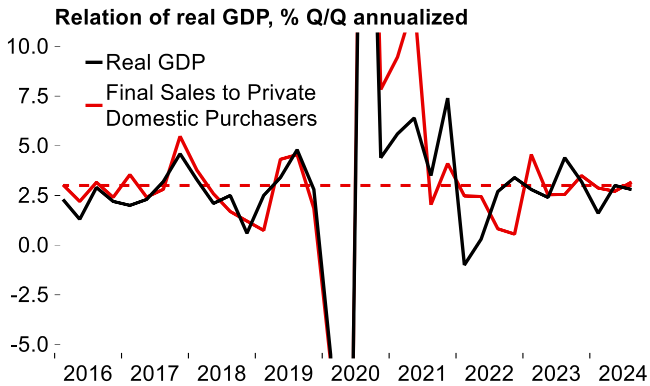
The US economy continues its robust expansion, with real GDP growing at an annual rate of 2.8% in Q3, a trivial difference from the 3.0% growth in Q2 (Chart 1). Net exports was the primary negative contributor, falling for the third consecutive quarter and contributing -0.6 percentage points to real GDP growth. The strength of the dollar has made US exports less competitive with respect to pricing, and market uncertainty surrounding the presidential election has largely offset the effects that Fed rate cuts had on dollar weakening. The US trade imbalance is expected to come deeper into focus in 2025, but the future impact on net exports is less certain.

Chart 1: Personal consumption, business investment, and government spending sustained strong growth in Q3



Source: BEA, MUFG Bank Economic Research Office

Chart 2: Domestic demand, reflecting spending for both households and businesses, remained strong in Q3



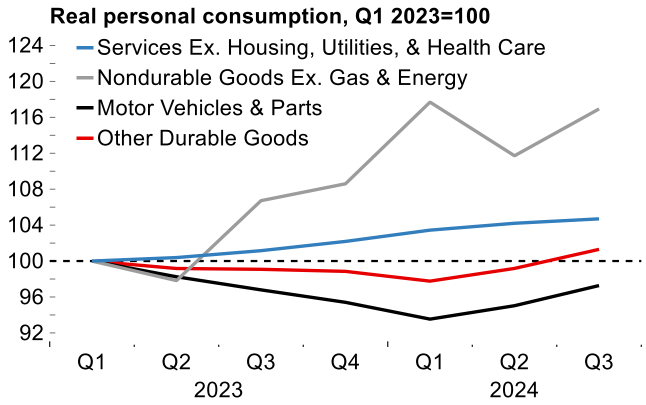
Note: Dashed line shows 2012-2019 average. Chart scale hides extreme growth rates.
Source: BEA, MUFG Bank Economic Research Office

Domestic demand, reflecting spending for both households and businesses, remained strong in Q3. Final sales to private domestic purchasers (sum of personal consumption expenditures and gross private fixed investment) grew at an annual rate of 3.2%, in-line with the pre-pandemic average of around 3% (Chart 2).

Household contributions to growth accelerated in Q3, with personal consumption expenditures contributing 2.5 percentage points to real GDP, up from 1.9 percentage points in Q2 (Chart 1). Growth was expansive, with consumption of goods accelerating from an annual rate of 3% in Q2 to 6% in Q3. The steady recovery in motor vehicles and parts consumption supported overall goods spending, though growth also accelerated for other durable goods and for nondurable goods excluding gas and energy (Chart 3). Growth in overall services consumption remained elevated at an annualized rate of 2.6%.

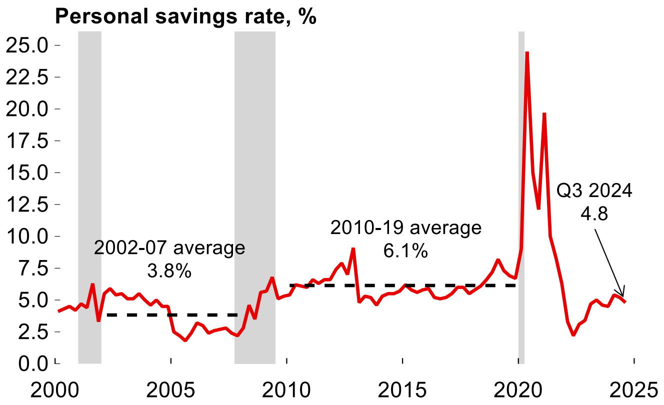
Heading into the holiday season, consumption growth may slow but households are still well positioned to spend. Weak jobs growth in the later summer months contributed to slower personal income growth from wages and salaries in Q3. This helped bring the personal savings rate down to 4.8%, lower than the pre-pandemic average of 6.1% from 2012-2019, but higher than the 3.8% average from 2002-2007 (Chart 4). Combined with continued growth in household net worth, the current personal savings rate is far more sustainable than previously thought (see previous brief here).

Chart 3: Consumption growth was widespread across durable and nondurable goods, as well as services



Source: BEA, MUFG Bank Economic Research Office

Chart 4: Weak jobs growth over the summer slowed growth in disposable incomes, lowering the personal savings rate

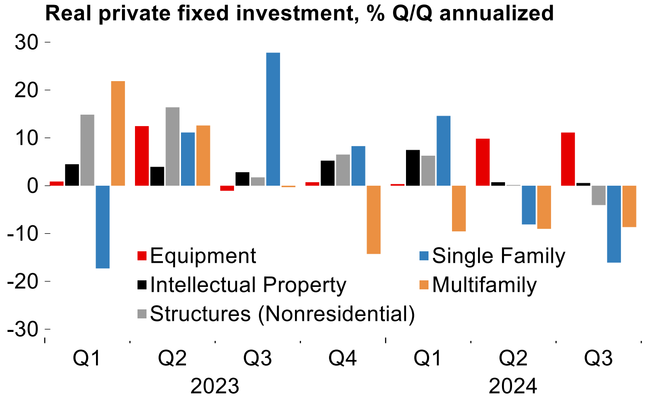


Source: BEA, MUFG Bank Economic Research Office

On the business end, fixed investment growth remained positive in Q3, contributing 0.2 percentage points to real GDP, but growth broadly slowed compared to Q1 and Q2 of this year. Investment in equipment accelerated, growing at an annual rate of 11.1% in Q3, compared to 9.8% in Q2, with a substantial share coming from information processing and transportation equipment (Chart 5). Investment will likely continue in these areas due in part to fiscal support from the Chips and Sciences Act, as well as domestic demand for AI related technology.

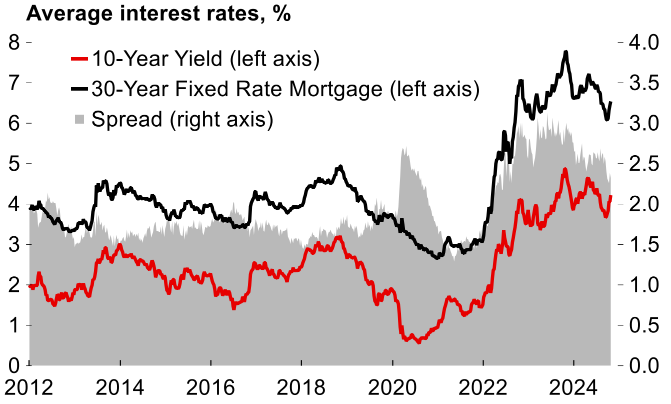
Fixed investments in residential structures suppressed overall growth, with investment falling at an annualized rate of -16.1% for single family homes and -8.7% for multifamily homes in Q3 (Chart 5). For single family homes, investment will likely recover in Q4. Unravelled expectations on future interest rates negatively impacted construction in Q3, but with Fed rate cuts underway, single family housing starts have already begun to rise. Shown in Chart 6, falling mortgage rates have supported the housing sector, as expected with the sizeable Fed rate cut in September, but market uncertainty has pushed the benchmark 10-year yield higher in recent weeks. This will expectedly keep mortgage rates elevated, slowing the potential recovery in single family housing investment.

Chart 5: Equipment investment accelerated in Q3, while residential investment fell



Source: BEA, MUFG Bank Economic Research Office

Chart 6: Growth in the benchmark 10-year yield will keep mortgage rates higher than expected



Source: Freddie Mac, Treasury Department, MUFG Bank Economic Research Office

The US economy has so far been undeterred by high interest rates. Growth is at or very near potential, which spells trouble for the Fed and their interest rate policy. Taylor Rule prescriptions using GDP as the output gap suggest that the appropriate level of the policy rate is not much lower than the current federal funds rate. Though uncertainty is high, overly optimistic rate cuts in an environment where growth is high and unemployment is low is a recipe for inflation.

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