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ECONOMY | ECONOMIC DATA

U.S. GDP Grew a Disappointing 1.2% in Second Quarter

Economic growth was well below expectations; cautious business investment offset robust consumer spending

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WASHINGTON—Declining business investment is hobbling an already sluggish U.S. expansion, raising concerns about the economy's durability as the presidential campaign heads into its final stretch.

Gross domestic product, the broadest measure of goods and services produced across the U.S., grew at a seasonally and inflation adjusted annual rate of just 1.2% in the second quarter, the Commerce Department said Friday, well below the pace economists expected.

Economic growth is now tracking at a 1% rate in 2016—the weakest start to a year since 2011—when combined with a downwardly revised reading for the first quarter. That makes for an annual average rate of 2.1% growth since the end of the recession, the weakest pace of any expansion since at least 1949.

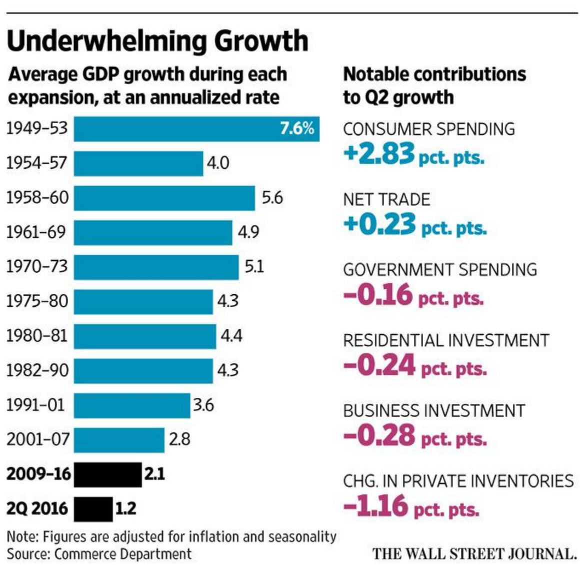
The output figures are in some ways discordant with other gauges of the economy. The unemployment rate stands at 4.9% after a streak of strong job gains, wages have begun to pick up, and home sales hit a post-recession high last month.

Consumer spending also remains strong. Personal consumption, which accounts for more than two-thirds of economic output, expanded at a 4.2% rate in the second quarter, the best gain since late 2014.

On the downside, the third straight quarter of reduced business investment, a large paring back of inventories and declining government spending cut into those gains.

“Consumer spending growth was the sole element of good news” in the latest GDP figures, said Gregory Daco, an economist at Oxford Economics. “Weakness in business investment is an important and lingering growth constraint.”

Mr. Daco and other economists expect growth to accelerate in the third quarter, but the weak first half means 2016 is likely to come in below an already disappointing trend. In another worrisome sign, S&P 500 companies are expected to report what is likely to be the fourth straight quarter of declining profits, down 3.7% from second-quarter 2015, according to a Thomson Reuters survey of analysts’ forecasts. Revenues are expected to decline 1.2%.



At the same time, JPMorgan Chase lowered its projected risk of a recession over the next 12 months to 30% on Friday, from an expansion high of 37% in early July, shortly after the U.K.'s vote to leave the European Union, pointing to upwardly revised corporate profit data included in the GDP report.

Lackluster growth could spill into a presidential campaign that is revolving around starkly different portrayals of the U.S. economy and the well-being of average workers.

Friday's figures could also raise new concerns to Federal Reserve officials who said this week near-term risks had diminished, signaling they might move to raise interest rates later this year, and possibly as early as September.

Federal Reserve Bank of Dallas President Robert Kaplan said Friday that the Fed has to be cautious about raising rates at a time when growth is still sluggish.

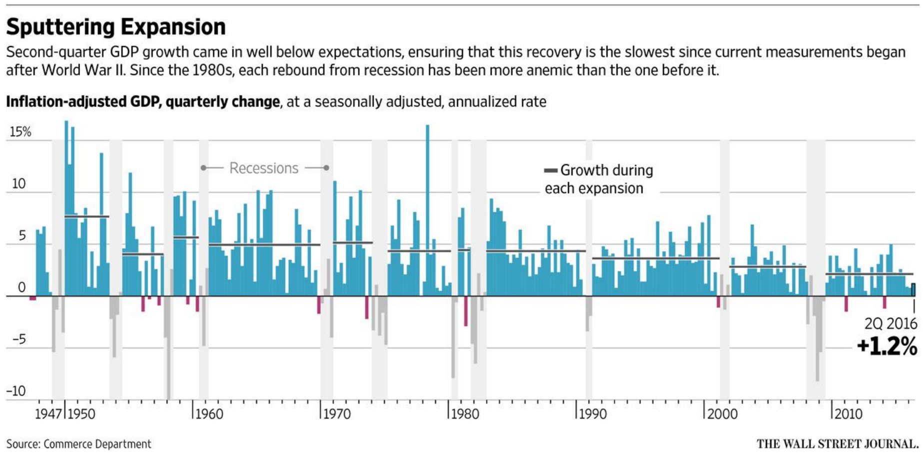
"We now need structural reforms and other fiscal policy," Mr. Kaplan said. "Then we will have more operating room where we can normalize rates."

In contrast, San Francisco Fed President John Williams said Friday underlying figures in the GDP report were encouraging. "We'll be raising rates, not lowering them, over the next several years," he said. He didn't offer specific timing.

A paring of inventories was a major driver of weak output figures, subtracting 1.16 percentage points from overall growth. That could suggest businesses aren't optimistic about future demand. But the category is volatile, and rebuilding of stockpiles could support future growth.

High inventories and soft export demand are weighing on United Parcel Service Inc.'s business-to-business shipments, the company told investors Friday. That stands in contrast to a healthy U.S. consumer market lifting its e-commerce business.

"Inventories are lingering longer than we thought," Chief Executive David Abney said Friday. "The strength of the U.S. dollar is not really helping us."



Companies also spent less on buildings and equipment this spring. Nonresidential fixed investment, a measure of business spending, declined at a 2.2% pace.

That's a concern because capital expenditures are an important ingredient in improving employee productivity, which has grown at an anemic pace in recent years, but is critical to workers' wages and corporate profits.

Manufacturers especially have been challenged by a strong dollar, which boosts the price of U.S.-made goods overseas. The energy industry has also been constrained, with relatively low oil and natural gas prices curtailing investments in mining and wells.

In some cases businesses may be substituting labor for capital, given depressed wage growth around the globe.

"Instead of buying an expensive piece of machinery, businesses are hiring really cheap workers they can fire whenever they want," said Megan Greene, chief economist at Manulife Asset Management.

She noted that companies are also increasing dividends and buying back stock rather than investing in capital.

The presidential election is on the minds of some firms.

Sales at Pennsylvania-based restaurant chain Saladworks are up almost 10% from a year earlier, but Chief Executive Patrick Sugrue said some of his best performing franchisees are reluctant to open new stores until after November.

"The election cycle puts everyone on hold," he said. "They're excited to open new stores, but they want to get a better peek under the tent at what's going on."

If the nine-month long slowdown in output growth extends further, the U.S. could join Europe and Japan as economies struggling to achieve anything more than the most modest growth. On an annualized basis, second-quarter growth in the eurozone was also 1.2%, a slowdown from 2.2% the prior period, Eurostat said Friday.

The latest U.S. figures don't capture much, if any, effect from the U.K.'s Brexit decisionbecause the vote took place during the final days of the quarter, which ended June 30. But uncertainty in Europe could add to caution among companies around the world.

"Looking beyond 2016, we continue to see macroeconomic uncertainty and pressures,"United Technologies Corp. Chief Financial Officer Akhil Johri told investors this week. He noted Brexit and a strong U.S. dollar as concerns for the Connecticut-based conglomerate.

—*Laura Stevens in Atlanta contributed to this article.*

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