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ECONOMIC TALKING POINTS

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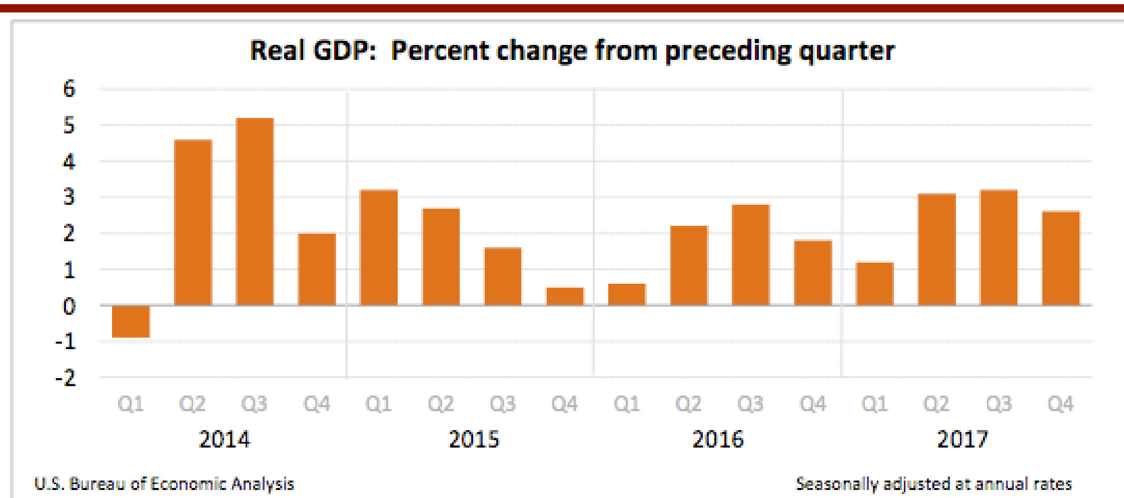
January 26, 2018

GDP: The Economy Entered 2018 With Considerable Momentum, But There Are Fresh Hazards Ahead

For the last nine months, the US economy has demonstrated considerable steadiness by expanding at a 3% pace. While some analysts today will perceive the 2.6% GDP growth rate in the final three months as a "slowdown," or "disappointment," our assessment is just the opposite. A deeper dive into the data reveals an economy that actually accelerated last quarter. I'll lay out that evidence in a moment.



The broader question is what does the latest GDP report tell us about 2018? Will the economy's impressive momentum in recent months continue through this year?

Let's begin with why we believe the economy wrapped up 2017 on an energetic note, even though GDP's headline growth was the smallest since early last year.

The all-important consumer certainly came through. Their spending rose by 3.8% in the final quarter, which turned out to be strongest of the year. In fact, the last time we saw a bigger quarterly figure was three years ago. Household purchases of both durable goods and nondurables shot up, while spending on services increased more modestly.

What has gotten Americans into such a good shopping mood? No mystery here.

- **The lowest joblessness in 17 years.**

- **Household wealth shot up to $96.9 trillion in the 3rd quarter, a record high whether viewed in nominal dollars, in inflation-adjusted dollars, or on a per capita basis. That figure is expected climb even further when the Federal Reserve releases fourth quarter numbers in early March.**

- **Americans were encouraged as well by the prospect of seeing bigger paychecks in 2018 as a result of the tax overhaul.**

- **Consumer spending was also supported by the fact that interest rates, inflation and energy prices remained relatively low and stable.**

- **All these factors catapulted confidence to a 17-year high during the fourth quarter, according to the Conference Board.**

Let's move on to the corporate sector. Businesses were also in buoyant spirits at the end of the year. Private fixed investment jumped by 7.9%, which again was much larger than the second and third quarters. Most impressive was how companies ramped up purchases of new equipment. It climbed by an 11.6% rate, the most in more than three years!

Trade also played an important role in stimulating economic activity. Stronger growth overseas boosted foreign demand for US goods, pushing exports up by 6.9%, beating the pace of the two earlier quarters.

Even federal, state and local spending in the final three months rose by the most of any quarter in 2017!

So what was behind the "disappointing" 2.6% growth rate last quarter?

What primarily pulled down headline GDP was a widening trade deficit. Trade deficits subtract from US growth since domestic demand is partially satisfied by foreign production. As a result, net exports deducted 1.13 percentage points from the fourth quarter's 3.68% growth rate that stemmed purely from consumer, business and government spending.

But here's the key point! The larger trade deficit in this case highlights the underlying robustness of the economy. Both exports and imports shot up precisely because economic activity in US and the rest of the world was so strong. But since the US economy is the largest, and given the propensity of Americans to spend more on imports than most other nations, it should come as no surprise that this can

produce larger US trade deficits. We prefer to focus on domestic demand, which was so substantial that imports rose 13.9%, double the pace foreigners were buying from the US (6.9%) in the final quarter.

The takeaway here is that the overall volume of trade reveals an increasingly vibrant American and foreign economy!

This can be further underscored by a look at "final sales to private domestic purchasers," which focuses solely on consumer and business spending in the US (and ignores the trade deficit, inventory investments and government outlays). Here we see that America's private sector expenditures was the most active it has been in years, with demand for goods and services up 4.6% in the fourth quarter, the most since Q3 of 2014.

For the year as a whole, the US economy expanded by 2.3% (our own forecast called for 2.4%), after growing 1.5% in 2016, which was the slowest in 7 years.

<u>So what does the latest GDP report tell us about the economy in 2018?</u>

From a purely fundamental standpoint, we see no sign the US business cycle is near its peak. The first half will continue to see healthy consumer spending, a further pick up in business investments and greater exports, all of which will propel economic growth this year by 2.7%.

However, most of this activity will take place in the first half. There are significant forces at work that will bring fresh headwinds for the economy later in the year. Let's list some of them.

1. Americans have supported this expansion for more than eight years and that raises the question of whether demand is close to being satiated. After all, how many more cell phones, autos, home electronic gadgets do households really need after nearly a decade of shopping?

This question takes on more relevance because consumers have financed much of these purchases by taking on more debt and saving less. Total household debt now stands at a record high $12.96 trillion. That may be manageable when interest rates were historically low, but it will be more problematic now that we're in a rising rate environment. Equally concerning is how much less Americans are saving. The savings rate dropped to 2.6% in the final quarter of 2017, the third lowest on record! If households chose to replenish some of their savings and/or reduce indebtedness, we will see less discretionary spending in 2018.

2. The biggest change in the contribution to GDP growth this year will come from the corporate side. Up until recently, more than 85% of the earnings of S&P 500 companies went into buying back their own stocks and increasing dividends. That certainly delighted shareholders. But by investing so little into new plant and equipment, it hampered productivity growth and made it more difficult for US firms to compete in a tough global marketplace. The failure of so many firms to plow those profits into modernizing their production facilities has left many workers relying on antiquated machinery, computers and software.

That reality finally sank in last year. Companies ramped up capital spending by 3.2% in 2017 (after a decline of 1.6% in 2016), and we expect this upward trend will accelerate in 2018 given the latest overhaul in corporate taxes. The outlook for business spending in 2019, however, looks dimmer as firms confront a higher cost of capital and growing concern this business cycle will top out late that year or in 2020.

3. There is also a foreboding sense 2018 will be a year of culminations. For example, Americans are watching with increasing concern at the bizarre political dynamics in Washington. There are ongoing investigations in Congress and at the Justice Department into Trump's relationship with Russia during the presidential campaign and allegations that he obstructed justice once in the White House. We could be approaching a seminal moment in this political drama that may determine the longevity of the Trump Administration.

4. Will voters be so frustrated by the policy paralysis in Washington that the GOP experiences a bloodbath in the midterm elections next November? If Republicans lose one or both houses of Congress, a rollback in the latest tax cuts could be on the horizon?

5. Last, but certainly not least, business leaders, investors and policymakers will have to carefully navigate through a minefield of geopolitical dangers. Will North Korea's obsession to build nuclear-tipped ICBMs lead to a catastrophic war on the Korean Peninsula? Are we about to see tensions between Saudi Arabia and Iran boil over into a hot war and push oil prices toward triple digits? Will China's annexation of the South China Sea and the militarization of its islands interfere with vital maritime traffic and lead to a confrontation with the U.S?

So we view 2017 as a productive year where all cylinders --- consumers, business, and government --- contributed to growth. That momentum will carry into the first half of 2018. But the second half looks more precarious as the aging recovery, higher interest rates and a myriad of exogenous risks could threaten to take the wind out of this expansion.

Key Economic Forecasts

- Actual
- Forecast

United States

	I 2017	II 2017	III 2017	IV 2017	I 2018	II 2018	III 2018	IV 2018	I 2019	II 2019	III 2019	IV 2019
Real Gross Domestic Product (GDP):												
%	1.2	3.1	3.2	2.6	2.4	3.2	2.5	2.5	1.9	2.2	2.0	2.4
Personal Consumption Expenditures:												
PCE %	1.9	3.3	2.2	3.8	2.4	2.8	2.4	2.4	2.2	2.1	2.3	2.7
Inflation, end of period, year-over-year:												
CPI %	2.4	1.6	2.2	2.1	2.2	2.2	2.3	2.3	2.4	2.4	2.5	2.7
Unemployment Rate (end of period):												
%	4.5	4.4	4.2	4.1	4.2	3.7	3.7	3.9	4.2	4.4	4.4	4.5
Non-farm Payrolls, monthly avg. thousand:												
	166	187	128	204	190	185	160	160	150	145	140	140
Treasury 10-yr Note Yield % (end of period):												
	2.39	2.30	2.33	2.41	2.60	2.63	2.85	3.10	3.35	3.38	3.40	3.40
Federal funds rate % (end of period):												
	0.88	1.13	1.13	1.38	1.63	1.63	1.88	2.13	2.38	2.63	2.63	2.63

GDP Growth - Global Economy

Country	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
US	-2.8	2.5	1.6	2.2	1.7	2.6	2.9	1.5	2.3	2.7	2.1
Eurozone	-4.1	1.7	1.4	-0.9	-0.3	1.2	1.6	1.7	2.3	2.4	1.7
United Kingdom	-5.2	1.7	0.7	0.3	1.8	2.9	2.2	1.8	1.4	1.0	1.4
Japan	-5.4	4.6	-0.4	1.6	1.5	-0.1	1.1	1.0	1.6	1.9	0.9
Canada	-2.8	3.1	3.1	1.7	2.2	2.5	0.9	1.4	3.2	2.7	2.5
India	6.3	8.4	8.6	6.7	4.9	7.4	7.9	7.1	6.8	7.5	7.5
China	9.2	10.5	9.5	7.8	7.7	7.3	6.9	6.7	6.9	6.6	6.3
Brazil	-0.3	7.5	2.7	0.9	2.3	0.1	-3.8	-3.6	0.9	2.3	2.8
Mexico	-4.7	5.2	4.0	3.9	1.4	2.3	2.7	2.0	2.1	2.0	2.5
Australia	1.2	2.8	2.6	3.6	2.4	2.6	2.4	2.4	2.7	2.8	3.0
Russia	-7.9	4.0	4.3	3.4	1.3	0.6	-2.8	-0.2	1.4	2.1	2.0
World	-1.9	4.2	3.0	2.6	2.9	3.0	2.7	2.4	3.3	3.4	3.5

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