RSQE FORECASTS

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The U.S. Economic Outlook for 2018–2019
Executive Summary: November 2017

Trump Bump? Not Just Yet

Candidate Trump promised 4 percent growth on the campaign trail. President Trump's budget proposal assumed 3 percent growth. Both seemed quite unrealistic. Real GDP growth during the two most recent quarters, however, came in at 3 percent. To get a sense of trend growth, we look at final domestic demand—GDP excluding the volatile inventory investment and net exports sectors. After averaging about 2.4 percent during 2016q2–2017q2, quarterly growth of final domestic demand slowed to a 1.8 percent annualized pace in 2017q3, the weakest reading since 2016q1. The slowdown was largely driven by a decline of consumption growth across several categories from a strong 2017q2 reading to a more sustainable pace.

The labor market continues to tighten, but at a slower pace than before as we approach full employment. Average payroll employment growth has decelerated from 250,000 jobs per month on average in 2014, to 226,000 in 2015, 187,000 in 2016, and 168,500 in 2017 so far. The record-breaking continuous streak of monthly payroll job gains now stands at 84 months. The unemployment rate dipped to 4.1 percent in October. And yet, the 12-month growth rate of average private hourly earnings seems to have gotten stuck below 2.8 percent.

Optimism Lingers

Business and consumer optimism about the economy remains high. The October level of the University of Michigan's Index of Consumer Sentiment was at 100.7, its highest reading since January 2004. NFIB's small business optimism index has also remained high since December 2016. The index is currently at levels last seen in 2005. While swollen confidence has not led to a surge in domestic spending, household spending and business fixed investment have both provided steady contributions to growth in the economy.

Institute for Supply Management (ISM) indexes point to increases in business sector activity. The ISM manufacturing index for October, at 58.7, is almost 7 index points above its level a year ago, and the average for the third quarter was last reached in 2004q3. The ISM nonmanufacturing index for October tells a similar story, with the 60.1 reading being the fourth-highest monthly reading since the survey began in July 1997. The quarterly reading of 56.3 for the third quarter also suggests steady growth in the services sector.

Shake-up at the House of Saud

Oil prices are rising again. The monthly average price of WTI increased from 45.2 dollars per barrel in June to 51.6 dollars in October, and jumped to around 57 dollars per barrel in recent days. We believe that this jump is caused at least in part by a recent episode of political uncertainty in Saudi Arabia, and hence will dissipate as tensions ease. Still, we expect that rising global demand, falling global inventories, and an extension of the OPEC supply cuts will nudge oil prices up in 2018 and 2019.

Vehicle Sales in Overdrive Again

In January–July of 2017, the light vehicle sales pace averaged 16.9 million units, a far cry from 2016's record-setting 17.5 million. Manufacturers tried but failed to control swelling inventories through production cuts, while keeping incentive spending in check. Starting in August, manufacturers ramped up incentives and the pace of light vehicle sales rebounded sharply, exceeding 18 million units in September–October. Still, some overstock remains, and November–December sales may exceed sustainable levels.

Inflation Puzzle for the Fed

Early in 2017, it appeared that inflation pressure might be picking up, as the 12-month core PCE inflation rate had held around 1.8–1.9 percent from July 2016 through February 2017. Between March and September 2017, however, core inflation has decelerated considerably relative to its February level. Core PCE infla-

tion was only 1.3 percent year-over-year in September. Core inflation is one of the key predictors of future headline inflation, and its recent weakness should worry the Federal Reserve.

The Fed has openly admitted that it does not completely understand what is driving the weakness in inflation, but appears resolved to ignore the slow inflation for now and maintain the pace of rate tightening, hoping that inflation will eventually catch up to the Fed's 2 percent target. We expect the FOMC to raise rates again at its December meeting. With the nomination of Jerome Powell, already a member of the Federal Reserve Board of Governors, as chair, the upcoming transition of power at the helm of the nation's central bank is shaping up to be fairly smooth and is unlikely to result in a major shift in the stance of monetary policy in the near term.

Cut, Cut, Cut

After two failed attempts at Obamacare repeal, Congressional Republicans and President Trump badly need a policy victory. While the passage of tax legislation in some form is quite likely, the magnitude and the scope of a bill that can gather enough support to pass in the face of multiple procedural hurdles is not yet clear. The budget resolution capped the deficit cost of the tax legislation at 1.5 trillion dollars, already only about a quarter as large as promised on the campaign trail. We believe that the size of the tax cut is likely to become smaller yet before it can pass in Congress.

The 2018–2019 Outlook

We expect all major private components of domestic final demand to expand at a robust pace over our forecast horizon. The likely passage of deficit-raising tax cuts will put downward pressure on federal government spending growth during our forecast horizon. GDP growth is 2.5 percent in 2018 and 2.1 percent in 2019. Net exports are a drag on growth to the tune of 0.3–0.4 tenths of a percentage point of GDP throughout the forecast horizon.

The housing sector continues to contribute to overall economic growth as residential investment expands in response to higher home prices. Annual housing starts grow at a moderate pace, increasing from 1.2 million in 2017 to 1.3 million in 2019.

Employment and Inflation

The unemployment rate is projected to continue decreasing slowly, from an average of 4.4 percent in 2017 to 4.1 percent in 2019. As labor markets tighten, we expect annual job gains to slow from 2.1 million jobs in 2017 to 1.8 million in 2019.

Annual core CPI inflation is projected to increase to 1.7–1.8 percent in 2017–18, rising to 2.1 percent in 2019. Headline inflation sits at 2.1 percent in 2017, and we expect it to slow down to a moderate 1.6 percent pace in 2018 and then rise to 1.8 percent in 2019, lagging behind core inflation largely due to a tame oil price outlook and weak food price inflation.

	Actual	**RSQE Forecast**		
	2016	2017	2018	2019
GDP (billions of current $)	18624.5	19379.0	20202.0	21038.7
Real GDP (billions of chained 2009 $)	16716.2	17090.5	17514.3	17885.5
% change: year-over-year	1.5	2.2	2.5	2.1
% change: 4th-qtr-to-4th-qtr	1.8	2.5	2.2	2.1
Nonfarm payroll employment (millions)	144.3	146.4	148.5	150.3
Civilian unemployment rate (%)	4.9	4.4	4.2	4.1
Capacity utilization, total industry (%)	75.7	76.3	77.2	78.2
Inflation (private nonfarm GDP deflator, % change)	1.3	1.8	1.7	2.0
Inflation (CPI-U, % change)	1.3	2.1	1.6	1.8
Inflation (core CPI, % change)	2.2	1.8	1.7	2.1
Light vehicle sales (millions)	17.5	17.1	17.1	17.0
Private housing starts (thousands)	1177.3	1199.4	1269.9	1305.5
3-month Treasury bill rate (%)	0.3	0.9	1.4	1.9
10-year Treasury note rate (%)	1.8	2.3	2.8	3.1
Conventional mortgage rate (%)	3.6	4.0	4.3	4.7
Real disposable income (billions of chained 2009 $)	12608.7	12782.0	13116.8	13533.8
% change	1.4	1.4	2.6	3.2
Corporate profits after tax (billions of current $)	1687.9	1808.9	1933.8	2102.2
Value of U.S. $ (FRB broad index), % appreciation	4.7	–0.1	–1.2	0.0
Current account balance (NIPA basis, billions of current $)	–460.9	–485.9	–534.1	–595.5
Federal surplus (FY, NIPA basis, billions of current $)	–660.8	–655.3	–682.4	–750.6