United States

- **US growth is expected to accelerate from 1.6% in 2016 to 2.3% in 2017 as a broadly-based reflation of the US economy continues to take hold.**
- **The possibility of greater fiscal stimulus and deregulation from the new US administration implies the potential for even faster growth moving into 2018 so long as the new administration doesn't resort to protectionist trade policies.**

THE BUMP PRECEDED TRUMP

The US economy is strengthening following a weak start to 2016. We expect growth to continue accelerating to 2.3% in 2017 and 2.4% in 2018, about half a percentage point above the Fed's estimate of long-term potential. This pick-up is driven by a strong labor market and improved household balance sheets, which are translating into strengthening consumption, a turnaround in inventories, increased manufacturing sales—particularly in autos—and better prospects for investment. The rebound in global oil prices is also starting to provide a much more positive backdrop for the US energy sector, the epicenter of the US slowdown over the past year. A widening trade deficit is likely to be the only clear drag on US growth in 2017 and 2018. If the new US administration follows through on its stated tilt toward greater fiscal stimulus and deregulation, without also setting off a trade disruption, then the US economy will likely perform even more strongly than we currently anticipate.

ROBUST LABOUR MARKETS AND MORE CONFIDENT CONSUMERS

As the recent FOMC minutes indicate, the US is at or close to full employment: the unemployment rate is at 4.6%, initial unemployment claims are close to a four-decade low (Chart 1), the participation rate is increasing (Chart 1 again), and wage growth is accelerating (Chart 2). The number of job openings—a measure of unmet labor demand favored by the Fed—is near a record high. Hiring may slow as the economy converges to full employment, but continued real wage growth in a tighter labor market should permit real income growth to remain robust throughout 2017 and 2018.

Stronger labor markets combined with cleaned up household balance sheets are setting the stage for further acceleration in US growth: the household debt-GDP ratio has fallen about 20 percentage points from its 2008 crisis high (Chart 3) and the household debt-service ratio remains near a record low (Chart 3 again). Growth in household net wealth has accelerated and is now advancing at its fastest pace in two years. Indicators of consumer confidence are at some of their highest levels since the 2008 financial crisis (Chart 4). More confident consumers with lighter debt burdens are likely to drive up consumption, increase demand for goods and services, and push up hiring and wages.

THE END OF THE INVENTORY CORRECTION

After years of slowing inventory accumulation in the face of uncertain growth prospects, inventory growth looks set to turn upward during 2017. The pace of sales growth is quickening across a broad range of industries, both in manufacturing and the vast service sector. In fact, purchases by households and businesses are now

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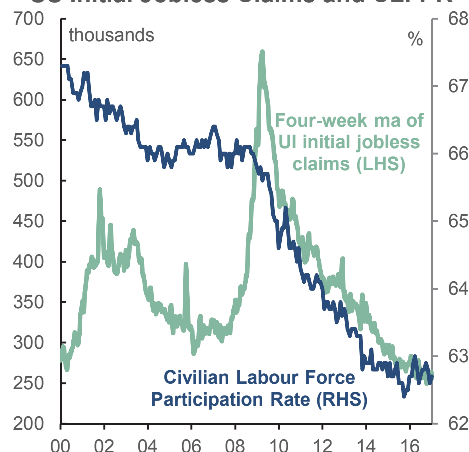
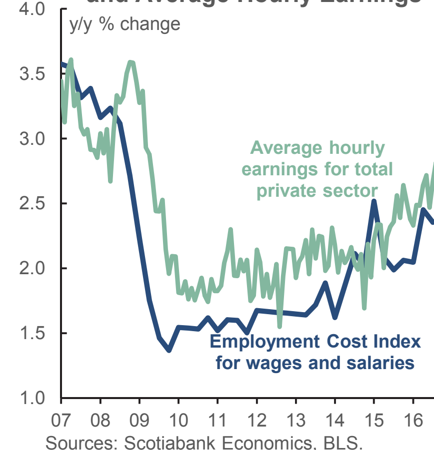
Chart 1



Sources: Scotiabank Economics, US Department of Labor, BLS.

Chart 2



Sources: Scotiabank Economics, BLS.

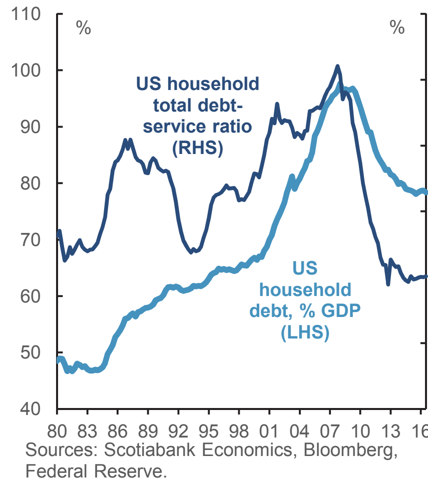
outpacing inventory accumulation for the first time since 2011 (Chart 5). Historically, a quickening in sales growth has usually led to some acceleration in the pace of inventory accumulation over the ensuing year.

In particular, retail and wholesale purchases are now advancing in excess of 3% y/y for the first time in two years, which is more than double the pace of current inventory growth. This implies that store shelves will need to be restocked in the coming months, a crucial development for continued acceleration in US growth. Retail and wholesale inventories account for 60% of overall non-farm business supplies and nearly 10% of overall economic activity.

MANUFACTURING PICKS UP

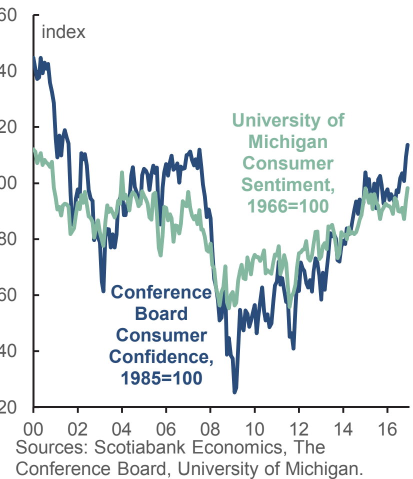
Orders for manufactured goods began to gain momentum in the second half of 2016 and are now growing at their fastest pace in two years: they are outpacing overall output gains and point to even stronger US industrial activity ahead in 2017. In fact, the US Purchasing Managers' Index, a leading indicator of manufacturing activity, has been steadily improving since mid-year and ended 2016 at a buoyant 21-month high (Chart 6). Orders have increased for both durable and nondurable goods, with the high-tech sector leading the revival with gains of over 5% during the past year.

Chart 3



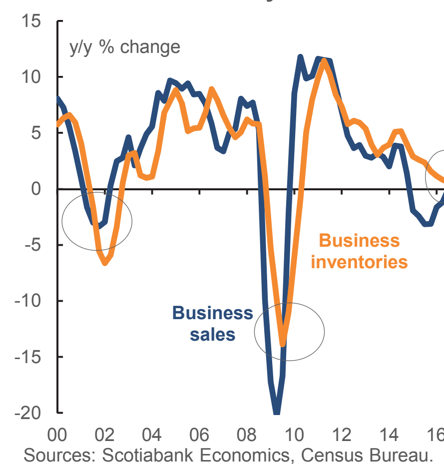
Sources: Scotiabank Economics, Bloomberg, Federal Reserve.

Chart 4



Sources: Scotiabank Economics, The Conference Board, University of Michigan.

Chart 5



Sources: Scotiabank Economics, Census Bureau.

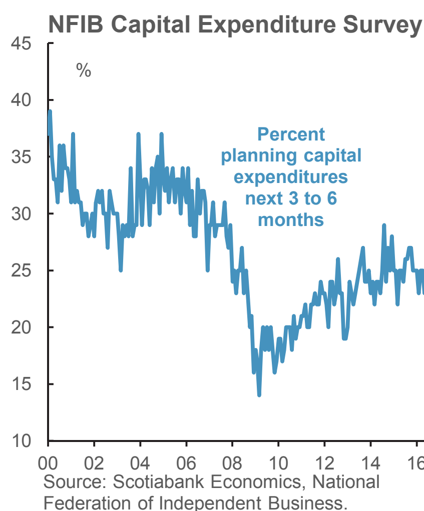
Chart 6

Sources: Scotiabank Economics, Federal Reserve Board, Institute for Supply Management.

Table 1 — Quarterly US Forecasts

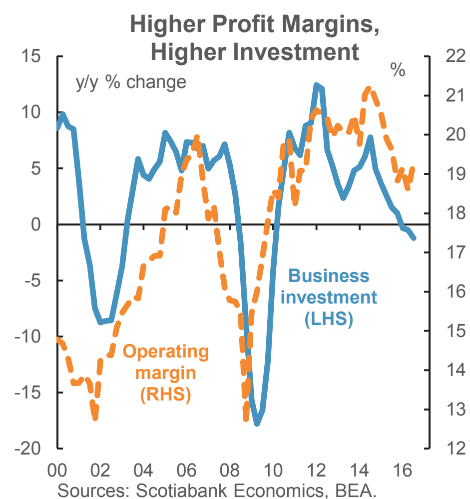
	2016				2017				2018			
	Q1	Q2	Q3	Q4e	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Economic												
Real GDP (q/q ann. % change)	0.8	1.4	3.5	2.2	2.0	2.1	2.3	2.3	2.5	2.5	2.3	2.4
Real GDP (y/y % change)	1.6	1.3	1.7	2.0	2.3	2.5	2.1	2.2	2.3	2.4	2.4	2.4
Consumer Prices (y/y % change)	1.1	1.1	1.0	1.8	2.7	2.6	2.7	2.4	2.3	2.3	2.4	2.3
Core CPI (y/y % change)	2.3	2.2	2.2	2.2	2.1	2.1	2.2	2.3	2.3	2.3	2.3	2.3
Financial												
Euro (EURUSD)	1.14	1.11	1.12	1.05	1.02	1.02	1.05	1.10	1.12	1.12	1.15	1.15
U.K. Pound (GBPUSD)	1.44	1.33	1.30	1.23	1.20	1.20	1.25	1.25	1.30	1.30	1.35	1.35
Japanes Yen (USDJPY)	113	103	101	117	115	115	117	117	121	121	122	122
Fed Funds Rate (%)	0.50	0.50	0.50	0.75	0.75	1.00	1.25	1.50	1.50	1.75	1.75	2.00
3-month T-bill (%)	0.20	0.26	0.27	0.50	0.55	0.80	1.05	1.25	1.30	1.55	1.60	1.80
2-year Treasury (%)	0.72	0.58	0.76	1.19	1.25	1.40	1.50	1.70	1.75	1.90	1.95	2.10
5-year Treasury (%)	1.20	1.00	1.15	1.93	2.00	2.10	2.20	2.30	2.40	2.50	2.55	2.60
10-year Treasury (%)	1.77	1.47	1.59	2.44	2.50	2.60	2.70	2.80	2.85	2.90	2.95	3.00
30-year Treasury (%)	2.61	2.28	2.31	3.07	3.05	3.15	3.20	3.30	3.35	3.40	3.45	3.50

Chart 7



Source: Scotiabank Economics, National Federation of Independent Business.

Chart 8



Sources: Scotiabank Economics, BEA.

The auto industry has also been a key contributor to growth. US auto sales have climbed for seven consecutive years and have set back-to-back annual records in 2015 and 2016. Vehicle production has also been moving higher, lifting industry employment 2% over the past year and outpacing overall US employment growth for the seventh year in a row. Operating rates have climbed to the highest level in decades, prompting automakers to announce significant capital expenditures in the United States in recent weeks. We expect a further advance in sales and production in 2017 as households continue to replace old vehicles. The average age of the US vehicle fleet has jumped to a record 11.6 years and there are more than 100 million vehicles on American roads that are older than average. Financing conditions also remain supportive, especially since more creditworthy buyers account for the majority of purchases and sub-prime's share of total financing volumes has been declining since mid-2015.

STRONGER BUSINESS INVESTMENT COMING

The stabilization in inventory growth, the pick-up in manufacturing orders, higher oil prices, and a year-long narrowing in corporate credit spreads have set the stage for an upturn in business investment (Chart 7). New orders for 'core capital equipment', a proxy for business investment, have advanced in five of the most recent six months. This has lifted machinery orders to their first quarterly increase in more than two years. This improvement has been concentrated in the oil and gas sector, which has since May 2016 boosted the number of rigs drilling by 50% and tripled its monthly purchases of machinery and equipment. In fact, the oil and gas sector has accounted for one-third of the overall advance in core capital equipment orders in the second half of 2016, significantly outpunching its traditional 8% share of overall capital expenditures. Outside of the oil and gas sector, business investment remains tepid: orders have fallen on a year-on-year basis since late-2014.

Past experience implies that growth in business investment hits its full stride only after both a double-digit improvement in profit margins has been attained and capacity utilization has tightened by roughly 2 percentage points. While growth in profit margins has troughed, it typically takes a year for profit growth to accelerate substantially (Chart 8). Meanwhile, capacity utilization in the US is still falling (Chart 9). Initial tax cuts and infrastructure spending by the incoming US administration may marginally quicken the present upturn in corporate earnings and profit margins, as well as improve operating rates. This would all hasten our expected rebound in business investment, but it is unlikely to bring it forward to any sooner than the second half of 2017.

Table 2 — United States

	2000–15	2016e	2017f	2018f
		(annual % change)		
Real GDP	1.9	1.6	2.3	2.4
Consumer Spending	2.3	2.7	2.7	2.6
Residential Investment	-0.7	4.8	2.7	2.7
Business Investment	2.4	-0.5	2.1	3.2
Government	1.0	0.8	0.9	1.2
Exports	3.8	0.5	2.1	2.8
Imports	3.5	0.8	3.0	3.5
Nominal GDP	4.0	3.0	4.3	4.4
GDP Deflator	2.0	1.3	2.0	2.0
Consumer Price Index	2.2	1.3	2.5	2.3
Core CPI	2.0	2.2	2.2	2.3
Pre-Tax Corporate Profits	5.9	-0.5	5.0	3.0
Employment	0.6	1.7	1.4	1.3
Unemployment Rate (%)	6.3	4.9	4.6	4.5
Current Account Balance (USD bn)	-521	-484	-513	-545
Merchandise Trade Balance (USD bn)	-668	-735	-774	-825
Federal Budget Balance (USD bn)	-529	-587	-610	-650
per cent of GDP	-3.8	-3.2	-3.1	-3.2
Housing Starts (mn)	1.27	1.17	1.26	1.34
Motor Vehicle Sales (mn)	15.4	17.5	17.8	17.9
Industrial Production	0.8	-1.0	1.5	2.0
WTI Oil (USD/bbl)	64	43	58	61
Nymex Natural Gas (USD/mmbtu)	5.09	2.55	3.25	3.15

HOUSING PROSPECTS REMAIN SOLID

Labor market gains, improved household balance sheets, and rising consumer confidence make the outlook for US housing positive: excess inventories have come down (Chart 10), increased participation by first-time buyers should continue to lift resale activity, new housing starts are on track to increase 8% in 2017, and prices are set to increase by 4% across major markets. Affordability remains better than the historical averages of major indices despite rising prices. Even so, the rates of both sales and price growth are expected to slow alongside the recent rise in mortgage rates. The 30-year fixed rate has climbed more than 70bps since early November to around 4.20% and home financing conditions since have eased only slightly.

On the supply side, growth in the total volume of sales could be curbed by a lingering shortage of lower-priced listings: some potential move-up buyers remain reluctant or unable to list, while new construction has been geared toward higher-priced properties. Growth in total new housing starts may also slow as a result of construction labor shortages, permit delays, and rising land and construction costs. Meanwhile, a growing glut of high-end rental unit completions is expected to prompt a pullback in new apartment construction, which has accounted for roughly 30% of new homebuilding in recent years compared with a long-run average of 20%.

FISCAL POLICY MILDLY STIMULATIVE

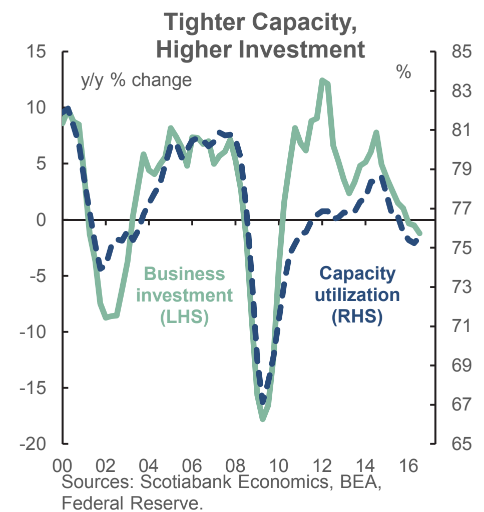
Fiscal policy is mildly simulative and looks set to remain so even without any additional measures under the new Trump administration. The federal deficit widened from 2.4% to 3.2% during fiscal 2016. Assuming a limited initial increase in spending, we expect the deficit to remain at 3.1% and 3.2% of GDP in fiscal 2017 and fiscal 2018, respectively. The White House may also try to demonstrate its commitment to reducing the burden of government by immediately using executive orders to trim some business levies and cut regulatory constraints, but their initial direct impact on the fiscal balance would be negligible.

Comprehensive tax reform, wide-ranging regulatory overhaul, and implementation of the mooted 10-year, USD 1tn increase in infrastructure spending are unlikely to begin taking effect until mid-2018, at the earliest. Until then, the uncertainty engendered by rolling policy shifts on the budget, the Affordable Care Act, climate change, and financial-sector regulation is likely to engender a “wait-and-see” approach to fiscal policy at the state and municipal level.

BIGGER TRADE DEFICITS AHEAD

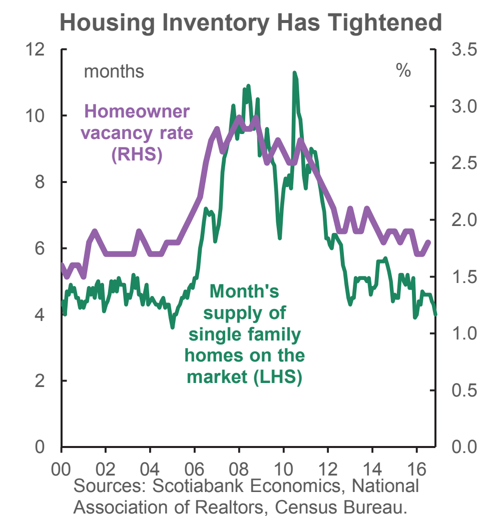
Continued strength in the US dollar (USD, see pp. 42–43 here) and strong US demand are likely to lead to an ongoing deterioration in the US trade balance. As we’ve previously noted, the strong dollar could lead to record trade deficits over the longer term: the trade-weighted USD tends to anticipate eventual movements in the US current account balance (Chart 11). For the moment, net exports are expected to pare US growth by about 0.2 percentage points during 2017 and 2018, respectively. The emergence of even wider trade deficits would increase the risk that the new US administration will follow through on its threats to enact mercantilist trade policies, which would substantially dent both US and global growth.

Chart 9



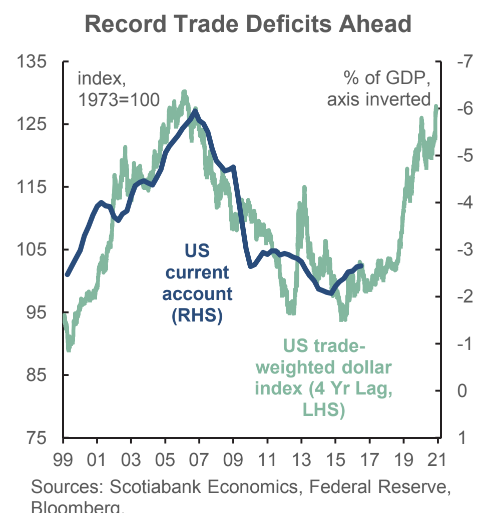
Sources: Scotiabank Economics, BEA, Federal Reserve.

Chart 10



Sources: Scotiabank Economics, National Association of Realtors, Census Bureau.

Chart 11



Sources: Scotiabank Economics, Federal Reserve, Bloomberg.

RISKS FROM KNOWN UNKNOWNS

The United States economy's continued exit from secular stagnation hinges largely on the actions of the US authorities. With demand strengthening and the supply side responding, the US government doesn't need to do much to bring about quicker economic growth. A light touch on fiscal stimulus and the pursuit of the new White House's deregulation agenda could see even higher growth rates than we project here without eliciting a pre-emptory monetary policy tightening from the Fed (see 14–16 here). In contrast, too much fiscal action at nearly full employment could prompt a quick hike in policy rates and a stronger USD. An ensuing widening in the US trade deficit would bring calls for higher tariffs, disruptions in trade with America's major economic partners, and a major reduction in growth, which would shake confidence in already highly-priced equity, corporate debt, and housing markets and hurt tax revenue. Similarly, a lack of follow-through on expectations of a consequential increase in infrastructure spending and regulatory reform would disappoint markets, which could have a material negative effect on both household and business demand and investment.

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