United States

- **Building on a strong finish to 2017, US growth momentum is expected to carry into 2018 before reverting back toward underlying potential in 2019.**
- **The recently-approved package of federal tax cuts is expected to contribute only a marginal addition to annual growth in an economy already firing on most cylinders with a closed output gap, tight labour markets, and strong household consumption.**
- **Inflation is expected to continuing edging up beyond 2% by mid-2018, prompting the Fed to follow through with three rate increases in 2018 and two more in 2019, to reach a terminal rate of 2.75%.**

MOMENTUM CARRIES INTO 2018

The US closed out 2017 on a relatively high note, with strengthening data on economic activity matched by optimism connected to the passage of USD 1.5 tn in federal tax cuts for the next decade that should put US business on a more competitive footing compared with their foreign counterparts (chart 1). We expect a solid hand-off into the first half of 2018, with real GDP growth projected to rise from 2.3% in 2017 to 2.5% in 2018, with some moderation toward potential at 1.8% in 2019, far short of the White House's targets. The composition of growth is expected to improve somewhat as strong consumption growth is increasingly matched by broadening industrial activity and stepped-up business investment, spurred in part by the tax changes that provide more advantageous treatment of capital equipment purchases. But overall, federal tax reform is expected to add only a marginal contribution to economy-wide real GDP in its initial years: the output gap is already closed, labour markets are tight with unemployment at a cycle-low, personal tax reductions are skewed toward high-income earners with relatively low marginal propensities to spend their savings, and most studies imply that ongoing increases in business investment stemming directly from the tax changes will be small. Farther out, the tax package is likely to become a drag on growth as some tax cuts expire.

Tighter labour and product markets, waning deflationary effects from the greenback, and an economy that continues to grow above potential imply that inflation will edge above 2% by mid-2018 and remain there through 2019. This should prompt the Fed to follow through with the three rate increases anticipated in the Federal Open Market Committee's (FOMC) dot plots for 2018 and two more during 2019, as outlined in the *US & Canadian Monetary Policy & Capital Markets* section.

STRONG JOB MARKET FUELS STEADY SPENDING GAINS

Consumers remain the backbone of the US expansion. Strength in big-ticket demand for motor vehicles, household furnishings and equipment has lifted real purchases of durable goods by more than 6% year-over-year, more than double the increase in non-durables and services. Confidence and spending are well supported by low unemployment testing the 4% threshold for the first time in almost two decades, strong wealth gains from rising home and equity prices, and still-low borrowing costs.

CONTACTS

Brett House, VP & Deputy Chief Economist
416.863.7463
Scotiabank Economics
brett.house@scotiabank.com

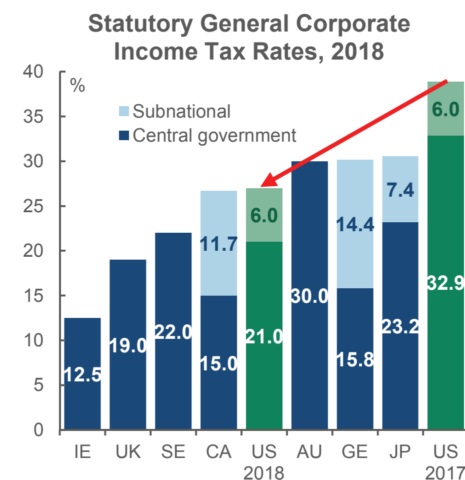
Carlos Gomes
416.866.4735
Scotiabank Economics
carlos.gomes@scotiabank.com

Juan Manuel Herrera
416.866.6781
Scotiabank Economics
juanmanuel.herrera@scotiabank.com

Adrienne Warren
416.866.4315
Scotiabank Economics
adrienne.warren@scotiabank.com

Mary Webb
416.866.4202
Scotiabank Economics
mary.webb@scotiabank.com

Chart 1



Sources: Scotiabank Economics, OECD.

Household consumption has been financed partly by increased borrowing and reduced saving, which could constrain spending going forward. Credit market debt as a share of disposable income has edged higher since early 2016, though it remains more than 25 percentage points below the 2007 peak (chart 2). The aggregate household savings rate has dropped three percentage points over the same period to 2.9%, its lowest level in a decade.

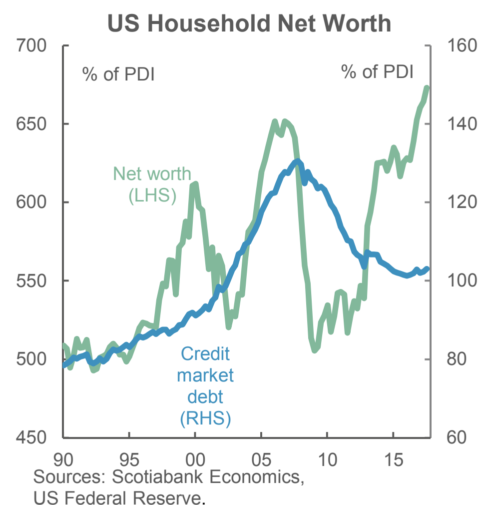
Household balance sheets, overall, remain quite healthy. Average household net worth is at record levels. Debt-servicing costs as a share of disposable income are near record lows. Just 5% of mortgage holders have negative home equity, down from a peak of 26% in 2009. Delinquency rates are low, though they are edging up for some types of lending, including credit-card balances.

Wage trends are forecast to accelerate this year with the US labour market at or near full employment, and a long-awaited pickup in productivity growth beginning to take hold. The broad U-6 measure of 'underemployment' that takes into account marginally attached workers and involuntary part-time workers is near a cycle low 8.1% (chart 3). Initial jobless claims are near historic lows. Job vacancies are trending near a record 6 mn unfilled positions, with reports of labour shortages becoming increasingly broad-based across industrial sectors.

Firmer wage gains should maintain relatively steady real spending growth of around 2.5% in 2018 despite some expected slowing in the pace of hiring. Household earnings and purchasing power are getting a lift from minimum wage increases in 18 states as of January 1, 2018, with two more states set for increases on July 1. Consumer spending should be supported also by personal income tax relief. However, the gains from these tax reforms are skewed toward higher-income earners with a lower marginal propensity to spend compared with lower-income households. As a result, the change in personal income taxes is expected to have only a very modest impact on broad consumption growth.

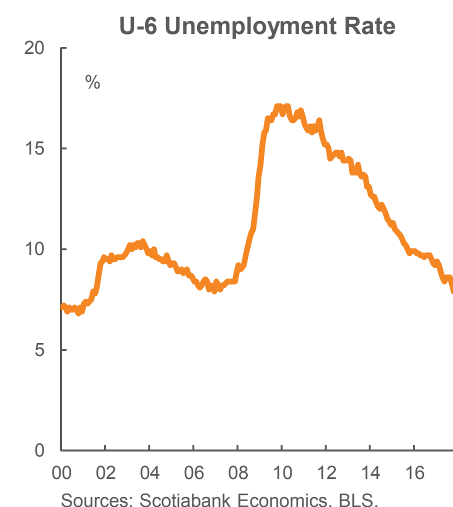
Meanwhile, weaker international tourism inflows are likely to continue to weigh on some retail and hospitality sectors. The number of international visitors to the United States in the first seven months of 2017 fell 4% from the same period a year earlier amid new travel restrictions and a strong US dollar (chart 4). Leading indicators of international long-haul bookings to the United States suggest a continued cool travel climate for 2018, in contrast to the generally bright outlook globally.

Chart 2



Sources: Scotiabank Economics, US Federal Reserve.

Chart 3



Sources: Scotiabank Economics, BLS.

Table 1

Quarterly US Forecasts	2017		2018				2019			
	Q3	Q4e	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Economic										
Real GDP (q/q ann. % change)	3.2	2.8	2.4	2.2	2.1	1.9	1.6	1.6	1.6	1.6
Real GDP (y/y % change)	2.3	2.5	2.8	2.6	2.4	2.2	2.0	1.8	1.7	1.6
Consumer prices (y/y % change)	2.0	2.0	2.0	2.3	2.3	2.2	2.2	2.3	2.4	2.4
CPI ex. food & energy (y/y % change)	1.7	1.8	1.8	2.1	2.2	2.2	2.2	2.2	2.3	2.3
Financial										
Euro (EURUSD)	1.18	1.20	1.18	1.18	1.20	1.20	1.24	1.24	1.28	1.28
U.K. Pound (GBPUSD)	1.34	1.35	1.35	1.35	1.37	1.37	1.38	1.38	1.40	1.40
Japanese Yen (USDJPY)	113	113	114	114	115	115	118	118	120	120
Fed Funds Rate (upper bound, %)	1.25	1.50	1.75	1.75	2.00	2.25	2.25	2.50	2.50	2.75
3-month T-bill (%)	1.04	1.38	1.80	1.80	2.05	2.30	2.30	2.55	2.60	2.80
2-year Treasury (%)	1.48	1.88	2.20	2.30	2.50	2.60	2.70	2.75	2.85	2.90
5-year Treasury (%)	1.93	2.21	2.50	2.60	2.70	2.75	2.85	2.90	3.00	3.05
10-year Treasury (%)	2.34	2.40	2.70	2.80	2.85	2.90	3.00	3.05	3.15	3.20
30-year Treasury (%)	2.86	2.74	2.85	2.95	3.00	3.05	3.15	3.20	3.30	3.35

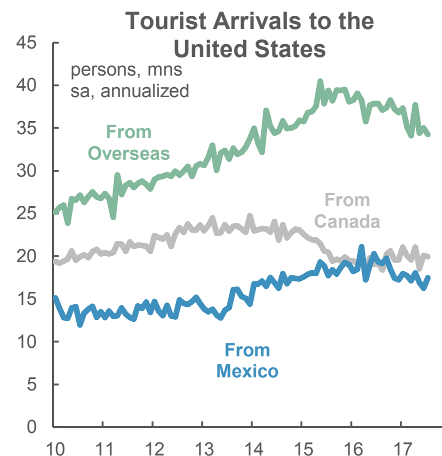
Sources: Scotiabank Economics, BEA, BLS, Bloomberg.

US HOUSING CYCLE STILL HAS ROOM TO RUN

The US housing market is showing renewed vigour. Existing home sales accelerated sharply in the final months of 2017, after appearing to stagnate through much of the year. Hurricane-related recoveries in the South have aided the recovery, but the improved momentum has been broadly based well beyond these regions.

Demand fundamentals remain favourable, including robust job growth, rising incomes, still-low borrowing costs, and a modest easing in bank lending standards for residential mortgages. Millennials entering their prime home-buying years represent an ongoing source of pent-up demand. For the first time since the 2007 housing crash, owner-occupied household formation is outpacing the number of new renter households, leading to a modest upturn in the homeownership rate.

Chart 4



Sources: Scotiabank Economics, US National Travel & Tourism Office.

Yet, the industry is facing several headwinds, including deteriorating—though still decent—affordability. The combination of higher home prices and rising interest rates has boosted total mortgage principal and interest payments for buyers by 10% over the past year, outpacing the 4% increase in median family income over the same period. Record-high student debt loads and rising rents further lift the savings bar for first-time homebuyers, whose share of purchases remains stuck under one-third, compared with a historical average of 40%.

A persistent shortage of inventory, most notably for entry-level homes, is also restraining activity. The pool of existing homes for sale has fallen to its lowest level in at least 18 years, representing just 3.4 months' supply. The dearth of resale listings has prompted more buyers to turn to the much smaller new home market, where sales are tracking their strongest pace in a decade.

Builders are responding, ramping up single-family starts by almost 10% last year. While this points to some supply relief in the pipeline, the overall rate of new construction will remain constrained by labour shortages and rising land and construction costs. Starts are forecast to climb to 1.25 mn units this year and 1.30 mn in 2019, up from an estimated 1.21 mn units in 2017. However, this still falls short of the estimated 1.40–1.50 mn annual units needed to plug the inventory gap.

Table 2

United States	2000–16	2016	2017e	2018f	2019f
	(annual % change, unless noted)				
Real GDP	1.9	1.5	2.3	2.5	1.8
Consumer spending	2.4	2.7	2.7	2.6	2.1
Residential investment	-0.4	5.5	1.3	1.8	1.7
Business investment	2.3	-0.6	4.6	4.4	2.5
Government	1.0	0.8	0.0	0.5	0.4
Exports	3.6	-0.3	3.1	2.6	2.7
Imports	3.4	1.3	3.3	2.8	3.2
Nominal GDP	3.9	2.8	4.1	4.4	3.8
GDP Deflator	2.0	1.3	1.8	1.9	2.0
Consumer price index (CPI)	2.2	1.3	2.1	2.2	2.3
CPI ex. food & energy	2.0	2.2	1.8	2.1	2.2
Pre-tax corporate profits	5.5	-2.1	5.0	4.4	0.5
Employment	0.7	1.8	1.5	1.3	1.0
Unemployment rate (%)	6.2	4.9	4.4	4.0	4.0
Current account balance (USD bn)	-507	-452	-443	-450	-498
Merchandise trade balance (USD bn)	-673	-753	-797	-843	-910
Federal budget balance (USD bn)	-532	-586	-666	-825	-935
percent of GDP	-3.7	-3.1	-3.4	-4.1	-4.5
Housing starts (mn)	1.27	1.18	1.21	1.25	1.30
Motor vehicle sales (mn)	15.5	17.5	17.1	17.4	17.3
Industrial production	0.7	-1.2	1.8	2.3	1.1
WTI oil (USD/bbl)	63	43	51	57	60
Nymex natural gas (USD/mmbtu)	4.94	2.55	3.02	2.95	2.95

Sources: Scotiabank Economics, BEA, BLS, Bloomberg.

INDUSTRIAL ACTIVITY BROADENS OUT

US industrial activity continues to strengthen and broaden out, pointing to an increasingly self-sustaining economic expansion. Demand for manufactured goods is accelerating in the US and across the world, and continues to outpace production gains. The economically-sensitive resource sector and capital goods are in the forefront of growth, and are widening their lead over less cyclical sectors, such as food processing. For example, US shipments of metals and machinery advanced 9% y/y in the four months to November, the best performance since the opening months of 2012. These sectors have historically provided good 'early warning signals' of potential economic pitfalls ahead, but are currently experiencing rising order backlogs which point to an 'all clear' sign for more room to run in the ongoing US economic expansion that is already the third-longest on record, and will become the second-longest by May 2018.

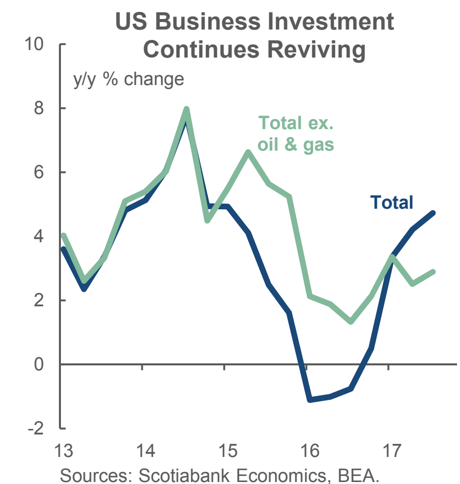
Industrial activity in the US, and indeed, across North America, is also starting to get a boost from the auto sector,

which had lagged the broadly-based industrial recovery over the past year due to high inventories on dealer lots. However, these bloated inventories have been cleared by the acceleration in US new car and light truck sales since September, setting the stage for US vehicle production to increase to an annualized 11.4 mn units in the opening months of 2018, nearly one million units above the five-year low set between July and September 2017.

BUSINESS INVESTMENT BECOMES A GROWTH DRIVER

US business investment is also beginning to 'fire on all cylinders', and is set to become an increasingly important driver of industrial activity, due in part to the recent US federal corporate tax overhaul which provides more positive treatment of capital equipment expenditures (chart 5). However, core capital goods orders, a proxy for business investment, had already begun to rev up before tax reform was passed. US core capital goods orders jumped 5% y/y January through November, the largest increase in more than five years. While the gain in capital goods orders has been driven mainly by a 60% y/y surge in demand for machinery from the oil and gas and mining sectors, demand is also reviving in other sectors as operating rates have climbed to cycle highs. For example, capacity utilization across US manufacturing plants is now at the highest level since mid-2008. The capital intensive high -tech sector has the highest capital utilization rate, with computer and peripheral equipment manufacturers operating at 95% of capacity, following a 12% y/y surge in output over the past year. Tightening operating rates are likely to lead to a double-digit increase in capital expenditures by high-tech companies over the coming year. However, even excluding high-tech, manufacturing operating rates have jumped 1.5 percentage points over the past year, the largest increase since mid-2014, which provides a positive backdrop for further gains in business investment.

Chart 5



Sources: Scotiabank Economics, BEA.

AN ALTERED FISCAL PROFILE

The recently legislated federal tax reform under the *Tax Cuts & Jobs Act*, most of which took effect on January 1, is likely to have a number of both intended and unintended consequences. First and foremost, the planned tax-rate reductions are costly. They imply, when combined with our assumption of moderate aggregate federal spending increases to extend the temporary budget deal beyond January 19, that the federal deficit can be expected to widen from USD 666 bn in fiscal 2017 to USD 825 bn in fiscal 2018 and onward to USD 935 bn in fiscal 2019 (table 2). These projections are necessarily preliminary until details of the new tax framework are articulated. The anticipated rise in the federal deficit from a low of 2.4% of GDP in fiscal 2015 to a projected 4.5% of GDP in fiscal 2019 is expected to push federal debt held by the public from just over 35% of GDP in September 2007 to over 79% of GDP by September 2019, its highest level since 1948.

Across all three levels of government, the forecast contribution of current and capital spending to overall GDP growth remains a muted 0.1 percentage points annually. State and municipal administrations have become increasingly cautious with their budget plans as debate continues over the Republicans' wish to devolve more program spending responsibilities from Washington, DC to lower levels of government. Those sub-national governments with income-tax systems linked to federal definitions of personal and corporate taxable income have the option to fully or partially decouple their tax levies to maintain revenue flows and manage deficits. For relatively high-tax State governments, such as those in California, New York and New Jersey, the introduction of a federal USD 10,000 cap on the state and local tax deduction further constrains their options. Overall, we expect States and local governments to take actions that offset some of the stimulus provided in the short-term by the federal tax cuts.

GOODS TRADE DEFICIT WILL CONTINUE TO EXPAND

We anticipate US import growth to outpace exports in 2018 for the fifth consecutive year. Following Congressional approval of the tax reform package in December, US firms are likely to increase their purchases of foreign machinery and similar industrial products in order to expand production domestically, with capacity utilization in the manufacturing sector at its highest point since mid-2008. At the same time, business confidence in the sector is at cycle highs. An upbeat economic outlook even prior to the passage of the tax bill lifted machinery imports by 12% y/y on average from January to November 2017. As the US economy approaches full employment, household consumption will be supported by strengthening wage growth; demand for foreign goods should remain strong throughout 2018 owing to direct purchases and indirect demand through the manufacturing sector.

In turn, increasing global expenses in capital goods augur well for a further expansion in US exports in the near future, but not quickly enough to stem a widening in the US current account deficit from 2% of GDP toward mid-2% levels near the end of 2019 (chart 6). In dollar terms, a measure more closely watched by the US administration, the country's quarterly merchandise trade deficit, which sat at USD 781 bn in Q3-2017, appears on track within the next year or so to reach its highest level since Q2-2008, when it hit USD 882 bn.

FOREIGN FINANCING HEADING HIGHER

Mirroring the US's wider fiscal and trade deficits, the balance of payment's financial (i.e., capital) account surplus is set to grow further owing to greater reliance on foreign financing. This coincides with a recent return of foreign buyers to US securities markets (chart 7).

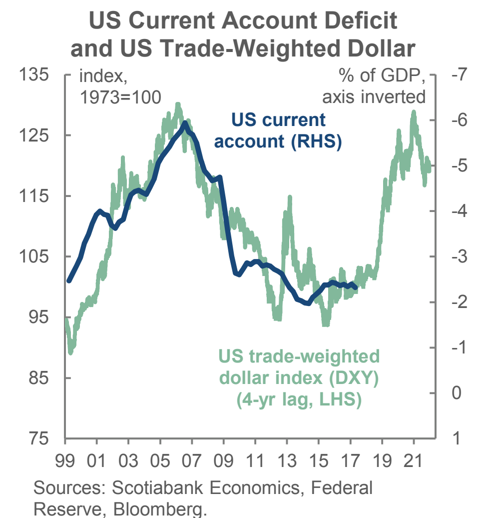
Net international purchases of US Treasuries (USTs) bounced back in 2017 from their September 2016 trough, notably lifted by sales to foreign official institutions as China increased its holdings of USTs after a massive drawdown in the second half of 2016 to soften a steep drop in the yuan (chart 8). Total foreign holdings of USTs by official and non-official accounts have remained relatively steady at around the USD 6 tn mark since early 2013, though once China and Belgium (owing to China's custodial accounts domiciled there) are excluded, UST holdings by other countries maintained a consistent upward trajectory over most of the last 5 years.

During the next several years, US Treasury issuance is set to increase in order to fund wider fiscal deficits arising from potential increases in entitlement outlays—mainly Social Security, Medicare and Medicaid—at the same time that federal revenues are set to decrease owing to the recent tax reform. As mentioned previously, we expect the federal deficit to widen from USD 666 bn in fiscal 2017 to USD 935 bn in fiscal 2019. The necessary increase in debt issuance, combined with an unwinding of the Fed's balance sheet, points to a swelling of the secondary UST market that will likely require even more participation by international buyers—just as larger financial account inflows in the balance of payments are needed to offset widening trade deficits.

RISKS REMAIN POLITICAL

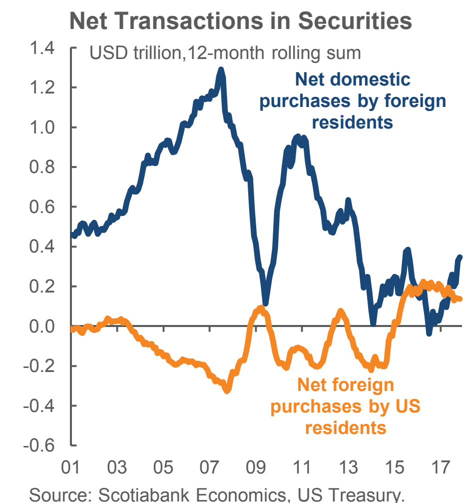
As global growth continues to synchronize and strengthen, fundamental support for further upside to the US economy is offset mainly by political risks at home and abroad. While a government shutdown should be avoided on January 19 with another short-term extension of federal spending authorizations, this would still leave a number of points of debate, such as the debt ceiling, unresolved. Additionally, the federal tax package combined with reduced domestic saving and a US dollar that remains relatively strong put the country on track to record ever-wider international trade deficits just as the NAFTA negotiations are reaching their climax. This could increase the chances of temporary disruption in the talks. Though access to the US market would likely remain unchanged until an agreement is reached on renegotiating and modernizing the pact, trade-intensive equities and currency markets would bear the brunt of any temporary uncertainty. However, concerns that the US could also withdraw from the WTO appear overblown: some 60% of the value of US exports rely on the preferential access to other markets provided by the most-favoured nation (MFN) tariffs that are accorded to WTO members.

Chart 6



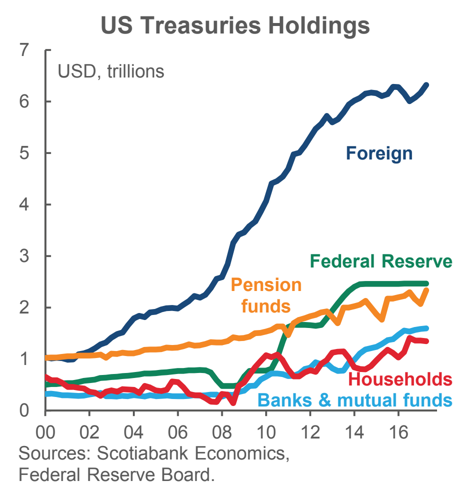
Sources: Scotiabank Economics, Federal Reserve, Bloomberg.

Chart 7



Source: Scotiabank Economics, US Treasury.

Chart 8



Sources: Scotiabank Economics, Federal Reserve Board.

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