United States

IN A HOT ECONOMY, COOLER HEADS EXPECTED TO PREVAIL

- **Growth is expected to peak in Q2 as fiscal stimulus in an already hot economy translates into stronger consumption, solid industrial indicators, tighter labour markets, and stronger price pressures.**
- **The potential for additional policy mistakes remains the clearest, entirely unnecessary threat hanging over our baseline outlook. We expect domestic political pressure on the White House to prevent a move to an all-out trade war with China and/or the US's major allies that would, if realized, tip the US into a recession in late-2019 and into 2020.**

US POLICY MISTAKES THE GREATEST THREAT TO FURTHER GROWTH

Over the last year, the US economy has enjoyed a benign combination of moderate growth, strengthening leading indicators, modest inflation, and gradually rising interest rates. Positive data surprises have been seen as a germane indication that monetary policy normalization would proceed, while negative data surprises have been taken as an indicator that accommodative monetary-policy conditions would be maintained. This sweet spot has allowed the current eight-and-a-half year run of uninterrupted growth to become the second longest US expansion in history in June. **We still expect the expansion to extend and become the longest on record in July 2019, but the current policy mix in the US significantly clouds expectations for the second half of 2019 and beyond.**

US economic policies are now firmly at cross purposes to one another. The White House's major tax changes and stepped-up spending should push real GDP growth to 2.8% this year (chart 1, table 1), well above estimates of potential growth around 2%. This compares to the 2.6% real growth rate projected in our May 3 ***Monthly Forecast Tables***. Unemployment is now down at historical lows. For 2019, real GDP growth is forecast to come in at a solid 2.3%, despite trade tensions and related uncertainty, which are together assumed to subtract 0.1 ppts from growth next year.

In the midst of mixed policy signals from the White House and some divergence in global growth, the Fed is expected to remain focused on US domestic price pressures, which have intensified over the past quarter. Compared with our Q2 ***Global Outlook***, we have added another increase in the fed funds rate in 2018, for a total of two rate increases between now and end-2018, and two more in 2019. This would, as detailed in the ***US & Canadian Monetary Policy & Capital Markets*** report, bring the fed funds rate to 3.0% by end-2019. Yield curves are expected to continue flattening, but the *Scotiabank Global Macroeconomic Model (SGMM)* does not anticipate a recession in the forecast horizon. This baseline does, however, assume that further protectionist pressures from the White House are curtailed either through negotiation or pushback from Congress, the business community, and citizens, such that the current trajectory pointing toward a misbegotten, all-out trade-war is diverted.

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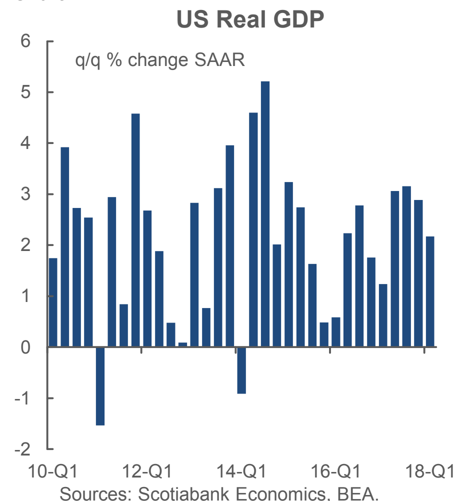
United States	2017	2018f	2019f
Real GDP (annual % change)	2.3	2.8	2.3
CPI (y/y %, eop)	2.1	2.4	2.4
Central bank policy rate (%, eop)	1.50	2.50	3.00
Canadian dollar (USDCAD, eop)	1.26	1.28	1.25

Source: Scotiabank Economics.

Chart 1



MORE PRUDENT HOUSEHOLDS SET TO SAVE SOME WAGE GAINS

US labour markets are tight and likely to get tighter. JOLTS job openings now exceed unemployed workers for the first time this century, which is expected to provide added upward pressure on compensation. Participation rates are likely to continue rising to post-crisis highs as demand pulls more people back into the labour force. Building on healthy job creation in 2017, employment is expected to continue growing in 2018 and 2019 (table 2) even as the unemployment rate is expected to continue plumbing new lows.

Nominal wages are expanding at a healthy clip with rising hours lifting the pace of weekly earnings growth to 3% y/y in May. Concurrent increases in inflation, however, have eroded a large share of this increase, with real weekly earnings rising by only 0.3% y/y and real hourly wages declining slightly by 0.1% y/y. Survey indicators point, however, to further acceleration in wage growth in the months ahead.

Household finances remain on firm ground. The Fed's household mortgage debt-service ratio, at just under 4.5%, is at its lowest level since 1980. Private consumption is set to gradually moderate over 2018–19 (table 2), despite projections for strong wage gains, as households continue to put their balance sheets on more sustainable footings. Some saving is likely to be precautionary, however, as households anticipate changes in health care costs owing to, amongst other things, changes to 'Obamacare' coverage.

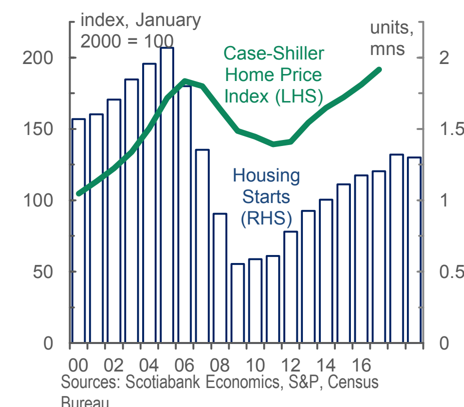
REAL ESTATE: POST-RECESSION INVENTORY SHORTAGE SET TO PERSIST

Measures of housing affordability continue to erode. While still manageable, price-to-rent ratios and price-to-income ratios are higher than at any time since the 2008 crisis, driven by fundamental supply and demand dynamics, higher materials prices, increased costs stemming from 20% US tariffs on Canadian softwood lumber, and rising interest rates.

A substantial shortfall in supply accrued since the last recession is expected to continue through 2019. Housing starts forecast at 1.30–1.32 mn units this year and next (chart 2) are set to undershoot the 1.5–1.6 mn unit annual average that most

Chart 2

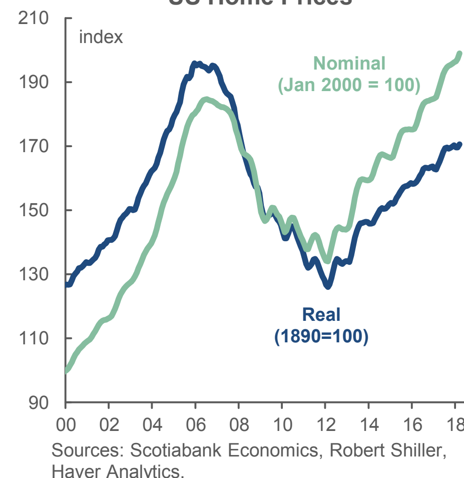
Still Historically Weak Building Activity Pushing Prices Up



Sources: Scotiabank Economics, S&P, Census Bureau.

Chart 3

US Home Prices



Sources: Scotiabank Economics, Robert Shiller, Haver Analytics.

Table 1

Quarterly US Forecasts	2017	2018				2019			
	Q4	Q1	Q2e	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Economic									
Real GDP (q/q ann. % change)	2.9	2.0	3.6	2.5	2.4	2.2	2.0	2.0	2.0
Real GDP (y/y % change)	2.6	2.8	2.9	2.8	2.6	2.7	2.3	2.1	2.0
Consumer prices (y/y % change)	2.1	2.3	2.4	2.4	2.4	2.4	2.4	2.4	2.4
CPI ex. food & energy (y/y % change)	1.7	1.9	2.2	2.3	2.3	2.3	2.3	2.4	2.4
Core PCE deflator (y/y % change)	1.5	1.6	1.9	2.0	2.1	2.1	2.1	2.1	2.1
Financial									
Euro (EURUSD)	1.20	1.23	1.17	1.17	1.20	1.22	1.25	1.30	1.35
U.K. Pound (GBPUSD)	1.35	1.40	1.32	1.30	1.32	1.32	1.35	1.37	1.40
Japanese Yen (USDJPY)	113	106	108	110	110	110	110	108	105
Fed Funds Rate (upper bound, %)	1.50	1.75	2.00	2.25	2.50	2.50	2.75	2.75	3.00
3-month T-bill (%)	1.38	1.70	1.92	2.20	2.45	2.50	2.70	2.75	3.00
2-year Treasury (%)	1.88	2.27	2.53	2.60	2.70	2.80	2.90	3.00	3.10
5-year Treasury (%)	2.21	2.56	2.73	2.85	2.90	2.95	3.00	3.10	3.20
10-year Treasury (%)	2.40	2.74	2.84	3.00	3.05	3.10	3.15	3.20	3.30
30-year Treasury (%)	2.74	2.97	2.96	3.15	3.20	3.30	3.35	3.40	3.45

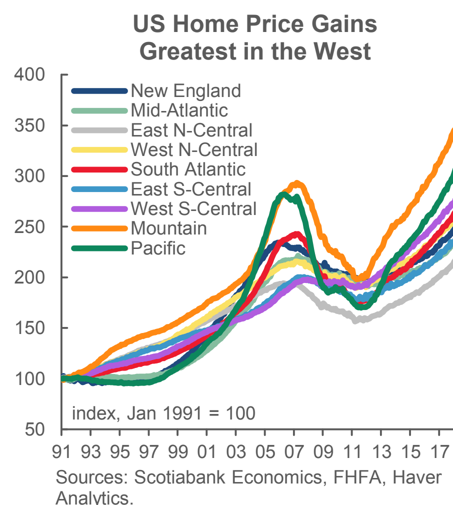
Sources: Scotiabank Economics, BEA, BLS, Bloomberg.

estimates imply would be consistent with underlying demand. The supply deficit's persistence is expected to push prices up further (chart 3), particularly in the western US (chart 4), and drive home values beyond the record for the nominal Case-Shiller index recorded in March.

Rapidly rising material costs are expected to weaken construction activity over the next two years and exacerbate supply-demand dynamics further. Western Spruce-Pine-Fir prices have hit record levels following a 48% y/y increase from January to May 2018. The National Association of Home Builders (NAHB) estimates that recent lumber price increases have added nearly USD 9k to the cost of an average new single-family home since January 2017.

Even as housing starts fail to keep up with demand, overall demand pressure is expected to step up further as robust labour markets and tax changes boost personal incomes. However, on new mortgages, the ceiling for the mortgage interest deduction is lowered from USD 1 mn to USD 750k and the interest deduction for home equity loans of up to USD 100k is eliminated.

Chart 4



Sources: Scotiabank Economics, FHFA, Haver Analytics.

First-time homebuyers are, however, likely to encounter increased difficulty in entering the real-estate market, with a significant erosion in availability and affordability amongst entry-level homes. Higher interest rates are discouraging refinancing and move-up buying, which has extended average homeownership durations to record levels and reduced the pool of entry-level properties available for purchase.

US MANUFACTURING AND INDUSTRY: ORDERS BACKLOG, RISING PRICES

The US manufacturing sector is set to post its strongest annual expansion since 2011 with gains in nearly all industrial sectors powering a steep increase in manufacturing jobs that is outpacing the rest of the economy for the first time since January 2012 (chart 5). The recent tax changes and highs in post-recession consumer confidence are both helping to drive domestic demand. Foreign orders for US manufactures are, however, likely to pull back owing to weakening business sentiment abroad and increasing reciprocal protectionism.

Capacity pressures remain relatively subdued across the sector at around 75% of potential output, though certain industries are facing production crunches as orders rise. Fabricated metals and machinery manufacturing have seen a notable surge in their respective operating rates since mid-2016 (chart 6) as new orders for these products have increased by 14% y/y and 6.3% y/y, respectively, on average year-to-date. The pace of growth in orders has resulted in a rising share of firms reporting an increase in order backlogs, from as low as 12% in late-2015 to around a third of firms in May. Similar to Canada, investment outlays in non-residential structures and equipment have posted large year-on-year increases and have expanded at their fastest pace since mid-2014 at 8.1% y/y in Q1-2018.

The US tariffs on steel and aluminum, in conjunction with rising global demand for basic production inputs, has resulted in a steep increase in prices paid for

Table 2

United States	2000–16	2016	2017	2018f	2019f
	(annual % change, unless noted)				
Real GDP	1.9	1.5	2.3	2.8	2.3
Consumer spending	2.4	2.7	2.8	2.6	2.3
Residential investment	-0.4	5.5	1.8	1.8	2.1
Business investment	2.3	-0.6	4.7	6.2	2.8
Government	1.0	0.8	0.1	2.2	2.5
Exports	3.6	-0.3	3.4	4.3	2.7
Imports	3.4	1.3	4.0	5.0	3.4
Nominal GDP	3.9	2.8	4.1	5.0	4.6
GDP Deflator	2.0	1.3	1.8	2.1	2.3
Consumer price index (CPI)	2.2	1.3	2.1	2.4	2.4
CPI ex. food & energy	2.0	2.2	1.8	2.2	2.3
Core PCE deflator	1.7	1.8	1.5	1.9	2.1
Pre-tax corporate profits	5.5	-2.1	4.4	5.1	1.7
Employment	0.7	1.8	1.6	1.4	1.1
Unemployment rate (%)	6.2	4.9	4.4	3.8	3.7
Current account balance (USD bn)	-504	-433	-449	-516	-574
Merchandise trade balance (USD bn)	-672	-751	-807	-908	-984
Federal budget balance (USD bn)	-532	-585	-665	-840	-1,030
percent of GDP	-3.7	-3.1	-3.4	-4.1	-4.8
Housing starts (mn)	1.27	1.17	1.20	1.32	1.30
Motor vehicle sales (mn)	15.5	17.5	17.1	17.1	17.0
Industrial production	0.6	-2.0	1.6	3.0	1.9
WTI oil (USD/bbl)	63	43	51	68	71
Nymex natural gas (USD/mmbtu)	4.94	2.55	3.02	2.93	2.90

Sources: Scotiabank Economics, BEA, BLS, Bloomberg.

these goods. Producer prices for steel and aluminum have risen by around 12% since January (chart 7). The Department of Commerce published its Section 232 investigation into steel and aluminum imports in February and demand appears to have been pulled forward since then to avoid the duties introduced on June 1. The Commerce Department has received more than 21,000 requests for exemptions from the tariffs as nearly every industry except US steel producers themselves has registered opposition to the duties. Decisions on these exemption applications could be delayed for months or years: there are roughly 700 requests for every Commerce staff member tasked with processing them.

All in all, year-on-year corporate earnings growth is likely to slow in the second half of 2018 as rising input costs and higher interest rates begin to crimp growth in nonfinancial corporate profits. After a relatively strong rebound in business investment projected for 2018, we expect expenditure on replacing and expanding capacity to slow in 2019 (table 2).

FISCAL STIMULUS DRIVES ELEVATED GROWTH AND WIDER DEFICITS

Our forecast remains relatively unchanged from last quarter. We expect stepped-up federal government spending plus the recent major tax changes to provide, on average, about a half-percentage-point of fiscal lift to US real GDP growth in 2018 and again in 2019. **Across all levels of government, public spending is expected to add 0.37 ppts to US GDP growth this year and 0.41 ppts in 2019, thereby ending an eight-year trend of modest or negative contributions to growth from government expenditure.**

Looking at the details of federal spending, outlays receive an additional boost this year from more than USD 100 bn in emergency non-defense spending to address hurricane and wildfire damage. This offers an offset to expected delays in the design and initiation of new federal initiatives under the USD 300 bn spending package.

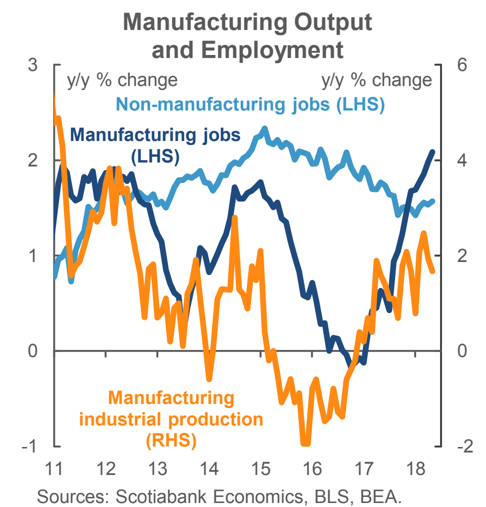
Growth in individual State-level public expenditures will continue to vary widely. In aggregate, however, mid-year spending reductions in fiscal 2018 have been far smaller than a year earlier. We expect State outlays, adjusted for inflation, to strengthen modestly in fiscal 2019 as firmer revenue collection following stronger economic growth encourages the States to address near-term spending priorities.

The White House's cut in the general corporate income tax rate from 35% to 21% in January is already causing a steep year-on-year drop in federal corporate income tax receipts (chart 8). As the States consider statutory adjustments to protect their tax receipts, other federal changes are expected to affect their operating balances, such as the removal of the federal individual penalty for individuals who do not have health insurance.

TRADE GAINS AMIDST THE GATHERING TARIFF STORM

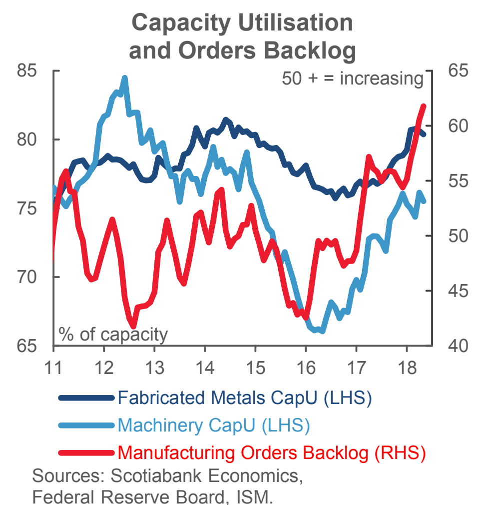
US exports are set for a strong performance in 2018, although trade disputes are likely to dent sales abroad if the US administration continues on its current protectionist path. We expect US goods exports to expand at a strong clip in 2018, at or slightly above the pace set last year. Increased demand by US consumers for foreign goods against a backdrop of an expanding fiscal deficit (chart 8 again) and

Chart 5



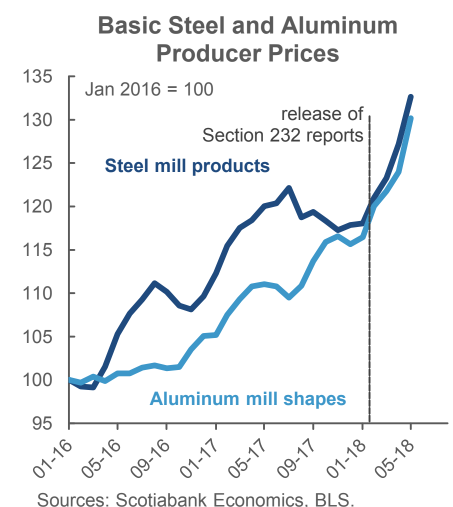
Sources: Scotiabank Economics, BLS, BEA.

Chart 6



Sources: Scotiabank Economics, Federal Reserve Board, ISM.

Chart 7



Sources: Scotiabank Economics, BLS.

aggregate dissavings will, however, prolong the ongoing widening of the US trade deficit.

Following the imposition of tariffs on steel and aluminum imports on so-called 'national security' grounds, a handful of affected nations have, or intend to, retaliate with reciprocal measures designed to hit equal flows, in value terms, of US exports. Most of these countries are also seeking review of the US tariffs at the WTO. These reciprocal tariffs are not limited to US metals exports, but also include other industrial and consumer goods, with a view to hitting politically-sensitive regions of the US. At the time of publication, the EU, China, and Mexico are collecting duties on about USD 9 bn worth of US exports; Canada followed suit on July 1 on over $12bn of imports from the US. Canada and Mexico are unlikely to escape the tariffs on steel and aluminum products until the renegotiation of NAFTA is concluded, which we don't expect before 2019 (chart 9).

The Commerce Department has also launched an investigation into the national security implications of imports of motor vehicles and parts. The White House threatens to impose tariffs of up to 25% on auto-sector imports under the same Section 232 of the 1962 *Trade Expansion Act* that the White House used to implement steel and aluminium imports.

Using our comprehensive *Scotiabank Global Macroeconomic Model*, we assess the impact of these protectionist measures in our report ***Steeling Ourselves for the Macro Costs of Tariffs***. Under one of the paper's alternative scenarios, the incidence of the steel and aluminum tariffs imposed on June 1 is expected to fall mainly on US industry and consumers; combined with possible US duties on autos and parts imposed in 2019 under Section 232 processes, US GDP growth would be hit by only about a combined 0.1 ppts in 2019 and 2020.

We believe, however, that a US move against cars and parts imports does not represent a stable equilibrium. Instead, it would set off a wider trade war as other countries retaliate with an array of tariffs. In a trade war scenario, the US economy would fall into recession in late-2019 and record a shallow annual contraction in 2020—just in time for the next Presidential election, which should itself give the White House pause.

China's nearly-immediate, symmetric, response to the 10% US tariff imposed on up to USD 50 bn of Chinese goods imported into the US has been followed by threats by President Trump to up the value of Chinese goods subjected to the

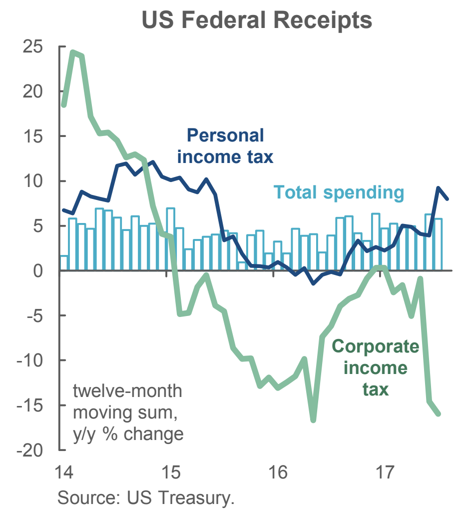
Table 3

Impact of US Protectionism on US Economy: Deviation from Baseline Forecast

	2018	2019	2020	2021	2022
Tariffs on Autos, Steel and Aluminium Scenario					
GDP growth, ppts difference	0.0	-0.1	-0.1	0.0	0.1
Monetary policy rate, ppts difference	0.00	-0.03	-0.07	-0.03	0.00
Core CPI inflation, ppts difference	0.0	0.0	0.0	0.0	0.0
Global Trade War (20% tariffs on trade with world)					
GDP growth, ppts difference	0.0	-1.0	-2.0	0.8	0.7
Monetary policy rate, ppts difference	0.00	-0.63	-1.19	-0.38	0.18
Core CPI inflation, ppts difference	0.0	0.0	-0.3	-0.1	0.1

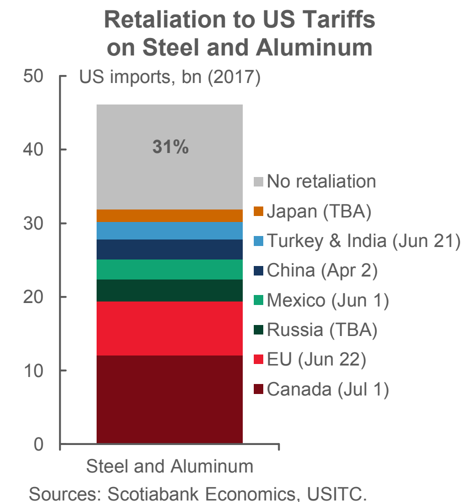
Source: Scotiabank Economics "Steeling Ourselves for the Macro Costs of Tariffs" (June 14, 2018).

Chart 8



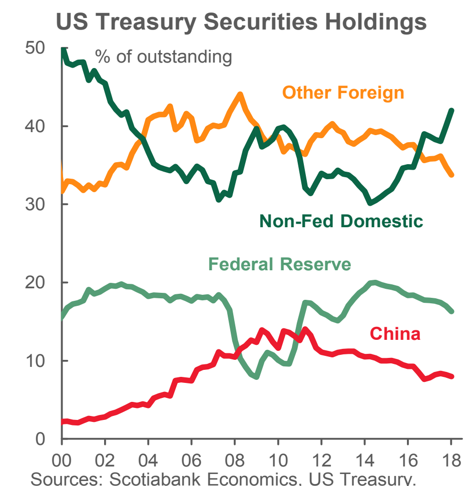
Source: US Treasury.

Chart 9



Sources: Scotiabank Economics, USITC.

Chart 10



Sources: Scotiabank Economics, US Treasury.

US tariff by an additional USD 200bn. At a total of USD 250 bn in affected US imports from China, Beijing would find it difficult to retaliate in kind: USD 250 bn is close to USD 100 bn greater than the total value of Chinese merchandise imports from the US. China has and will respond through additional means.

China has already begun intensifying non-tariff barriers through stepped-up standards inspections and more onerous administrative requirements on trade. The Chinese government may also complicate the operations of US multinationals stationed in China, where they generated USD 356 bn in revenue during 2015, the latest year for which data are available. Beijing may additionally act on its currency and reserves. It could alter its purchases of US Treasury securities, of which it owns 8% of the total amount outstanding (chart 10), but it is unlikely to boycott the market entirely considering the hit this might imply to the value of China's own holdings. Some substitution of other USD-denominated international sovereign debt for USTs may, however, be pursued. Similarly, China's scope to push down the value of the RMB is limited by the fear that such a move would stoke a renewed round of capital outflows, but it has already indicated that it will loosen monetary conditions by dropping banks' reserve requirement ratios by 50 bps on July 5.

A US-China trade war would cause a substantial hit to the global economy because of the multiple trade and financial links between the two countries. We expect mounting US political and business opposition to the White House's protectionist bent to prevent the imposition of the threatened auto tariffs and an escalation of the present trade skirmish into an all-out war. Congressional efforts have already begun, although so far unsuccessfully, to limit the White House's discretion to impose tariffs under Section 232. It is concerning, however, that Congress did not take any action to curtail the White House's scope of action under the President's Trade Promotion Authority (TPA, aka 'Fast Track') during its April–June renewal period.

SUMMING UP: MAINTAINING FAITH IN THE SYSTEM AND THE CURRENT PRESIDENT'S SELF-INTEREST

The outlook for the US—and by extension, the global economy—hinges on some strong assumptions about the robustness of the American political system to curb a move toward a major policy mistake. We continue to believe that rising efforts in the US Senate and House, supported by regional political and business leaders, will prevent a further intensification of recent moves by the White House to slap tariffs on widening slices of US commerce with the rest of the world. If further duties are avoided, our baseline projections laid out here should not be meaningfully impaired by the existing tariffs on steel and aluminium.

The White House threat to add further tariffs on autos and parts imports represent, however, a meaningful negative inflection point. If these tariffs are realized, it would be difficult to prevent a further spiral into a US-led global trade war as other countries retaliate in myriad ways, which would plunge both the US and its major trading partners into recession beginning in the second half of 2019 and into 2020, just as the US will be heading into Presidential, Congressional, State, and local elections. Political, business, and diplomatic pressure should, therefore, be focused on preventing a mistaken crossing of this economic Rubicon.

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