United States

- **The US economy remains in a sweet spot of accelerating growth, moderate price pressures, improving labour markets, robust consumer demand, increasing manufacturing orders, and rising investment.**

- **The major risks to the US outlook lie within: in the midst of a firming global environment, policy missteps by the US authorities represent the greatest threat to the continuation of the US recovery.**

STRONG MACRO FUNDAMENTALS TRUMP POLICY UNCERTAINTY

Recent data prints confirm the gathering strength in the US economy we detailed in the previous quarter's *Global Outlook*. Consequently, our projections of real GDP growth of 2.3% in 2017 and 2.4% in 2018 remain unchanged (table 1). Although financial markets are beginning to reflect concerns that the 'Trump bump' in equity prices has run ahead of likely policy action by the new administration, the underlying macroeconomic fundamentals of the US economy continue to improve and are receiving additional support, as previously anticipated, from firmer global demand for US goods and services. The US recovery is proving robust to policy volatility in Washington, DC and should remain intact unless tax reform proposals seriously underwhelm expectations or the Trump Administration initiates a massive disruption in international trade.

WORK HARD, CONSUME HARD

US consumer spending remains well-supported by robust job gains, solid income growth, and strong household balance sheets. Reflecting these sound fundamentals, consumer sentiment indices are around their highest levels since 2000. Consumption is expected to increase by 2.7% in 2017 (table 2) and contribute nearly two percentage points to the economy-wide 2.3% increase in GDP.

Monthly payroll increases have averaged almost 200,000 over the past year, led by the construction and service sectors. Hiring surveys signal continued brisk labour demand across most regions and industries in 2017; manufacturers report their strongest hiring plans since the 2008–09 recession. Nevertheless, with most indicators also showing that the US labour market is near full employment, we expect the pace of hiring to slow as the year progresses. The US unemployment rate is already at a decade-low of 4.7%, wage growth is starting to accelerate, labour-force participation rates are turning up, and the aggregate employment-to-population rate is at an eight-year high.

Household incomes should get a further boost from higher minimum wages: increases took effect in 19 states during January 2017; three other states have legislated increases for July 2017 and additional increases are scheduled during 2018–20. Households may also pull forward consumption in anticipation of personal income-tax cuts long-promised by then-candidate and now President Trump.

Faster US consumption growth in 2017 is also supported by stronger household balance sheets that have been shored up by rising home values and equity-

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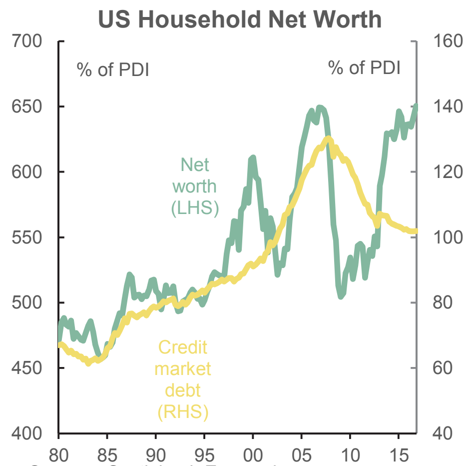
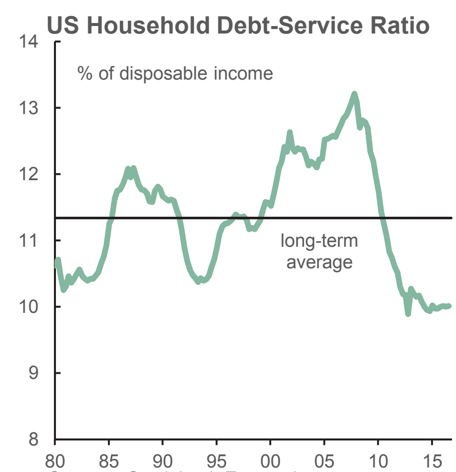
Chart 1



Sources: Scotiabank Economics, US Federal Reserve.

Chart 2

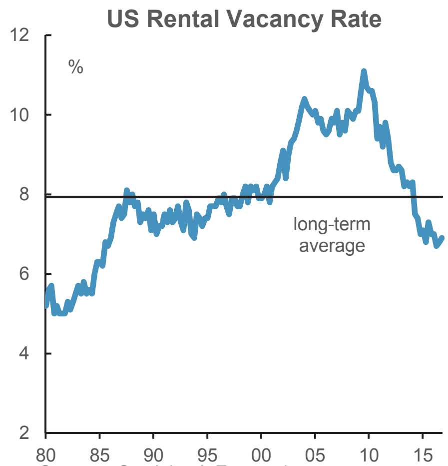


Sources: Scotiabank Economics, US Federal Reserve.

market gains. The US consumer's balance sheet should be able to support solid spending growth even as the Fed moves to raise the Fed funds target rate and increase consumer borrowing costs. Household net worth relative to disposable income is at a record high near 650%, while household credit-market debt as a share of disposable income is at an eight-year low (chart 1). At 10% of after-tax income, debt-service payments pose the weakest burden to consumers since at least 1980 (chart 2).

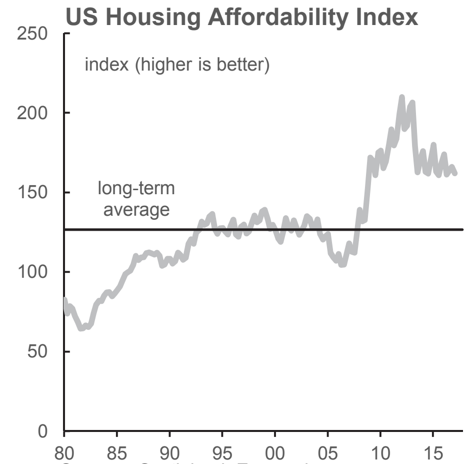
Strong household balance sheets should also support continued growth in residential investment, with knock-on demand for large-ticket consumer durables such as furniture, appliances, and electronics. The auto sector will also benefit from a combination of solid household finances and increasing demand to replace ageing vehicles: some 40% of the US vehicle fleet is as least 12 years old, owing to an extended period of weak vehicle purchases in the years following the global financial crisis. With interest rates still low and plentiful options for attractive financing, US vehicle sales are expected to hit a third consecutive annual record in 2017. The recent rise in delinquencies among subprime auto leases is unlikely to dampen overall

Chart 3



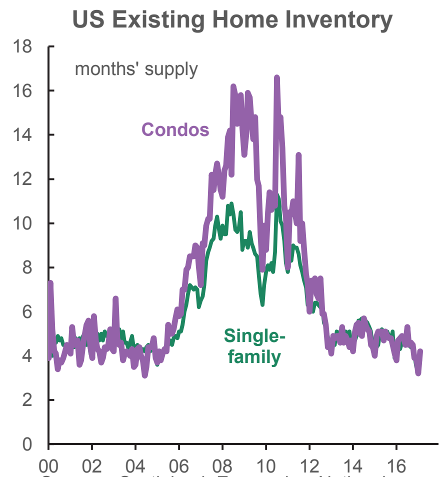
Sources: Scotiabank Economics, US Census Bureau.

Chart 4



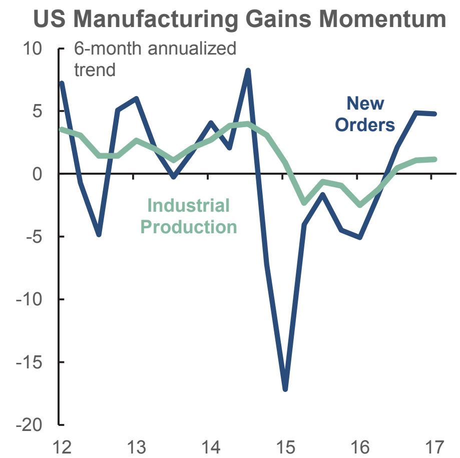
Sources: Scotiabank Economics, National Association of Realtors.

Chart 5



Sources: Scotiabank Economics, National Association of Realtors.

Chart 6



Sources: Scotiabank Economics, Federal Reserve Board, US Census Bureau.

Table 1 — Quarterly US Forecasts

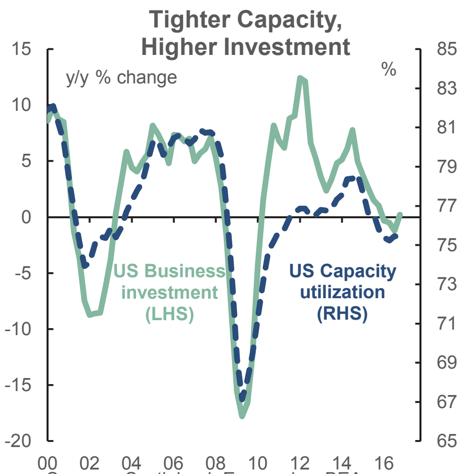
	2016				2017				2018			
	Q1	Q2	Q3	Q4	Q1e	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Economic												
Real GDP (q/q ann. % change)	0.8	1.4	3.5	2.1	1.6	2.5	2.5	2.4	2.4	2.4	2.3	2.3
Real GDP (y/y % change)	1.6	1.3	1.7	2.0	2.2	2.4	2.2	2.3	2.5	2.4	2.4	2.3
Consumer Prices (y/y % change)	1.1	1.1	1.0	1.8	2.6	2.6	2.6	2.4	2.4	2.4	2.4	2.3
Core CPI (y/y % change)	2.2	2.2	2.2	2.2	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Financial												
Euro (EURUSD)	1.14	1.11	1.12	1.05	1.07	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	1.26	1.20	1.25	1.25	1.30	1.30	1.35	1.35
Japanes Yen (USDJPY)	113	103	101	117	111	115	117	117	121	121	122	122
Fed Funds Rate (upper bound, %)	0.50	0.50	0.50	0.75	1.00	1.25	1.25	1.50	1.50	1.75	1.75	2.00
3-month T-bill (%)	0.20	0.26	0.27	0.50	0.75	1.00	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	1.92	2.05	2.20	2.30	2.40	2.50	2.55	2.60
10-year Treasury (%)	1.77	1.47	1.59	2.44	2.39	2.55	2.70	2.80	2.85	2.90	2.95	3.00
30-year Treasury (%)	2.61	2.28	2.31	3.07	3.01	3.05	3.20	3.30	3.35	3.40	3.45	3.50

vehicle demand as the subprime share of overall purchases has been declining during the past two years.

HOUSING: THE AMERICAN DREAM ROLLS ONWARD

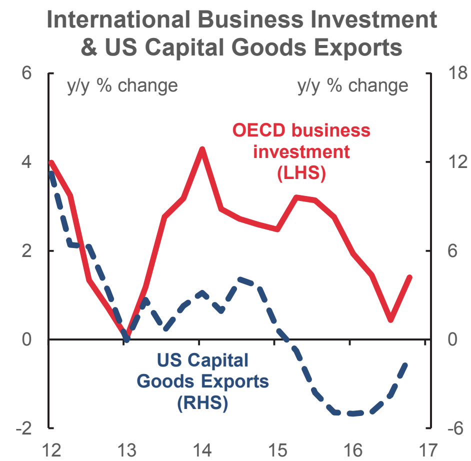
Solid job and income gains, rising consumer confidence, and ageing millennials should sustain the existing forward momentum in US housing activity into 2018. Increased participation by first-time buyers has helped to lift US home sales to their highest levels in a decade. Purchases by non-occupying investors remain elevated, a reflection of the ongoing strength in rental demand and historically low vacancy rates (chart 3).

Chart 7



Sources: Scotiabank Economics, BEA, US Federal Reserve.

Chart 8



Sources: Scotiabank Economics, OECD, US Census Bureau.

The pace of housing sales growth is nonetheless expected to slow during 2017. Affordability remains good from a historical perspective, but has begun to weaken alongside rising home prices and higher mortgage rates (chart 4). A persistent shortage of listings, especially for lower-priced homes, is also restraining activity. The inventory of existing homes for sale stands at just 1.75 mn, equivalent to 3.8 months' supply—near all-time lows (chart 5).

US housing starts are forecast to increase to 1.26 mn units in 2017 and 1.34 mn in 2018, with builder confidence in the market emboldened by tight resale inventory, rising home prices, and the potential for regulatory reform under the Trump Administration. The overall level of construction should remain below the historical average of around 1.5–1.6 mn units, reflecting labour shortages as well as rising land and construction costs.

MANUFACTURING ACCELERATES

US industrial activity continues to gain momentum alongside stronger domestic and international demand. New orders for goods manufactured in the United States are now advancing at the fastest annualized pace since mid-2014 and will continue to drive industrial activity higher (chart 6). In fact, US manufacturing output has increased for five consecutive months through February 2017, the best run in nearly three years. Consumer goods are leading the way, with orders and output climbing at a nearly double-digit year-over-year pace for the first time since 2011. These products account for more than 40% of overall US manufacturing activity. Demand for them should continue to receive support from the strengthening consumer fundamentals outlined above, solid payroll expansion, and the fastest wage gains in nearly a decade.

INVESTMENT SPENDING TURNS POSITIVE

Inventory restocking, record North American vehicle production, and rising demand foreign demand for US goods should buoy a nascent turnaround in investment spending during the months ahead. Orders for non-

Table 2 — United States

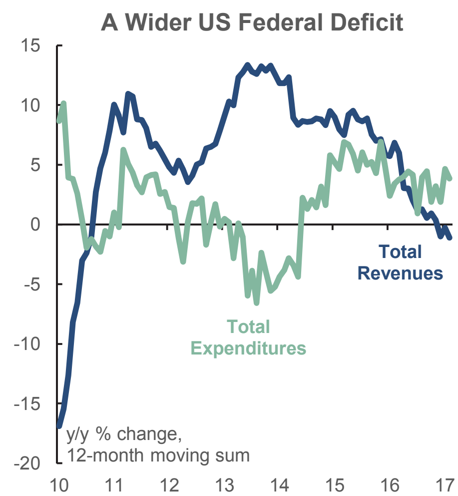
	2000–15	2016	2017f	2018f
	(annual % change, unless noted)			
Real GDP	1.9	1.6	2.3	2.4
Consumer Spending	2.3	2.7	2.7	2.7
Residential Investment	-0.7	4.9	3.8	2.7
Business Investment	2.4	-0.5	2.6	3.3
Government	1.0	0.8	0.9	1.1
Exports	3.8	0.4	2.3	2.8
Imports	3.5	1.1	4.4	3.5
Nominal GDP	4.0	3.0	4.3	4.4
GDP Deflator	2.0	1.3	2.0	2.0
Consumer Price Index	2.2	1.3	2.4	2.4
Core CPI	2.0	2.2	2.3	2.3
Pre-Tax Corporate Profits	5.9	-0.1	6.5	3.5
Employment	0.6	1.8	1.5	1.3
Unemployment Rate (%)	6.3	4.9	4.6	4.5
Current Account Balance (USD bn)	-521	-481	-472	-503
Merchandise Trade Balance (USD bn)	-668	-750	-820	-874
Federal Budget Balance (USD bn)	-529	-587	-610	-650
percent of GDP	-3.8	-3.2	-3.2	-3.2
Housing Starts (mn)	1.27	1.18	1.26	1.34
Motor Vehicle Sales (mn)	15.4	17.5	17.8	17.9
Industrial Production	0.8	-1.0	1.7	2.0
WTI Oil (USD/bbl)	64	43	53	56
Nymex Natural Gas (USD/mmbtu)	5.09	2.55	3.10	3.05

defense capital goods turned positive in the final months of 2016 alongside stabilization in capital spending in the oil and gas sector, after a peak-to-trough plunge of nearly 70% from 2014 through mid-2016. The oil and gas industry normally accounts for 8% of overall spending on machinery, but, since last spring, the sector has accounted for nearly a third of the increase in US machinery orders. Demand for machinery has also bottomed-out across other sectors, but the subsequent improvement has been muted and awaits a further recovery in profits and capacity utilization to gain more traction (chart 7).

Chart 9

Sources: Scotiabank Economics, US Census Bureau.

Chart 10



Sources: Scotiabank Economics, US Treasury.

While manufacturing operating rates have increased by nearly a percentage point since August, the overall capacity utilization rate hasn't recovered, as warmer-than-normal winter conditions have led to an 11% plunge in utilities output since December—the largest fall-off on record in data dating back to 1972. Utilities account for 5% of overall US re-investment spending and weak electricity demand could dampen the emerging upturn in overall investment spending.

MANUFACTURED EXPORTS GAIN MOMENTUM

While domestic purchases are the main driver of US manufacturing activity, strengthening global investment demand has also started to provide a boost to orders for US capital goods (chart 8). US exports of manufactured goods are now expanding in excess of 4% y/y, their best performance in four years (chart 9). While transportation equipment and information technology are the major US manufactured exports, international demand for US machinery has also turned positive in recent months and will provide a further kick to industrial activity as the sector has one of the highest export intensities amongst US industries: more than 35% of all machinery manufactured in the United States is destined for export, significantly above the 20% average for other industrial sectors. The pickup in global demand for US-made machinery and other capital goods points to a possible upturn in investment spending around the world. Investment has been one of the weak links in the global economic expansion in recent years, with overall capital expenditures growth slowing to only an annualized 2% since late 2014, 30% lower than the growth rate in the prior two years.

GOVERNMENT SPENDING AT BEST A MODEST POSITIVE

A moderate widening of the US federal deficit from 3.1% of GDP in calendar 2016 (chart 10) toward about 3.25% of GDP in 2018 is our base case. The expanding budget gap in part reflects some modest net federal tax relief projected for fiscal 2018. Total government activities, on both the current and capital sides, are likely to contribute a modest 0.1 percentage point to real GDP growth in calendar 2017 before increasing toward 0.2 percentage points in 2018.

We expect that the Trump Administration will match a large portion of its security and public-safety expenditure increases by limiting spending across a range of non-defence agencies and departmental programmes that are, individually, relatively small. In addition, state government expenditures are likely to become more circumspect given elevated uncertainty regarding future federal changes to healthcare and other social programmes. The healthcare impasse reinforces our expectation of significant delays in the Trump Administration's major initiatives, including the promised USD 1 tn 10-year infrastructure boost. The time needed to pass appropriations legislation, amend the sequester, and ratify a debt ceiling increase is expected to frustrate tax-reform efforts and delay more substantial federal outlays in the near term. Longer-term, pushing Social Security and Medicare issues down the road signals wider budget shortfalls in the years ahead and continuing acrimony over the debt limit.

RISKS TO THE UNITED STATES LIE MAINLY INSIDE THE BELTWAY

With the ongoing, broadly based improvement in US fundamentals, combined with a further acceleration in growth in other major advanced and emerging economies, the US outlook faces few straightforward economic downside risks at home or from abroad. Instead, the threats to the US are rooted mainly in the intersection between policy and politics.

The most present danger is that US federal tax reform and public-infrastructure plans will underwhelm market expectations. Equity markets have until recently priced a corporate tax cut in line with President Trump's comments from 35% to around 20% for the top bracket and the articulation this year of a USD 1 tn infrastructure spending package. A lesser tax cut and/or more extensive delays in moving ahead on public infrastructure spending could prompt firms to put some capital expenditure plans back on the shelf and cause significant repricing of equity risk. Our growth projections do not incorporate substantial tax relief, an outsized pick-up in business investment, or massive public infrastructure spending, but a large correction in equity markets, and its associated knock-on effects on household wealth and consumer confidence, would likely feed back into the real economy and threaten our outlook.

On trade, the Trump Administration's actions have so far inclined toward a less protectionist stance than campaign rhetoric indicated, but this could easily change as the uneasy balance between free-traders and mercantilists in the Administration continues to shift. Although the new President scored an own-goal by pulling the US out of the Trans-Pacific Partnership (TPP), the White House now says the TPP will serve as a "starting point" for future bilateral deals. On NAFTA, a draft negotiating memo indicates that only modest changes will be sought. But on China, President Trump is pursuing an aggressive line that US trade deficits with China remain unacceptable, without indicating what his government may do to address them. Self-defeating tariffs, quotas, and other trade barriers remain a possibility that could derail the US expansion and threaten global growth by touching off a trade war.

Geopolitical developments outside the US—from a possible confrontation with North Korea to ongoing tensions with Russia, turmoil in Europe surrounding Brexit, and national elections on the continent—could also dent risk appetite and place a brake on both the US and global recovery.