United States

- **Our outlook is changed only modestly from the previous quarter as the diminished prospects for fiscal stimulus are offset by the abatement of a variety of risks to US growth. As a result, we shaved our growth projections marginally to 2.2% in 2017 and to 2.2% in 2018.**
- **Aside from geopolitical developments, policy mistakes are still the main risk to the US outlook, but consumer demand, rising industrial activity, and increased investment all appear increasingly resilient to missteps from Washington.**

LEARNING TO LOVE THE LATE CYCLE

As the US economy heads into the eighth year of what is now its third-longest expansion, the fundamentals for continued solid growth remain in place, though any slack in the economy is rapidly closing with the economy at full employment. Our outlook is changed only modestly from three months ago.

On one hand, we have removed nearly all of the very limited additional fiscal stimulus that we had programmed in 2017 and 2018 on the current expectation that virtually no meaningful tax reform or expanded infrastructure spending is likely to be implemented by the US federal government over the next 18 months. On the other hand, a variety of material risks to the US outlook have abated: the USD has weakened, bond yields are lower for longer than expected, financial conditions have materially eased, oil prices are lower than projected, and trade policy risks are proving to be more bark than bite, thereby generating less of a drag than expected on investment.

Taking all of these factors into account, our projections for US growth have been shaved only slightly from our last *Global Outlook*, down from 2.3% to 2.2% in 2017, and from 2.4% to 2.2% in 2018. Growth continues to be driven by support from a strong labour market, rising consumption, recovering capex, and a slightly better external picture, all of which should compensate for a relatively soft Q1.

STRONG CONSUMER DEMAND REFLECTS STRONG LABOUR MARKETS

Consumption growth in Q1 dipped to its lowest rate in several years, but we expect it to regain its footing through the remainder of 2017 and lead overall growth into 2018 on the back of strong labour markets, accelerating wage growth, solid household balance sheets, and positive consumer sentiment. The most recent data show a solid rebound in spending after the winter's lull and consumer confidence is near its highest levels in a decade and a half.

Strong consumer demand reflects strong labour markets. Unemployment at 4.3% is some 30 bps below the Fed's 4.6% estimate for the non-accelerating inflation rate of unemployment (NAIRU). Both narrowly- and broadly-defined indicators of joblessness are at decade lows, while the number of job openings is at a record high of more than 6 mn. The NFIB survey shows hiring plans for the next three months at their highest levels in 16 years, though the pace of hiring has slowed. Monthly job gains averaged just 121,000 in the March to May period compared

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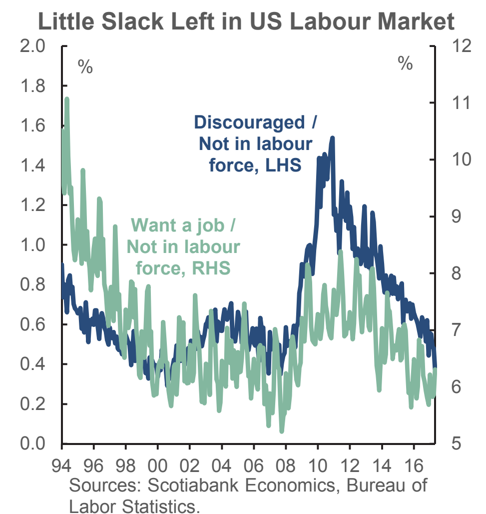
Chart 1



Sources: Scotiabank Economics, Bureau of Labor Statistics.

with 201,000 over the prior three months. Business surveys point to increasing skilled labour shortages. Immigration restrictions have likely added to labour shortfalls in some sectors such as agriculture and construction.

Labour market participation, however, remains weak at just below 63%. Yet, it's not clear that there is a reserve pool of people ready to re-enter the work force. In fact, there appears to be little slack at all left in the labour market. The share of people outside the labour force who say they want a job is only 6.3% compared with an all-time low of 5.2% in October 2007 (chart 1). Similarly the share of people outside the labour force who say they're not looking for work because of discouragement over job prospects is, at 0.37%, near 2007's low of 0.35%.

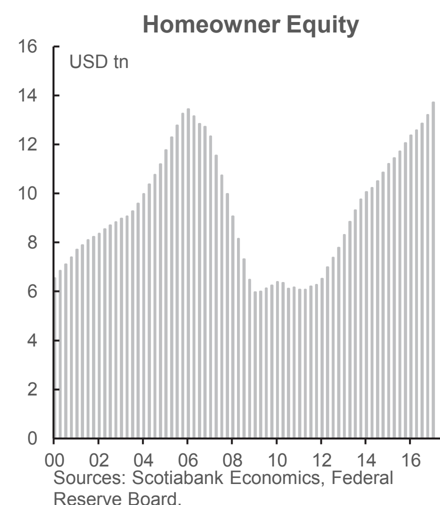
Modest wage gains should begin to accelerate with the unemployment rate so low. Growth in average hourly earnings has been stuck in a narrow 2.5–3.0% y/y range over the past year, only marginally above underlying inflation trends, held back by competitive pressures and weak labour productivity. Still, this represents an acceleration in wage growth from around 1.9% y/y in 2012. Real wage gains are outpacing productivity growth and labour's share in US GDP is rising. Relatively low-income, less-credentialed workers are seeing the quickest wage gains, which should ensure a further boost in aggregate demand.

HOUSEHOLD FINANCES ARE SOUND

US household balance sheets are on a solid financial footing. Household net worth is at a record high, household debt relative to income is at a 15-year low, and debt-service ratios are at historic lows. Homeowner equity has more than doubled in the past five years (chart 2).

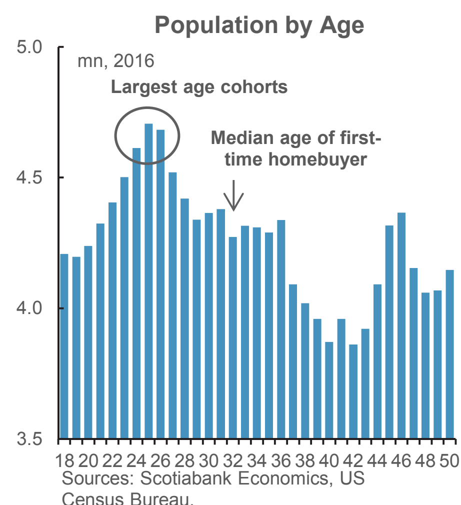
Financial conditions have broadly eased since the beginning of the year owing to a slightly weaker dollar, lower yields on US Treasuries, and stronger equity markets, which should together provide further support to US households. Consumer credit is growing healthily, while most delinquency rates remain low and stable. Lower energy prices are providing an additional boost to household purchasing power in the near-term.

Chart 2



Sources: Scotiabank Economics, Federal Reserve Board.

Chart 3



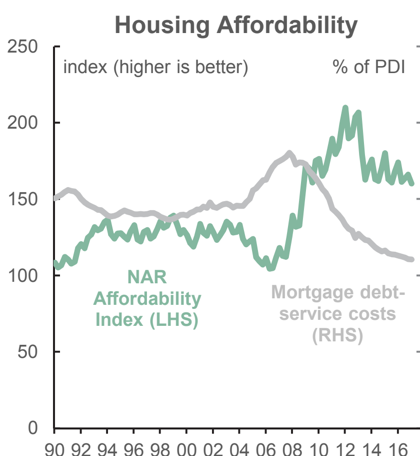
Sources: Scotiabank Economics, US Census Bureau.

Table 1 — Quarterly US Forecasts

	2016				2017				2018			
	Q1	Q2	Q3	Q4	Q1	Q2e	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Economic												
Real GDP (q/q ann. % change)	0.8	1.4	3.5	2.1	1.4	2.7	2.4	2.2	2.1	2.1	2.0	2.0
Real GDP (y/y % change)	1.6	1.3	1.7	2.0	2.1	2.4	2.2	2.2	2.4	2.2	2.1	2.1
Consumer prices (y/y % change)	1.1	1.1	1.1	1.8	2.6	2.0	2.1	2.0	2.0	2.4	2.3	2.3
CPI ex. food & energy (y/y % change)	2.2	2.2	2.2	2.2	2.2	1.8	1.9	1.9	2.0	2.3	2.3	2.3
Financial												
Euro (EURUSD)	1.14	1.11	1.12	1.05	1.07	1.14	1.12	1.13	1.15	1.18	1.20	1.20
U.K. Pound (GBPUSD)	1.44	1.33	1.30	1.23	1.26	1.30	1.28	1.28	1.28	1.28	1.31	1.31
Japanes Yen (USDJPY)	113	103	101	117	111	112	110	110	112	112	115	115
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	1.01	1.05	1.30	1.30	1.55	1.70	1.90
2-year Treasury (%)	0.72	0.58	0.76	1.19	1.25	1.38	1.50	1.65	1.75	1.85	1.95	2.10
5-year Treasury (%)	1.20	1.00	1.15	1.93	1.92	1.89	1.95	2.10	2.25	2.40	2.55	2.60
10-year Treasury (%)	1.77	1.47	1.59	2.44	2.39	2.30	2.35	2.50	2.70	2.90	2.95	3.00
30-year Treasury (%)	2.61	2.28	2.31	3.07	3.01	2.83	2.90	3.15	3.35	3.40	3.45	3.50

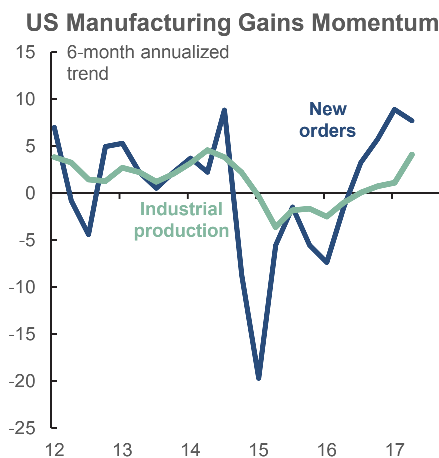
Nonetheless, consumer spending growth during 2017–18 is expected to slow from the average 2.9% annual advance of the prior three years. Auto sales appear to be plateauing amid a tightening in lending standards and a fade in pent-up demand. Following last year's record-setting performance, auto sales adjusted for population growth have returned to their long-term trend.

Chart 4



Sources: Scotiabank Economics, NAR, US Federal Reserve.

Chart 5



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

Stalled health-care reform, possible cuts to social programmes, and delayed income tax reductions also could temper consumer enthusiasm. Refinancing activity is likely to moderate over the coming year as mortgage rates move higher. Tougher immigration policy and a still-strong US dollar are dampening tourism inflows, with reports pointing to a drop in international flight and hotel bookings to the United States for the summer months.

HOUSING OUTLOOK POSITIVE, BUT RESTRAINED

The outlook for US housing is positive, though restrained. The fundamental drivers of housing demand—low unemployment and low interest rates—remain supportive. From a demographic perspective, the pool of potential buyers remains sizeable. The largest population cohort in the United States is currently aged 24–26 and totals some 14 mn (chart 3); its members should soon be entering the homeownership market.

Yet, a number of factors are starting to crimp a faster pace of home sales, most notably among first-time buyers whose share of overall transactions remains below historical norms. These include a persistently low level of listings, especially for entry-priced homes; still-tight credit conditions; and record high student-loan debt. Meanwhile, rising home prices are leading to worsening affordability conditions that will be exacerbated by any potential rise in interest rates (chart 4).

Housing starts are forecast to strengthen to 1.23 and 1.33 mn units, respectively, in 2017 and 2018. However, these levels still fall short of long-term demographic demand, which we estimate at around 1.4 mn. While builder confidence remains high, construction is being held back by skilled labour shortages, rising land costs, and increases in construction prices. Construction timelines from start to completion have steadily lengthened since 2013.

Table 2 — United States

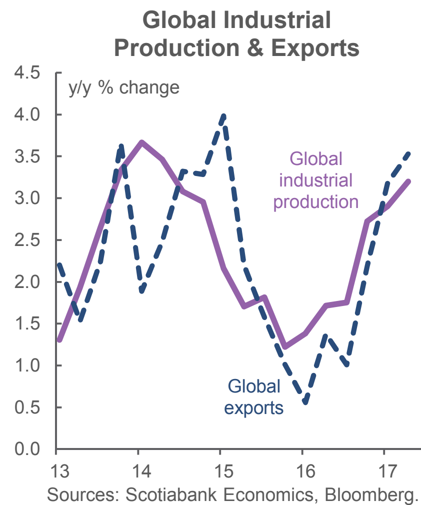
	2000–15	2016	2017f	2018f
	(annual % change, unless noted)			
Real GDP	1.9	1.6	2.2	2.2
Consumer spending	2.3	2.7	2.6	2.6
Residential investment	-0.7	4.9	4.5	2.6
Business investment	2.4	-0.5	3.8	2.9
Government	1.0	0.8	0.2	0.6
Exports	3.8	0.4	2.9	2.5
Imports	3.5	1.1	4.3	3.5
Nominal GDP	4.0	3.0	4.2	4.2
GDP Deflator	2.0	1.3	1.9	2.0
Consumer price index (CPI)	2.2	1.3	2.2	2.2
CPI ex. food & energy	2.0	2.2	2.0	2.2
Pre-tax corporate profits	5.9	-0.1	4.1	3.5
Employment	0.6	1.8	1.4	1.2
Unemployment rate (%)	6.3	4.9	4.4	4.3
Current account balance (USD bn)	-511	-452	-488	-534
Merchandise trade balance (USD bn)	-668	-753	-827	-890
Federal budget balance (USD bn)	-529	-585	-625	-655
percent of GDP	-3.8	-3.2	-3.2	-3.2
Housing starts (mn)	1.27	1.18	1.23	1.33
Motor vehicle sales (mn)	15.4	17.5	17.4	17.6
Industrial production	0.8	-1.2	1.5	2.0
WTI oil (USD/bbl)	64	43	51	53
Nymex natural gas (USD/mmbtu)	5.09	2.55	3.10	2.95

INDUSTRIAL ACTIVITY GAINS MOMENTUM

US industrial activity continues to strengthen even as orders in the transportation sector, especially for commercial aircraft, have fallen to a seven-year low. The

improvement is broad-based, with demand for both durable and non-durable goods advancing year-over-year at the fastest pace in several years and continuing to outpace output gains (chart 5). The backlog of unfilled orders is also on the upswing, which points to some further acceleration in US industrial activity in the second half of 2017. Consumer products—which account for more than 40% of overall US industrial activity—continue to lead the way, with year-to-date demand rising at the quickest pace in six years. However, orders for metal products and machinery are also on the upswing, pointing to improving overall business conditions in the United States and across the globe. In fact, while some 'soft data', such as purchasing managers surveys, have moderated in recent months, 'hard data', such as industrial production at factories around the world is advancing at the fastest pace in nearly three years, providing a significant boost to global exports and shipping activity (chart 6).

Chart 6



Sources: Scotiabank Economics, Bloomberg.

Chart 7

Sources: Scotiabank Economics, OECD, US Census Bureau.

INVESTMENT SPENDING PICKS UP

Overall US business investment growth hit its fastest rate in five years during Q1. While we don't expect this pace to continue through the rest of the year, the progressive easing in financial conditions for business since the end of 2016 should sustain investment growth through the end of 2017. Increased borrowing is supporting investment growth: the ratio of debt to nonfinancial corporate income has nosed toward 92%, taking this ratio near to its pre-2008 peak of around 95%. Business investment is expected to account for about a quarter of overall GDP growth in 2017, its largest contribution in three years.

US business investment is being led by more than a 50% jump in oil and gas investment since the third quarter of 2016. Capital expenditures have also started to improve in other sectors, lifting non-energy investment at its fastest pace in nearly two years. Spending is strongest for high tech and industrial equipment, which climbed at double-digit annualized rates in the opening months of 2017, nearly four times the average growth of the previous four years. Some businesses have even started to break ground on new buildings, lifting capital expenditures on new structures 8% y/y in early 2017, the best performance in nearly three years. While plant utilization rates still remain 3.5 ppts below their historical average, utilization rates have begun to move steadily higher, climbing 0.5 ppts in recent months. Further improvement in construction activity is likely in the second half of 2017, especially since profit margins and revenue growth have picked up across the US industrial sector. Demand for cement and other construction materials has already started to trend higher, with rail volumes of these products currently advancing at the fastest pace since late-2014.

Investment spending also appears to be trending higher in other countries, lifting global machinery exports at a double-digit year-over-year pace since the opening months of 2017. This represents a sharp reversal from declining trade volumes during the past two years. This trend is reinforced by data from several multinational machinery suppliers that have raised their full-year 2017 revenue and earnings guidance in recent months alongside strengthening global demand. Overall, this pattern points to a further acceleration in US industrial and capital-goods exports. These products account for two-thirds of overall exports and are now advancing at the fastest pace in six years (chart 7).

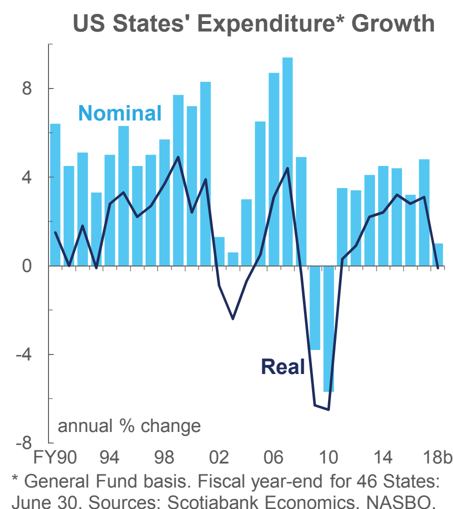
LITTLE ADDITIONAL FISCAL STIMULUS EXPECTED

We expect that federal spending will still rise in calendar 2018: health reform is expensive and we project some visible outlays on priorities such as defense ahead of the November 2018 mid-term elections. Caution on budget management at the State level will only partially offset these outlays.

The contribution of governments' current and capital spending to real GDP growth is expected to be negligible in calendar 2017, followed by a small contribution of 0.1 ppts in calendar 2018. Our projected widening of the US federal deficit by USD 40 bn in fiscal 2017 largely reflects mandatory programmes plus weak revenue growth as individuals and corporations manage income to defer tax payments until after the promised tax-rate cuts are implemented. Negotiations on substantive federal tax reform now appear to be significantly delayed, with any eventual implementation now pushed past end-2018. The President's 10-year infrastructure boost remains sufficiently vague that several major municipalities are framing their own financing structures to proceed with urgently required construction.

An early look at State budgets for fiscal 2018 indicates that aggregate General Fund spending increases are expected to slow from 4.8% last year to 1.0% in FY18 (chart 8). States are principally preoccupied by concerns about their capacity to finance their future Medicaid obligations in light of proposals from Washington that would impose caps on federal contributions. A range of other cutbacks proposed by the US administration, from reductions in rental assistance to more modest funding for environmental programmes beyond new EPA guidelines, are, together, adding to caution in budget management at the State level.

Chart 8



* General Fund basis. Fiscal year-end for 46 States: June 30. Sources: Scotiabank Economics, NASBO.

EXTERNAL RISKS REMAIN LIVE, BUT MUTED

Exports grew solidly in Q1 despite a relatively strong USD. With the Fed expected to continue on its tightening path while the ECB and BoJ remain on hold, the USD should stay relatively solid against most major global currencies; hence, we expect imports to grow faster than exports in both 2017 and 2018 as both consumers and business take advantage of relatively cheap USD prices on foreign goods. Overall, net trade is expected to exert a drag on the economy, reducing overall GDP growth by 0.3 ppts in both 2017 and 2018. This is likely to keep the broader current account deficit more or less unchanged over the next couple of years: the deficit is expected to increase from 2.4% of GDP in 2016 to 2.5% in 2017 and 2.6% in 2018.

The US administration's early self-inflicted wound through its January withdrawal from the Trans-Pacific Partnership (TPP) is unlikely to be repeated with NAFTA, where we expect renegotiations to produce a mutually beneficial updating of the agreement. Similarly, we discount talk of widespread tariffs on steel as sabre-rattling that is unlikely to be matched with action.

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