United States

- **The recent hurricanes will have limited effects on the US economy. Strong employment gains should boost consumption as a driver of the US economic expansion and push growth to 2.2% y/y in 2017, before plateauing in 2018 at 2.3% and decelerating to 1.7% y/y in 2019, close to potential.**
- **The US industrial sector is on track to rise from two years of doldrums, stemming from recovery in the extractive sectors and gains in capital-goods industries as investment picks up across the economy. This rebound could be dampened if federal tax reform fails to materialize.**
- **The concurrent pick-up in global growth should boost US exports in the coming years, but the country's current account deficit will likely widen as imports continue to grow owing to a still-strong US dollar.**

THE MORE VIOLENT THE STORM, THE QUICKER IT PASSES

Hurricanes Harvey and Irma dominated US news in recent weeks, but despite the havoc they wrought in the southern states of the US and Puerto Rico, neither is expected to have a meaningful impact on overall US economic activity. US growth averaged just above 2% in the first half of 2017, and looks set to come in at a similar pace in the second half following the storms (table 1). This steady growth performance, with 2.2% y/y projected in 2017 and 2.3% y/y in 2018 (table 2), nevertheless remains above both the Fed and Scotiabank Economics' estimates of potential growth averaging around 1.8% during 2017–19 (chart 1). Strong consumption growth combined with a rebound in industrial activity should keep the US in excess-demand territory during 2017 and 2018, even if Washington proves unable to deliver on meaningful changes in taxes and spending.

US CONSUMERS REGAIN THEIR MOJO

After a brief early-year lull, consumers are once again leading the US expansion. Solid consumer fundamentals, including a robust job market, should sustain steady consumption growth of around 2.5% through next year. Monthly hiring gains are averaging around 185,000 new positions, a strong performance at this late stage of the economic cycle. Consumer confidence is near 16-year highs.

Wage gains remain muted, but should begin to accelerate given drum-tight labour markets and firming labour productivity trends. Most measures of US labour-market slack imply that the economy is at full employment. The US jobless rate is near a 16-year low of 4.4%, while broader measures of labour underutilization that account for marginally attached and underemployed workers are also plumbing decade-lows. The job openings (JOLTS) rate is near its highest level since at least 2000, evidence of growing labour shortages driven by stronger growth and demand (chart 2).

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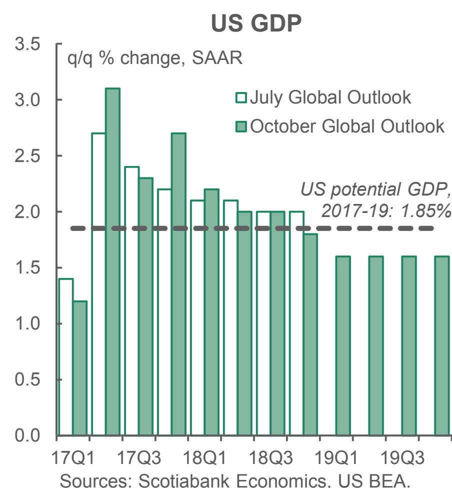
Chart 1



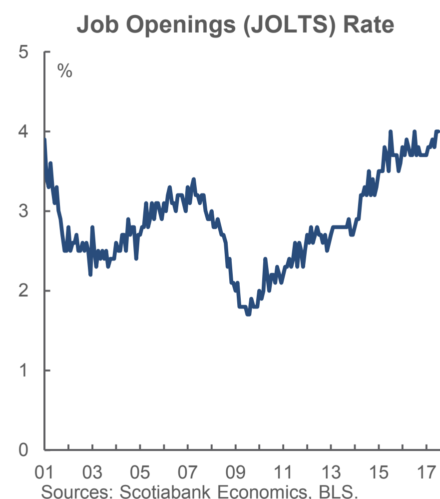
Sources: Scotiabank Economics, US BEA.

Solid household balance sheets also are providing support to consumer spending. Rising home and equity values have driven household net worth to record levels. Debt-service charges consume about 10% of disposable income, near the lowest level on record. Households have rebuilt significant home equity.

Household vehicle purchases remain resilient, and should continue to move higher in 2018 given an ageing vehicle fleet. The slowdown in overall auto sales this year in large part reflects de-fleeting in the US rental car market. Replacement demand for vehicles damaged by hurricane-induced flooding also will provide a boost to sales into 2018.

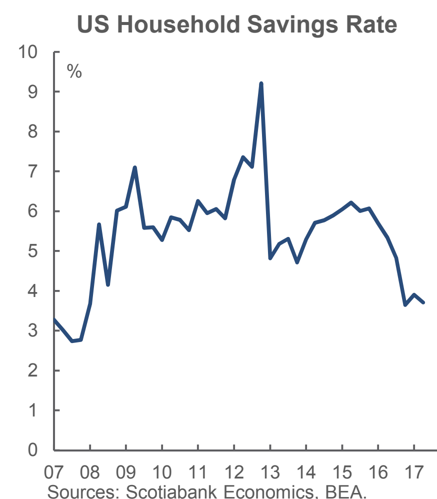
There are a few downside risks to the US consumer outlook. An increasing share of spending is being financed by debt or savings. Growth in consumer credit has more than doubled over the past year to 6% y/y, led by revolving credit. Savings rates have been drawn down, and are nearing pre-recession lows (chart 3). Delinquency rates are turning up for some debt categories, including credit cards. Conversely, the potential for the US administration to implement personal income tax reform remains an upside risk. No significant tax relief is currently built into our forecast.

Chart 2



Sources: Scotiabank Economics, BLS.

Chart 3



Sources: Scotiabank Economics, BEA.

A MORE MUTED US HOUSING OUTLOOK

The US housing recovery has lost some momentum. Taking into account weaker activity in regions hit hard by recent hurricanes, total existing home sales in 2017 are expected to end the year largely on par with 2016 levels. Housing starts also are expected to be relatively flat year-on-year.

The fundamental drivers of housing demand remain solid, including low borrowing costs, strong job growth, rising incomes, and elevated consumer confidence. Lenders are gradually easing loan standards. Millennials are ageing into their prime home-buying years. In short, there is still considerable pent-up demand for housing. The US homeownership rate, after hitting a record low of 63.1% in mid-2016, is edging higher across age cohorts.

Table 1

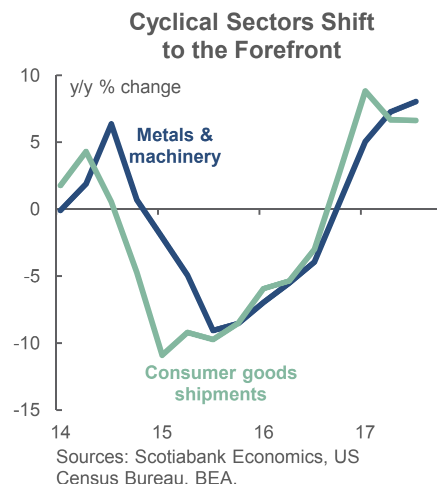
Quarterly US Forecasts	2017			2018				2019			
	Q2	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Economic											
Real GDP (q/q ann. % change)	3.1	2.3	2.7	2.2	2.0	2.0	1.8	1.6	1.6	1.6	1.6
Real GDP (y/y % change)	2.2	2.1	2.3	2.6	2.3	2.2	2.0	1.9	1.8	1.7	1.6
Consumer prices (y/y % change)	1.9	1.8	1.8	1.7	2.1	2.2	2.2	2.2	2.3	2.4	2.4
CPI ex. food & energy (y/y % change)	1.8	1.7	1.8	1.8	2.1	2.1	2.2	2.2	2.2	2.3	2.3
Financial											
Euro (EURUSD)	1.14	1.18	1.18	1.18	1.18	1.20	1.20	1.24	1.24	1.28	1.28
U.K. Pound (GBPUSD)	1.30	1.28	1.33	1.35	1.35	1.37	1.37	1.38	1.38	1.40	1.40
Japanese Yen (USDJPY)	112	110	112	114	114	115	115	118	118	120	120
Fed Funds Rate (upper bound, %)	1.25	1.25	1.50	1.50	1.75	1.75	2.00	2.00	2.00	2.25	2.25
3-month T-bill (%)	1.01	1.04	1.30	1.40	1.60	1.70	2.00	2.05	2.05	2.30	2.30
2-year Treasury (%)	1.38	1.48	1.55	1.75	1.85	1.95	2.10	2.20	2.30	2.35	2.45
5-year Treasury (%)	1.89	1.93	2.00	2.10	2.15	2.20	2.30	2.40	2.50	2.55	2.60
10-year Treasury (%)	2.30	2.34	2.30	2.35	2.45	2.60	2.70	2.75	2.80	2.90	3.00
30-year Treasury (%)	2.83	2.86	2.80	2.80	2.85	3.00	3.10	3.10	3.15	3.20	3.30

Sources: Scotiabank Economics, BEA, BLS, Bloomberg.

Yet, a number of factors are expected to continue to restrain activity. Rising home prices, high student debt loads, and a persistent shortage of affordable listings all remain a significant hurdle for many potential buyers. The number of available existing homes for sale has fallen to historic lows. Market conditions remain most challenging for first-time buyers, whose share of home purchases remains stuck at just over 30%, well below the historical average of near 40%. Rising rates and higher borrowing costs will worsen affordability.

We have downgraded our expectations for new home construction since last quarter's *Global Outlook*. While builder confidence remains high, the ability to ramp up activity more sharply is constrained by rising land prices, higher construction costs, and labour shortages. Housing starts are now expected to total 1.25 and 1.30 mn units, respectively, in 2018 and 2019—up from an estimated 1.20 mn units this year (table 2 again), but still well below underlying demographic requirements estimated at around 1.40 mn units annually.

Chart 4



Sources: Scotiabank Economics, US Census Bureau, BEA.

INDUSTRIAL RECOVERY ACCELERATES

US industrial activity continues to gain momentum. Domestic demand for manufactured products is advancing at its fastest pace since 2011 and business confidence has jumped to its highest level since the start of the millennium. Consumer goods originally led the way, buoyed by a solid labour market and the healthiest household balance sheets in more than a decade. However, the economically-sensitive resource sector and capital goods industries have moved to the forefront of growth in recent months, as both US and global growth consolidates (chart 4). In particular, US demand for metal products has advanced at a 10% y/y pace this year to date, reversing the sharp fall-off we saw through mid-2016. For example, US steel demand has surged by about 18% y/y over the year to date, the best performance since 2011. This improvement reflects enhanced prospects for business investment and construction activity, and should be bolstered by reconstruction efforts and increased federal spending following the recent hurricanes. For context, in the aftermath of 2005's Hurricane Katrina, Congress approved aid packages exceeding USD 100 bn (0.7% of GDP); an even larger stimulus is likely following the latest hurricane season.

BROAD-BASED REBOUND IN BUSINESS INVESTMENT

US business investment climbed an annualized 7% in the first half of 2017, the best performance in three years, which has led to a significant acceleration in machinery demand. As of August, US machinery demand had risen 7% y/y in the year to date, with double-digit gains across most industries. While a 54% y/y rebound in the oil & gas sector activity in the first half of 2017 is providing a major boost to machinery and steel products, non-energy investment is also strengthening, which is helping to lift non-defense capital goods orders at an accelerating pace and points to further improvement ahead in business investment (chart 5). Of note, US demand for construction machinery has surged about 17% y/y so far during 2017, with a similar advance reported in rail volumes for cement and other construction materials. In fact, investment in nonresidential structures is outpacing the growth in capital equipment this year for the first time since 2014. New plant construction has even begun to stabilize, as industrial operating rates have climbed from

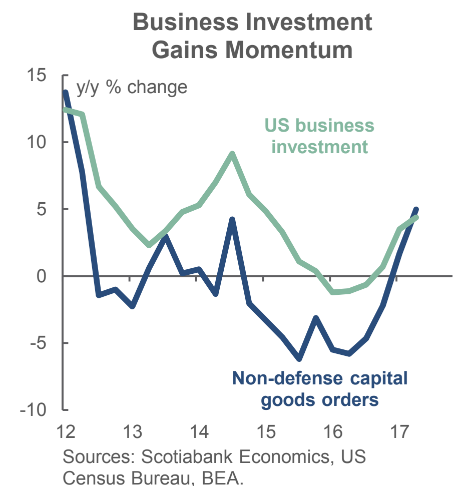
Table 2

United States	2000–16	2016	2017f	2018f	2019f
	(annual % change, unless noted)				
Real GDP	1.9	1.5	2.2	2.3	1.7
Consumer spending	2.4	2.7	2.7	2.5	2.1
Residential investment	-0.4	5.5	1.5	1.5	1.6
Business investment	2.3	-0.6	4.4	3.5	2.3
Government	1.0	0.8	0.1	0.7	0.5
Exports	3.6	-0.3	3.2	2.7	2.7
Imports	3.4	1.3	3.8	3.3	3.2
Nominal GDP	3.9	2.8	3.9	4.0	3.7
GDP Deflator	2.0	1.3	1.7	1.7	1.9
Consumer price index (CPI)	2.2	1.3	2.0	2.1	2.3
CPI ex. food & energy	2.0	2.2	1.8	2.0	2.2
Pre-tax corporate profits	5.5	-2.1	4.0	3.4	0.5
Employment	0.7	1.8	1.5	1.2	1.1
Unemployment rate (%)	6.2	4.9	4.4	4.3	4.2
Current account balance (USD bn)	-507	-452	-491	-552	-605
Merchandise trade balance (USD bn)	-673	-753	-816	-883	-952
Federal budget balance (USD bn)	-532	-585	-650	-660	-700
percent of GDP	-3.7	-3.1	-3.4	-3.3	-3.4
Housing starts (mn)	1.27	1.18	1.20	1.25	1.30
Motor vehicle sales (mn)	15.5	17.5	17.1	17.4	17.3
Industrial production	0.7	-1.2	1.5	1.8	1.0
WTI oil (USD/bbl)	63	43	50	52	56
Nymex natural gas (USD/mmbtu)	4.94	2.55	3.08	2.85	3.00

Sources: Scotiabank Economics, BEA, BLS, Bloomberg.

the cycle-low set in the first quarter of 2016. However, profit margins have yet to rebound, held back by sub-par earnings in some key sectors.

Chart 5



Sources: Scotiabank Economics, US Census Bureau, BEA.

STILL, ONLY LIMITED FISCAL STIMULUS ANTICIPATED

The forecast contribution of current and capital spending across all levels of government to annual real GDP growth is projected to edge up to a muted 0.1 percentage point annually in 2018 and 2019. State and municipal governments are responding cautiously to the ongoing volatility in federal policy discussions given the Republicans' wish to devolve more program responsibility to lower levels of government. We assume a moderate widening of the federal fiscal deficit from a low of 2.4% in fiscal 2015 to 3.3% in fiscal 2019 as revenue growth fails to keep pace with annual expenditures that are being pushed up by net interest payments, mandatory outlays, and significant one-time events.

Fiscal policy would be broadly more stimulative if some combination of the Republicans' proposed corporate and personal income-tax reforms is eventually legislated. Some of the US administration's key proposals are summarized below, though we acknowledge that critical supporting details are not known. Proposed tax relief for citizens includes: collapsing the existing seven federal personal income tax brackets to three (i.e., 12%, 25%, and 35%), with the option of a fourth bracket for the very highest earners; expanding the standard deductions, enhancing the child tax credit; and eliminating the Alternative Minimum Tax and the Estate Tax. For corporations, the federal income tax rate would be trimmed from 35% to 20%, and for small businesses that pass through profits to their owners, the tax rate would be 25%. For five years, investment in machinery and equipment could be fully written off in the first year. For multinationals operating abroad, the current worldwide tax would be replaced by a territorial system.

Details on the means by which these tax cuts would be financed, however, remain to be determined by Congress. Representatives are unlikely to agree to eliminate several key deductions, notably those provided on mortgage interest, charitable donations, and state and local taxes, to finance tax reform. As a result, the recently proposed package of reforms is unlikely to succeed, but its failure could spur some interim stop-gap measures in order for the White House and legislators to show some progress.

EXPORTS RISE, BUT TRADE DEFICITS SET TO WORSEN

American merchandise exports have posted their largest annual gains in half a decade, supported by a substantial recovery in commodity exports and renewed strength in manufactures. Higher oil and minerals prices have lifted growth in mining, petroleum, and coal exports to a 45% y/y average in the year to July. Last year, these exports shrank at a yearly pace of 22% over the same period; their current levels remain at around three-quarters of the export flows that prevailed prior to the 2015 oil crash. Overall, total goods exports have grown by 7% y/y as of July, surpassing the 4.1% y/y gains over the same period in services exports—the first time this has happened since 2012, thanks mainly to the recovery in the mining sector.

Still, persistent strength in the USD—which remains near post-recession highs, supported by capital inflows in response to the Fed's efforts to normalize monetary policy—should keep merchandise imports growing faster than exports. While the surplus on services trade has remained relatively constant since 2014, a recent 8% y/y increase in the goods trade deficit has contributed to a slight widening of the country's current account deficit (chart 6). The US's trade and current account deficits will likely continue to expand with savings rates at pre-recessions lows (chart 3 again) and the US Administration pushing to provide additional fiscal stimulus through infrastructure spending or tax cuts—thereby undermining one White House priority while delivering on another.

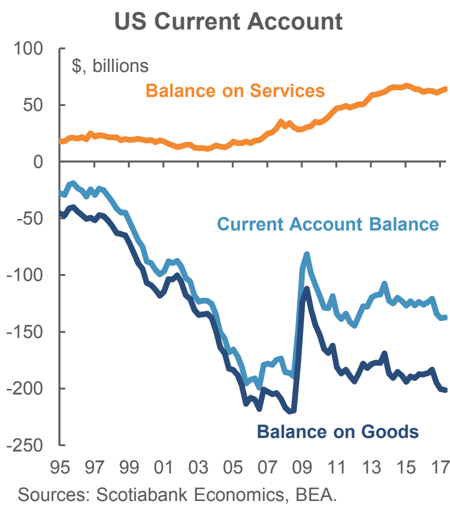
FOREIGN PURCHASES OF US SECURITIES RETURN

In international financial markets, net foreign purchases of US securities have remained in the black for seven consecutive months, the longest streak since 2012–13, after oscillating between net outflows and net inflows nearly every month since mid-2015 as China reduced its reserve holdings of US Treasuries (chart 7). In the year to July, Chinese holdings of US Treasuries have recovered by some USD 117 bn as pressure on the Chinese authorities to support the yuan have eased. Foreign purchases of domestic corporate stocks and fixed-income instruments have also picked up over the last 18 months in the search for yield (chart 8).

THE RISKS OF AMERICAN EXCEPTIONALISM

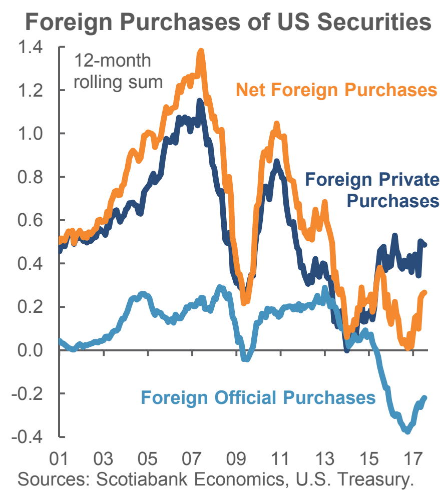
Some aspects of the uncertain policy terrain in the US have firmed up in recent months, while others have become softer. The deal between the White House and Congressional Democrats put a temporary end to the debt-ceiling debate, but this issue could flare anew in 2018. The recent collapse of successive health-care reform bills exemplifies how the divided Republican-controlled Congress may also find it difficult to pass meaningful tax reform or major spending initiatives—which could put a halt on the emerging rebound in business investment. Growth could be further stifled by protectionist efforts to crimp the North American Free Trade Agreement (NAFTA), and stifle trade in, amongst other things, aircraft, lumber, aluminum, steel, and solar panels.

Chart 6



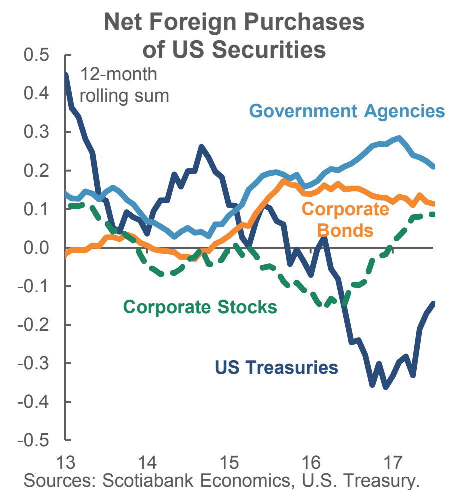
Sources: Scotiabank Economics, BEA.

Chart 7



Sources: Scotiabank Economics, U.S. Treasury.

Chart 8



Sources: Scotiabank Economics, U.S. Treasury.

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