United States

DON'T BLAME THE ECONOMY

- **As widely anticipated by most economic forecasts, the temporary boost from the Tax Cuts and Jobs Act (TCJA) and increased federal government spending has started to wane, with US economic growth slowing below potential during 2019–20.**
- **The unforced errors from Washington, including stepped up sabre-rattling on trade, the government shutdown, and executive leadership churn have heightened uncertainty and driven weeks of chaotic repricing in asset markets, but should do limited additional damage to consumption, investment, and growth.**
- **The US is expected to set in July a new record for its longest-ever expansion. The risk of a recession taking hold during the next two years remains low.**

SLOWDOWN EXPECTED IN 2019

After two quarters of exceptional growth driven by the White House's early-2018 fiscal stimulus package, the high-flying American economy is, as expected, coming back to Earth. While growth in Q4 is expected to hit close to 3% q/q in seasonally adjusted annualized terms, we see activity continuing to decelerate into 2019 and 2020, as the growth impact from the 2018 tax reforms and spending package wanes.

Despite the recent correction in equity markets, our forecast for the US is little changed from last quarter: we continue to project GDP growth at 2.4% in 2019, with a dip just below the US's 1.9% potential to 1.7% in 2020 as quarterly growth gradually slows (table 1).

- According to ***The Scotiabank Global Macro Model*** the swoon in equity markets would have to be substantially more prolonged to make a serious dent in our forecast of US growth.
- In addition, we have been marking down our US forecast on account of trade uncertainty since mid-2018. Since the equity market correction seemed to have been triggered by concerns about an escalating China-US trade spat, we see the stock market fall as validating our forecast, not implying additional weakness.

While we still expect three 25 bps hikes by the Fed in 2019, leaving the upper limit of the fed funds target at the cyclical peak of 3.25% in Q4-2019 (see ***Monetary Policy and Capital Markets***), tighter financial conditions and moderation in global growth led us to delay the first hike to Q2-2019 compared to Q1-2019 expected in our December monthly forecast **update**.

In the absence of major policy shocks, we do not see a recession looming in our baseline forecast: the US output gap is expected to close over the projection horizon, with growth dipping below that of potential GDP.

- On existing data, the odds of a US recession over the next 12 months have edged up only slightly in the NY Fed's recession probability model (chart 1).

CONTACTS

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

Marc Desormeaux, Provincial Economist
416.866.4733
Scotiabank Economics
marc.desormeaux@scotiabank.com

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

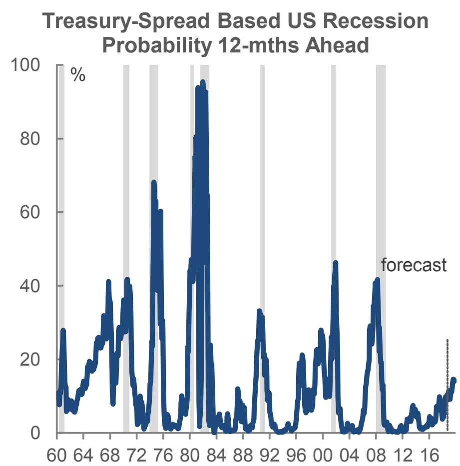
René Lalonde, Research Director
416.862.3174
Scotiabank Economics
rene.lalonde@scotiabank.com

Nikita Perevalov, Senior Economist
416.866.4205
Scotiabank Economics
nikita.perevalov@scotiabank.com

United States	2017	2018e	2019f	2020f
Real GDP (annual % change)	2.2	2.9	2.4	1.7
CPI (y/y %, eop)	2.1	2.0	2.1	2.3
Central bank policy rate (%, eop)	1.50	2.50	3.25	3.25
Canadian dollar (USDCAD, eop)	1.26	1.36	1.27	1.23

Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, FRBNY. Shaded areas represent recession periods.

FORECAST RESTS ON BALANCE OF POLICY RISKS

Our forecast for a gradual slowing of the US economy rests on three key assessments.

- First, we do not expect the US trade spat with China to intensify further, since it would impose pointed costs on US consumers and industry in the run-up to the 2020 US presidential election.

- Second, the current budget impasse and the government shutdown are likely to be resolved more quickly than the current rhetoric out of Washington implies; although past government shutdowns have caused limited damage to growth, suspensions in government services antagonize voters and impose hardships on federal employees. Incentives are aligned to find a face-saving compromise, and there is a wide spectrum of ways for both sides to claim victory.

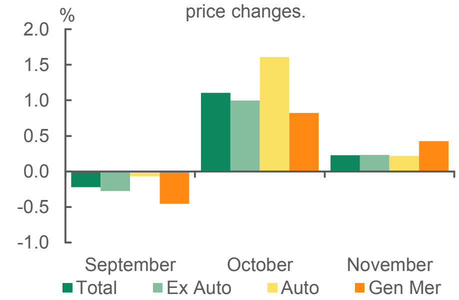
- Finally, to the extent that, in the words of the US Federal Reserve chair J. Powell, financial markets ran “well ahead of the data”, we expect market volatility to subside in line with the still-robust outlook for the US economy in the absence of further policy shocks.

The remainder of this section lays out our assessments for the US real economy that underpin this outlook.

Chart 2

Percent Change in Retail and Food Services Sales from Previous Month

Data adjusted for seasonal variation and holiday and trading-day differences but not for price changes.



Sources: Scotiabank Economics, U.S. Census Bureau, Advanced Monthly Retail Trade Survey, December 14, 2018.

FUNDAMENTALS ARE STILL BROADLY SOLID

The US economy's major indicators are showing some pockets of softness, but, overall, the recent data point to the underlying resilience of this extended late-cycle expansion (table 3), as shown by the broad set of numbers that feed into most major surprise indices and GDP nowcast models. While backward-looking indicators are relatively solid (industrial production was up nearly 4% from a year ago in November, including strong growth in durable goods)—some forward-looking indicators were more mixed.

- Manufacturing PMI took a 5.2-point dive in December on the back of weaker new orders, which brought the overall index down the most month-on-month since 2008.

Personal consumption expenditure (PCE) inflation was just below the Federal Reserve's 2% target with support from strong employment gains, unemployment rate at a historic low and the economy in excess demand, as well as wage gains that are

Table 1

Quarterly US Forecasts	2018		2019				2020			
	Q3	Q4e	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Economic										
Real GDP (q/q ann. % change)	3.4	2.7	2.1	1.8	1.8	1.7	1.7	1.7	1.6	1.7
Real GDP (y/y % change)	3.0	3.1	3.1	2.5	2.1	1.9	1.8	1.7	1.7	1.7
Consumer prices (y/y % change)	2.6	2.0	1.6	1.6	1.7	2.1	2.3	2.3	2.3	2.3
CPI ex. food & energy (y/y % change)	2.2	2.1	2.0	2.0	2.1	2.1	2.1	2.1	2.1	2.1
Core PCE deflator (y/y % change)	2.0	1.9	2.0	1.9	2.0	2.0	2.0	2.0	2.0	2.0
Financial										
Euro (EURUSD)	1.16	1.15	1.17	1.22	1.26	1.30	1.30	1.30	1.32	1.32
U.K. Pound (GBPUSD)	1.30	1.28	1.32	1.35	1.37	1.40	1.42	1.42	1.45	1.45
Japanese Yen (USDJPY)	114	110	110	110	108	108	107	107	105	105
Fed Funds Rate (upper bound, %)	2.25	2.50	2.50	2.75	3.00	3.25	3.25	3.25	3.25	3.25
3-month T-bill (%)	2.20	2.36	2.40	2.65	2.90	3.15	3.15	3.15	3.15	3.15
2-year Treasury (%)	2.82	2.49	2.75	2.90	3.10	3.30	3.30	3.30	3.30	3.30
5-year Treasury (%)	2.95	2.51	2.80	3.00	3.20	3.35	3.35	3.35	3.40	3.45
10-year Treasury (%)	3.06	2.68	2.90	3.10	3.30	3.40	3.45	3.45	3.50	3.55
30-year Treasury (%)	3.21	3.01	3.10	3.25	3.50	3.50	3.60	3.60	3.65	3.65

Sources: Scotiabank Economics, BEA, BLS, Bloomberg.

running ahead of price increases. These pay increases are feeding directly through to higher incomes and increased consumer confidence, which together have catalyzed stronger retail sales so far in Q4 in advance of the holiday season (chart 2), underpinned by a consumer credit expansion after years of household balance-sheet clean-up and lower debt-service burdens (chart 3). Although our rate path for the Fed is expected to raise the cost of servicing household debt, the nominal disposable income growth of over 4% should ensure that consumption growth remains robust, albeit moderating.

INVESTMENT AND MANUFACTURING SLOWING DESPITE CORPORATE TAX CUTS

Despite the significant fiscal measures introduced in support of the business sector, such as lower corporate tax rates passed in the TCJA of 2017, investment spending by businesses has been relatively muted just as we expected. Following a spike in growth in the first half of 2018, partly explained by the oil and gas sector expansion and partly by the tax cuts, growth in business investment moderated in Q3-2018.

- Non-residential structures investment declined unexpectedly in Q3-2018, while spending on machinery and equipment moderated (chart 4), even as capacity utilization in most manufacturing sectors has ticked up above its post-GFC average (see selected manufacturing industries in chart 5).

- Nevertheless, one bright spot in 2018 were sales of motor vehicles, a big-ticket item, which remained robust mostly as a result of demand from businesses. Solid December auto sales closed 2018 at 17.2mn vehicles sold, the third highest year on record.

The overall muted response of business investment to the tax stimulus may be due to i) a relatively small share of overseas profits repatriated to the US (over $500bn in Q1-Q3 of 2018, compared to up to $3tn estimated to be parked overseas, see chart 6), ii) a preference for share buybacks using the extra funds, with S&P500 companies deploying over $500bn for that purpose in Q1-Q3, and iii) the uncertainty caused by the erratic trade policy actions by the US administration, which is making businesses leery of committing funds to expand US capacity, in particular for companies that depend on international trade (e.g. multinationals).

Going forward we expect business investment to moderate further, in line with slowing consumer and export demand and higher interest rates.

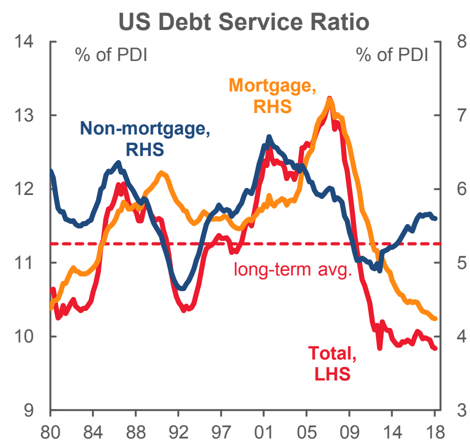
MIXED PICTURE IN RESIDENTIAL REAL ESTATE

Residential real estate is one of the weaker pockets in the recent US economic data and near-term outlook.

- Residential real estate investment declined in three quarters so far in 2018, with housing starts averaging 1.26mn (SAAR) up to November and below the 1.5–1.6 mn units needed to fill underlying demand.

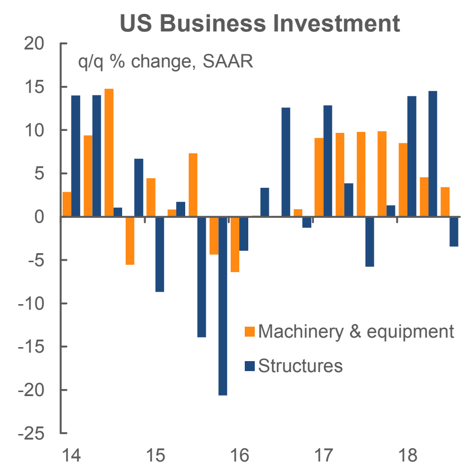
- Although house price growth slowed to 5.0% y/y in October, home affordability remains a challenge with the National Association of Realtors' (NAR) housing affordability index at or near its lowest levels since 2008 in the four major markets it surveys (chart 7).

Chart 3



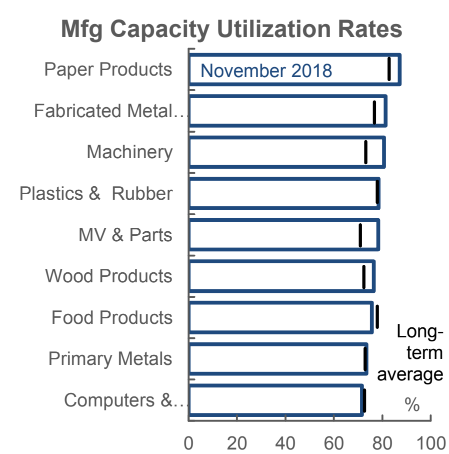
Sources: Scotiabank Economics, US Federal Reserve.

Chart 4



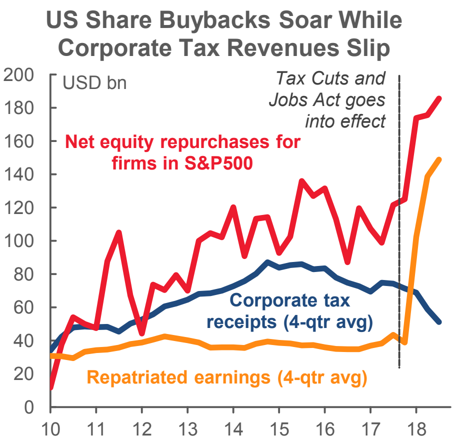
Sources: Scotiabank Economics, BEA.

Chart 5



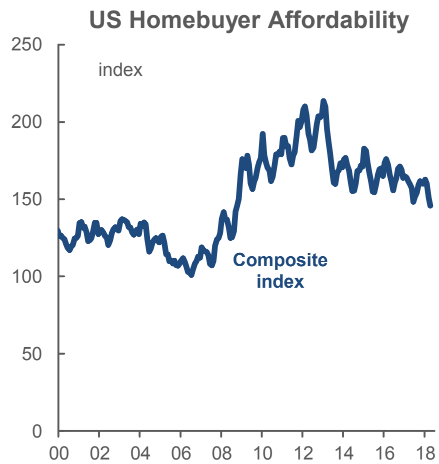
Sources: Scotiabank Economics, BEA

Chart 6



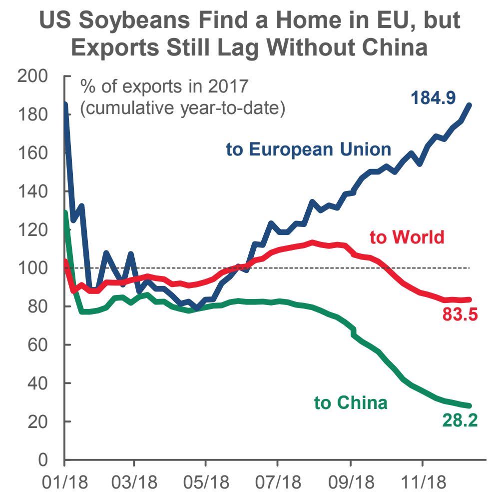
Sources: Scotiabank Economics, BEA
US Treasury, Bloomberg.

Chart 7



Sources: Scotiabank Economics, NAR.

Chart 8



Sources: Scotiabank Economics, USDA.

- Home sales peaked in November 2017 and new and existing unit sales have continued to drift down since then, particularly at the lower end of the market where inventory is constrained in part by the drag that higher rates exert on refinancing and move-up purchases.

BALANCE OF PAYMENTS DRAG

Despite the professed desire to reduce the US trade deficit, the US administration's fiscal policies combining expansionary tax cuts and increased spending, on the back of a strong US dollar, instead consistently widen US trade deficits by underpinning increasing imports.

On the other hand, the administration's trade policies, to the extent that they induce a backlash by the US trade partners, lead to weaker exports going forward. This dynamic was in full view in Q3-2018:

- US exports declined by close to 5% Q/Q SAAR as the US lost export market share, for example in China. Chart 8 shows that as US-China trade tensions flared in the middle of 2018, soybeans exports from the US to China started to underperform relative to 2017, albeit partly offset by exports to the European Union.

- Total imports of goods and services, on the other hand, increased by over 9% Q/Q SAAR in part in expectation of tariffs being imposed.

We project that trade tensions between China and the US are set to continue in 2019. However, we do not think that an all-out trade war, with rising tariffs covering an ever-enlarging share of bilateral trade, is likely, since it would impose significant costs on US consumers and businesses in the context of looming elections and jittery capital markets. While an eventual resolution is expected, and the arrival of the US delegation in Beijing on January 7th is an

Table 2

United States	2000–17	2017	2018e	2019f	2020f
	(annual % change, unless noted)				
Real GDP	2.0	2.2	2.9	2.4	1.7
Consumer spending	2.4	2.5	2.7	2.6	1.9
Residential investment	-0.3	3.3	0.0	0.7	1.9
Business investment	3.0	5.3	6.8	3.1	2.2
Government	1.0	-0.1	1.7	2.3	1.6
Exports	3.7	3.0	4.0	1.6	1.9
Imports	3.7	4.6	4.7	4.0	2.9
Nominal GDP	4.0	4.2	5.2	4.5	3.8
GDP Deflator	1.9	1.9	2.2	2.1	2.0
Consumer price index (CPI)	2.2	2.1	2.4	1.8	2.3
CPI ex. food & energy	2.0	1.8	2.1	2.0	2.1
Core PCE deflator	1.7	1.6	1.9	2.0	2.0
Pre-tax corporate profits	5.3	3.2	8.1	4.2	1.9
Employment	0.7	1.6	1.6	1.3	1.0
Unemployment rate (%)	6.1	4.4	3.9	3.7	3.8
Current account balance (USD bn)	-501	-449	-480	-571	-641
Merchandise trade balance (USD bn)	-680	-807	-884	-985	-1068
Federal budget balance (USD bn)	-540	-665	-805	-1,000	-1,045
percent of GDP	-3.7	-3.4	-3.9	-4.7	-4.7
Housing starts (mn)	1.26	1.20	1.26	1.25	1.26
Motor vehicle sales (mn)	15.6	17.1	17.2	16.8	16.7
Industrial production	0.7	1.6	3.9	3.1	2.1
WTI oil (USD/bbl)	62	51	65	58	62
Nymex natural gas (USD/mmbtu)	4.83	3.02	3.07	3.25	2.80

Sources: Scotiabank Economics, BEA, BLS, Bloomberg.

encouraging sign, we believe exports will continue to grow at an anaemic pace due to globally moderating export demand and the strong US dollar. In addition to stronger import growth over the projection horizon, weak exports mean that net trade is expected to subtract from GDP growth over 2019–20.

OUTPUT GAP CLOSING

Looking forward, with the economy at full employment, we expect a broad moderation across most GDP components, including consumption, government spending, investment, and trade (table 2 on previous page). The declining impact of the fiscal stimulus on growth in 2020, rising federal funds rate and weakening demand in US trade partners imply that US GDP is likely to start reverting to the level of potential output in 2019. As a result, the output gap, which is likely to peak at 0.7% of GDP in 2019, is expected to halve in 2020. Diminishing excess demand should reduce inflationary pressures at the same time as oil prices rise, keeping core PCE inflation stable at 2.0% in 2019–20 and total PCE inflation rising to 2.1% in 2020.

RISKS GOING FORWARD

While we think risks are balanced going forward, there are a number of risk factors on the positive and negative side of the ledger.

- A failure to reach an agreement and reopen the US government can become more of a drag on growth if a progressively larger share of government services becomes disrupted.

Trade risks still loom large in the forecast.

- China-US trade truce expires at the end of February. In the absence of constructive steps to resolve the impasse, an escalation of the conflict is possible, which provides a downside risk to the US economy. On the other hand, a successful resolution of the trade spat poses an upside risk to the US and global economies.

- The auto tariffs review is expected in mid-February, which could provide a possible trigger for a trade conflict between the US and a broader set of trade partners.

On a positive note, there could be a window of opportunity for the Congress and the administration to agree on a further increase in spending, in particular related to the infrastructure program.

Table 3

US Economic Indicators

% change (unless otherwise specified)	1-month	3-month	12-month	Recent Evolution[1]
Real GDP	--	0.8	3.0	
Prices				
Consumer price index	0.0	0.4	2.2	
Consumer price index ex. food and energy	0.2	0.5	2.2	
Personal consumption expenditure price index	0.1	0.4	1.8	
Core personal consumption expenditure price index	0.1	0.4	1.9	
Labour Market				
Employment	0.2	0.5	1.8	
Unemployment rate (level change, ppt)	0.2	0.2	-0.2	[2]
Private sector average hourly earnings	0.4	0.8	3.2	
Initial jobless claims	-7.3	0.5	-12.6	[2]
Continuing jobless claims	5.3	4.2	-8.1	[2]
Retail, Wholesale & Trade				
Trade balance (level change, USD bn)	-0.9	-5.1	-8.5	[2]
Retail sales	0.2	1.1	4.2	
Wholesale inventories	0.8	2.5	6.9	
Vehicle sales	0.6	0.6	-1.5	[2]
Housing Sector				
Housing starts	3.2	-1.9	-3.6	
Existing home sales	1.9	-0.2	-7.0	
New home sales	-8.9	-10.2	-12.0	
S&P CoreLogic Case-Shiller 20-city home price index	0.0	0.1	5.0	
Industrial Sector				
Industrial production	0.6	0.6	3.9	
Durable goods orders	0.8	-3.6	5.3	
Factory orders	-2.1	0.8	6.9	
Business inventories	0.6	1.6	5.2	
ISM manufacturing (level change, ppt)	-5.2	-5.7	-5.2	[2]
ISM non-manufacturing (level change, ppt)	-3.1	-4.0	1.6	[2]
Household Sector				
Consumer confidence	-6.1	-5.3	4.1	[2]
Nominal personal income	0.2	1.0	4.2	
Nominal Personal spending	0.4	1.3	4.7	
Nominal consumer credit	0.6	1.5	4.3	
Financial Markets				
10-year treasury yield (level, %)	2.70[3]	3.16	2.56	[2]
S&P 500	-2.6	-7.8	-6.5	[2]
WTI oil	1.5	-29.2	-18.5	[2]
Trade-weighted USD[4]	-0.6	0.5	7.5	[2]

[1]January 2017 – present, y/y % change.
[2]January 2017 – present, levels.
[3]Current yield.
[4]Federal Reserve trade-weighted broad US dollar.
Sources: Scotiabank Economics, Bloomberg.