July 12, 2019

United States

- **The US economic expansion is set to surpass previous records on the back of continuing growth in domestic demand, but activity is slowing as the impact of fiscal stimulus wanes.**
- **Nevertheless, the risk of a trade war has increased and in the event of a severe global trade conflict we expect a US recession and significant monetary easing.**
- **However, weak inflation as well as uncertainty are likely to be the main reasons for a dovish outlook for the Fed.**

GROWTH OUTLOOK

This month the US sets a new record for the longest uninterrupted economic expansion in its recorded history. We forecast that this expansion will continue over the next few years, although the rate of growth is likely to slow: GDP growth is expected to decline from 2.5% in 2019 to 1.6% in 2020, as the impact of the 2018 fiscal stimulus declines and uncertainty takes its toll on investment and trade. Underlying this outlook is the quarterly profile for GDP growth that is expected to be below potential until Q4-2020 (table 1), which drives the output gap down from excess demand of 0.6% on average in 2019 to 0.2% in 2020.

Notwithstanding a weak start to 2019, **US consumption** is expected to remain robust over 2019–20, with growth averaging 2.2% in 2019 and 1.9% in 2020, supported by healthy household finances, low debt servicing costs, strong growth in personal disposable incomes (3.9% y/y in May), tight labour markets, and consumer confidence near post-crisis highs.

In contrast, **business investment** growth was relatively muted in Q1-2019 at 4.4% q/q saar, compared to 6.9% in 2018, and is likely to slow further, even as most major industrial sectors are operating at or beyond their long-term average capacity utilization rates, and credit supply remains ample with real interest rates still low by historic standards.

The relatively subdued investment outlook, with capital spending growth averaging 4.0% in 2019 and 2.3% in 2020, is in part due to uncertainty about the future of US trade policy and the viability of integrated international supply chains, which appear to be putting expenditure plans on hold. All of this could turn around on a dime with a change in protectionist actions and policy volatility from the White House, but these chronic conditions are unlikely to lift entirely under this administration.

Given our benign baseline macro forecast, we incorporate 75 bps of easing by the Federal Reserve due mainly to the weak inflation outlook, with the insurance motive in the face of trade uncertainty playing a supporting role.

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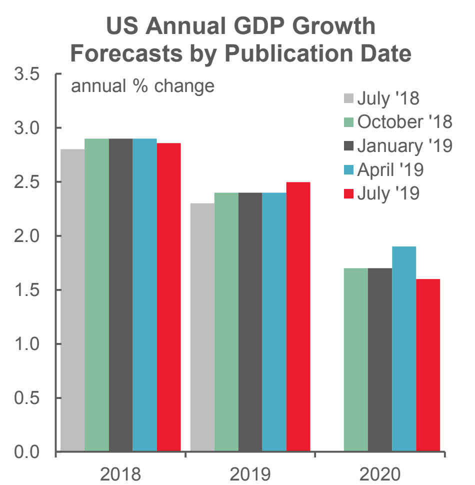
United States	2017	2018	2019f	2020f
Real GDP (annual % change)	2.2	2.9	2.5	1.6
CPI (y/y %, eop)	2.1	2.2	1.7	2.1
Central bank policy rate (%, eop)	1.50	2.50	1.75	1.75
Canadian dollar (USDCAD, eop)	1.26	1.36	1.28	1.25

Source: Scotiabank Economics.

Chart 1



Source: Scotiabank Economics.

TRADE WAR, WHAT IS IT GOOD FOR?

On trade uncertainty, our base case remains that the trade dispute between the US and China will not escalate substantially during the latter part of 2019 as the economic costs of imposing further tariffs against China should deter the White House from taking action, especially with the 2020 US presidential campaign in sight. However, our conviction behind this call weakened in early June following the breakdown in Sino-US talks and in light of the US's late-May tariff threat on Mexico. Rising uncertainty led us to downgrade our US GDP growth forecast in 2020 by about 0.2 ppts in our last forecast tables published on June 7th and this impact remains unchanged in the current forecast.

So far, the impact of the US-China trade war has been most noticeable in declining trade between the two countries (chart 2), while, on the aggregate, US consumer prices have not (yet) been materially affected. Given that the uncertainty around the outlook for trade has increased, in this section we consider two alternative scenarios.

Chart 2

Sources: Scotiabank Economics, US Customs Bureau.

- Scenario 1 is a relatively contained China-US trade war, where the US imposes a 25% tariff on the remainder of Chinese imports (USD 300 bn), drawing a 25% tariff in retaliation from China. This would lead to US GDP growth being weaker by a cumulative 0.5 ppts during 2019–20 and an additional 25 bps rate cut in 2020 (see box 1, charts and table B.1 at the back of this section). The impact on inflation is likely to be small in this scenario.
- In Scenario 2, if the US imposes 25% duties on all countries, which retaliate with similar tariffs. The US economy would likely fall into recession in the first half of 2020, forcing the Fed to cut its policy rate by 100 to 125 bps relative to our current baseline that already incorporates 75 bps of easing. In the same scenario, Canada falls into a severe recession as well, with GDP contracting by 1.6% in 2020, which would require the BoC to lower its policy rate to the effective lower bound by the end of 2020.

Thus, the likely spillovers into Canada from a severe growth downturn in the US, including a significantly lower overnight rate, are at odds with OIS pricing of less than one cut in Canada and four in the US, and point to other explanations for the dovishness in US rates markets.

Table 1

Quarterly US Forecasts	2018	2019				2020			
	Q4	Q1	Q2e	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Economic									
Real GDP (q/q ann. % change)	2.2	3.1	1.8	1.9	1.4	1.5	1.5	1.9	2.1
Real GDP (y/y % change)	3.0	3.2	2.6	2.2	2.1	1.6	1.6	1.6	1.7
Consumer prices (y/y % change)	2.2	1.6	1.6	1.6	1.7	2.0	2.0	2.0	2.1
CPI ex. food & energy (y/y % change)	2.2	2.1	2.0	2.0	2.0	2.1	2.2	2.2	2.2
Core PCE deflator (y/y % change)	1.9	1.7	1.6	1.6	1.7	1.8	1.9	1.9	1.9
Financial									
Euro (EURUSD)	1.15	1.12	1.14	1.13	1.15	1.19	1.22	1.24	1.24
U.K. Pound (GBPUSD)	1.28	1.30	1.27	1.25	1.25	1.28	1.30	1.32	1.40
Japanese Yen (USDJPY)	110	111	108	108	108	107	107	105	105
Fed Funds Rate (upper bound, %)	2.50	2.50	2.50	2.00	1.75	1.75	1.75	1.75	1.75
3-month T-bill (%)	2.36	2.39	2.09	1.85	1.60	1.60	1.60	1.60	1.60
2-year Treasury (%)	2.49	2.26	1.76	1.70	1.70	1.80	1.80	1.80	1.80
5-year Treasury (%)	2.51	2.23	1.77	1.75	1.80	1.90	1.90	1.90	1.90
10-year Treasury (%)	2.68	2.41	2.00	2.10	2.20	2.35	2.40	2.45	2.45
30-year Treasury (%)	3.01	2.82	2.53	2.65	2.70	2.85	2.85	2.90	2.90

Sources: Scotiabank Economics, BEA, BLS, Bloomberg.

WHAT IS DRIVING US INFLATION?

In addition to the risks to the macroeconomic outlook presented by erratic US trade policy, a tepid and decelerating inflation rate has been a concern for the Federal Reserve. Core and total PCE inflation have averaged 1.6% and 1.4%, respectively, through May of this year, continuing a broader pattern of disappointingly weak inflation in the US. Total PCE inflation has averaged 1.85% since 2000, below the Federal Reserve's 2.0% target, mainly due to subdued inflation in the aftermath of the global financial crisis (post-2007 average PCE inflation has been 1.55%).

The more recent weakness can be partly explained by a few temporary factors such as lower prices for wireless services in 2017 and a plunge in transportation services inflation more recently (chart 3). Sequential temporary negative shocks to prices in various sectors can point to a weak underlying trend in aggregate inflation, and can also help de-anchor inflation expectations. Hence they are still being carefully watched by policymakers. In fact, market-based inflation expectations have been declining recently, a worry for FOMC participants noted in Chairman Powell's opening remarks at his June 19th press conference (see chart 4).

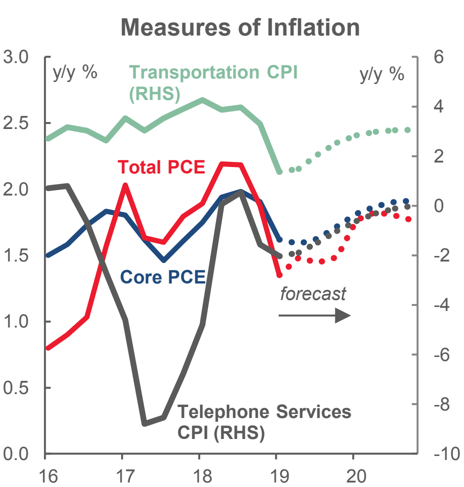
Table 2

United States	2000–17	2017	2018	2019f	2020f
	(annual % change, unless noted)				
Real GDP	2.0	2.2	2.9	2.5	1.6
Consumer spending	2.4	2.5	2.6	2.2	1.9
Residential investment	-0.3	3.3	-0.3	-1.9	0.8
Business investment	3.0	5.3	6.9	4.0	2.3
Government	1.0	-0.1	1.5	2.0	1.6
Exports	3.7	3.0	4.0	2.0	1.8
Imports	3.7	4.6	4.5	1.8	2.9
Nominal GDP	4.0	4.2	5.2	4.2	3.3
GDP Deflator	1.9	1.9	2.3	1.6	1.6
Consumer price index (CPI)	2.2	2.1	2.4	1.7	2.0
CPI ex. food & energy	2.0	1.8	2.1	2.0	2.2
Core PCE deflator	1.7	1.6	1.9	1.6	1.9
Pre-tax corporate profits	5.3	3.2	7.8	0.2	1.9
Employment	0.7	1.6	1.7	1.5	1.0
Unemployment rate (%)	6.1	4.4	3.9	3.8	3.9
Current account balance (USD bn)	-500	-440	-491	-543	-606
Merchandise trade balance (USD bn)	-680	-805	-887	-894	-971
Federal budget balance (USD bn)	-540	-665	-779	-896	-892
percent of GDP	-3.7	-3.4	-3.8	-4.2	-4.0
Housing starts (mn)	1.26	1.20	1.25	1.24	1.26
Motor vehicle sales (mn)	15.6	17.1	17.2	16.8	16.7
Industrial production	0.7	2.3	4.0	1.9	1.7
WTI oil (USD/bbl)	62	51	65	56	55
Nymex natural gas (USD/mmbtu)	4.83	3.02	3.07	2.71	2.75

Sources: Scotiabank Economics, BEA, BLS, Bloomberg.

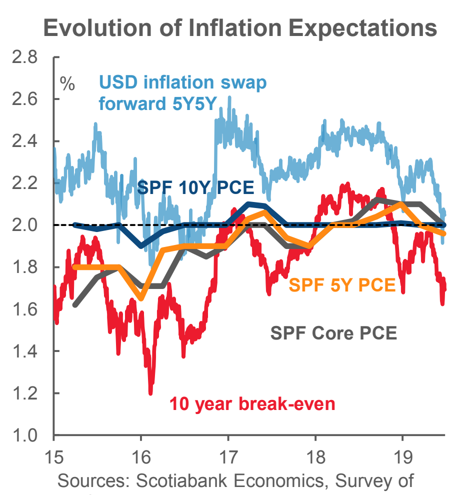
Our forecast for total and core PCE inflation is consistent with these weak inflation expectations going forward and is based on our newly-estimated US Phillips Curve (see here for more details). Our US Phillips Curve captures the impact on core PCE inflation of such fundamental factors as: year-over-year inflation in the unit labour cost as a measure of cost-push inflationary pressure; the output gap, partly based on potential output from the Congressional Budget Office (chart 5); the real price of oil; and the real-effective exchange rate. In addition, we include y/y price inflation for transportation and telephone services to control for temporary factors, which significantly improves the forecasting ability of the equation since 2016 (see chart 6).

Chart 3



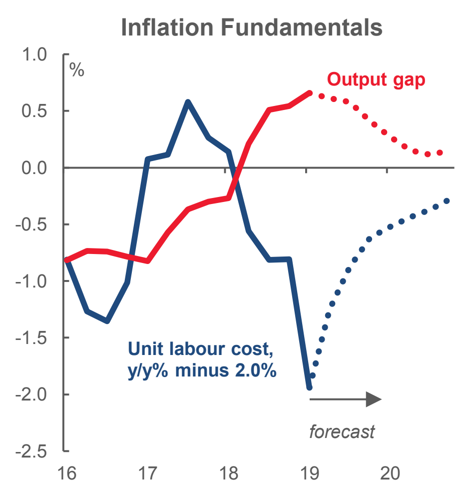
Sources: Scotiabank Economics, BLS.

Chart 4



Sources: Scotiabank Economics, Survey of Professional Forecasters, Bloomberg.

Chart 5

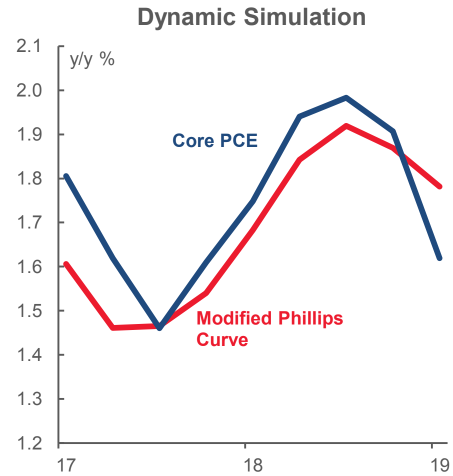


Sources: Scotiabank Economics.

Over the forecast horizon, core PCE inflation is expected to average just 1.6% in 2019, before rising to 1.9% in 2020 on the back of the additional monetary stimulus which helps bring inflation closer to the target. Conditional on the 75 bps of monetary easing, the fundamental drivers identified above are expected to push inflation slightly higher: the output gap is expected to be a persistent inflationary tailwind through early-2020 as the US economy remains in substantial excess demand, partly offset by the weak labour cost inflation, which remains far below 2.0% and provides disinflationary pressure. In contrast, the temporary factors mentioned above, such as prices for phone and transportation services, continue to push inflation down over the projection horizon.

In our forecast, the weak inflation outlook is enough to warrant a 50 bps cut by the Federal Reserve and we introduce an additional 25 bps of easing as insurance, especially in the context of trade policy uncertainty and falling inflation expectations. Financial markets are even more dovish, expecting at least 100 bps of cumulative easing in the next few years (see the *US & Canadian Monetary Policy & Capital Markets* report), possibly due to a combination of an even weaker inflation outlook and trade risks to growth.

Chart 6



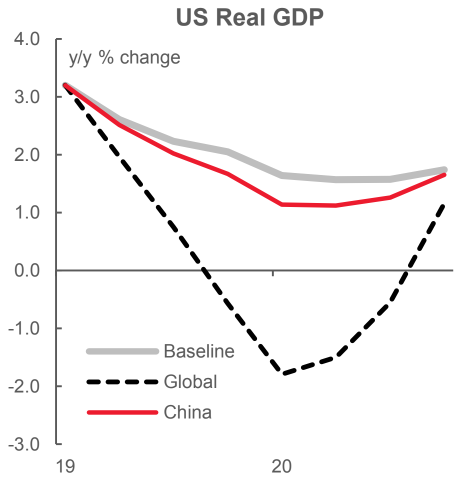
Source: Scotiabank Economics.

While in the US both risks to growth and inflation concerns could underlie significant monetary easing expected by the financial markets from the Federal Reserve, inflation worries fit the facts slightly better.

- First, with a few exceptions, the macroeconomic activity data in the US has remained relatively benign.
- Second, any significant US growth concerns, in particular from a global trade war, would undermine confidence in Canadian growth due to tight trade and financial links between the two countries. This would likely imply significantly lower expectations for the overnight rate path, which is inconsistent with barely one interest rate cut by the BoC over the next few years expected by the markets.
- Finally, if inflation is the main concern, our model simulations show that if inflation were to decline abruptly to 1.3% over the next few quarters in the absence of a US growth slowdown, the Federal Reserve would cut the Fed Funds rate by 100 bps, while the Bank of Canada would not have alter its policy stance, provided Canadian inflation held up.

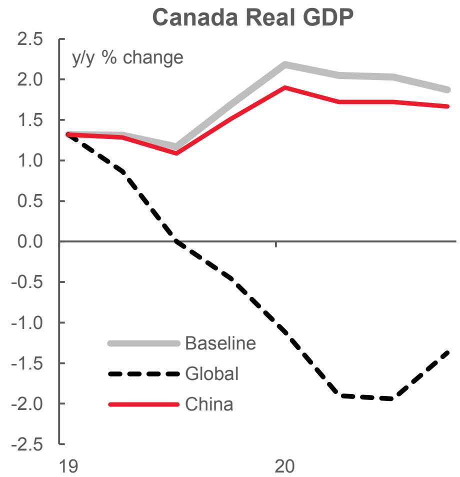
Box 1

Chart B.1



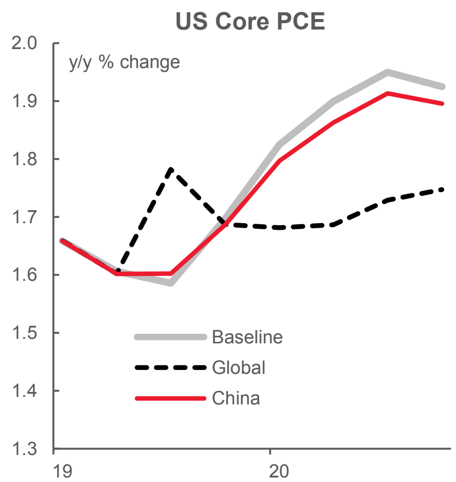
Source: Scotiabank Economics.

Chart B.2



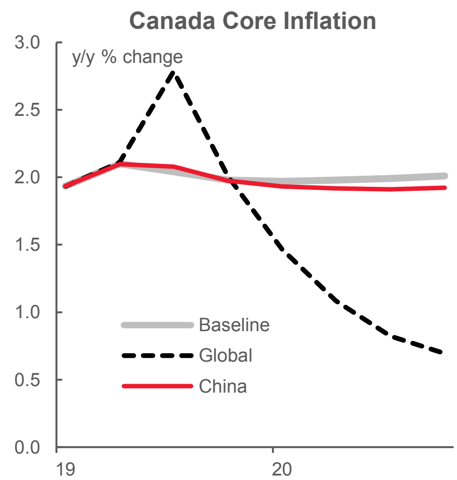
Source: Scotiabank Economics.

Chart B.3



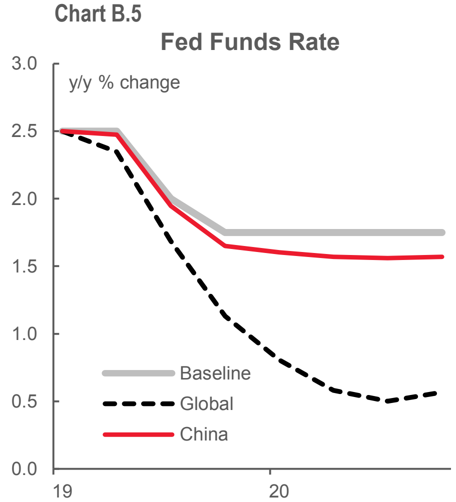
Source: Scotiabank Economics.

Chart B.4



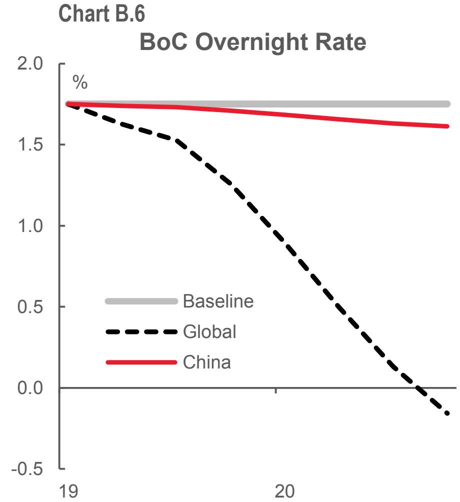
Source: Scotiabank Economics.

Chart B.5



Source: Scotiabank Economics.

Chart B.6



Source: Scotiabank Economics.

Table B.1

US	**2019**	**2020**
Real GDP (annual % change)		
Baseline	2.50	1.60
China	2.33	1.26
Global	1.31	-0.71
Core PCE (annual % change)		
Baseline	1.60	1.90
China	1.60	1.87
Global	1.65	1.71
Fed Funds Rate (%)		
Baseline	1.75	1.75
China	1.70	1.58
Global	1.48	0.61

CANADA	**2019**	**2020**
Real GDP (annual % change)		
Baseline	1.40	2.00
China	1.33	1.72
Global	0.46	-1.62
Core inflation (annual % change)		
Baseline	2.00	2.00
China	2.01	1.93
Global	2.20	1.03
BoC Overnight Rate (%)		
Baseline	1.75	1.75
China	1.73	1.65
Global	1.54	0.34

Source: Scotiabank Economics.