This report is an extract from Scotiabank Economics' *Q1 Global Outlook* published on January 13, 2020.

January 13, 2020

United States

SLOWING GROWTH CUSHIONED BY DOMESTIC DEMAND

- **Growth is expected to continue slowing from 2.3% in 2019 to 1.7% in 2020, before firming up slightly in 2021 as uncertainty begins to abate. Inflation isn't expected to reach the Fed's 2% target until early-2021.**
- **US-initiated trade wars have exacted a significant toll on manufacturing and have inhibited business investment, but domestic demand is expected to cushion downside risks, sustain activity in services and housing, and eventually underpin a modest recovery in capex and goods production.**

FISCAL STIMULUS WANES, RATE CUTS KICK IN

Overall, real GDP growth is expected to slow from 2.3% in 2019 to 1.7% in 2020, before accelerating slightly to 1.8% in 2021 as uncertainty begins to abate and 2019's policy rate cuts feed through into the real economy (table 1). Beyond the short-term volatility related to the October GM strike and the Boeing 737 Max production shutdown, US output growth is expected to trend below potential in 2020 and to close the small margin of positive excess demand accumulated over the past few years on the back of 2018's fiscal stimulus. Embedded in this outlook, the elevated trade-policy and geopolitical uncertainty in 2020 (chart 1) are shaving an average of 0.4 ppts from what headline real growth rate would otherwise be during 2020.

Core inflation, which has remained relatively weak, owing partly to idiosyncratic factors such as transportation costs and mobile phone charges, is forecast to rise only gradually to the Fed's 2.0% target by the beginning of 2021 (chart 2). It is expected to be lifted by the last vestiges of excess demand in 2020 and wage growth that is slightly outpacing productivity gains. As inflation is projected to remain below target until 2021, we anticipate that the Federal Reserve will cut the federal funds rate once more in 2020, leaving the upper end of the range at 1.50% until end-2021.

CONSUMPTION GROWTH TO REMAIN SOLID

Private consumption is expected to be the main driver of growth, averaging around 2.3% during 2019–21, close to its annual mean since the financial crisis, supported by household balance sheets with early-cycle characteristics and robust labour markets (table 2). Average household combined principal and interest payments on accumulated debt account for the lowest share of personal disposable income (PDI) in forty years, while average household net worth is the highest multiple of PDI this century (chart 3). Wages continue to rise at rates near decade highs that are well above headline inflation, driven up by high quit rates in relatively tight labour markets (chart 4). Personal consumption accounts for around 69% of US GDP and the key financial and labour-market indicators that inform household spending decisions point to continued growth—despite the US economy being in the 11th year of a record-long expansion.

TRADE WARS AREN'T MAKING MANUFACTURING GREAT AGAIN

As was widely anticipated, White House trade policy is not producing much winning for the US balance of payments. As a share of GDP, the US's goods trade deficit over the

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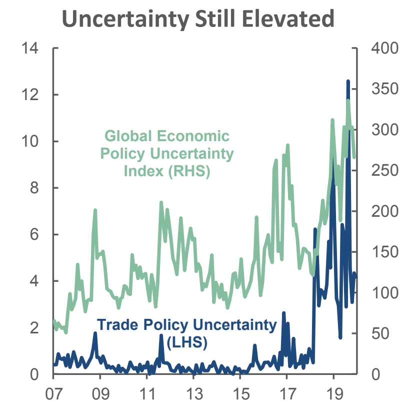
United States	2018	2019e	2020f	2021f
Real GDP (annual % change)	2.9	2.3	1.7	1.8
CPI (y/y %, eop)	2.2	2.0	2.2	2.4
Central bank policy rate (%, eop)	2.50	1.75	1.50	1.50
Canadian dollar (USDCAD, eop)	1.36	1.30	1.25	1.25

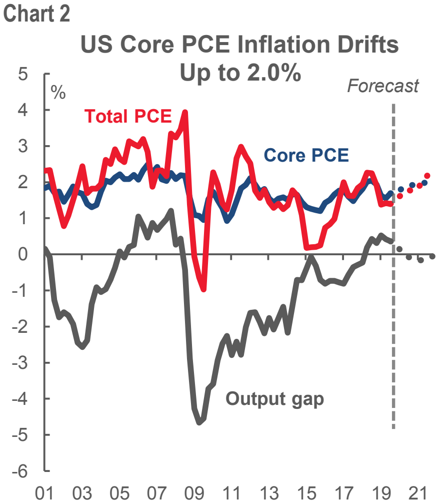
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, PolicyUncertainty.com

Chart 2

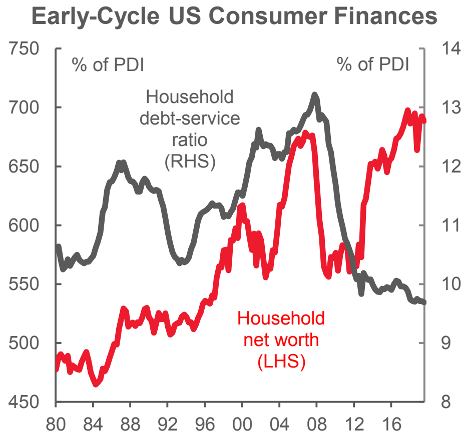


Sources: Haver, Scotiabank Economics.

last two years has narrowed only marginally below its 2010-onward average, driven mainly by a slight reduction in US import demand, where lower merchandise imports from China have been largely offset by increased imports from Mexico, Europe, and developing countries in Asia. In addition, the US surplus in services trade has declined since the start of the US-China trade war (chart 5). The lagged effects of years of a still-strong USD, the largest fiscal deficits since 2012, anaemic export order books, and ongoing uncertainty are forecast to widen the US trade deficit further.

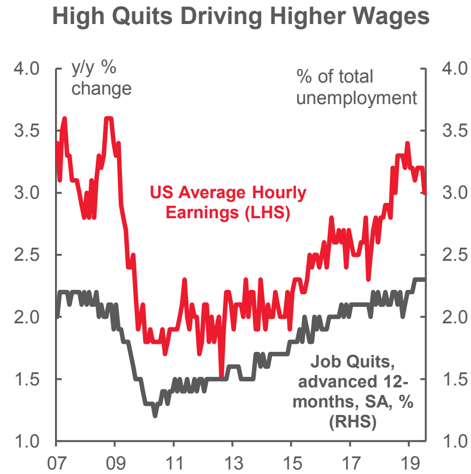
Despite the developing trend towards subdued growth in exports of services, US service industries continued to expand briskly over 2018–19. The data through Q2-2019, the latest date available, show that real value added at service industries in the private sector expanded by close to 3% Q/Q SAAR on average after Q1-2018. This pace of growth was sustained by the expansion of the information and professional service industries, which have ridden the technology boom and the growing demand for specialized expertise. Goods-producing industries, in contrast, grew by only 2.1% on average over the same period, hobbled by weak construction and manufacturing activity. Hence, the long-run trend that has seen goods production account for a progressively smaller share of total US output continues unchecked (chart 6).

Chart 3



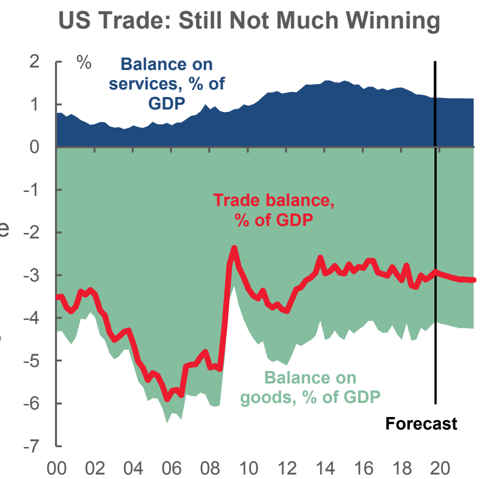
Sources: Scotiabank Economics, BEA, Federal Reserve Board.

Chart 4



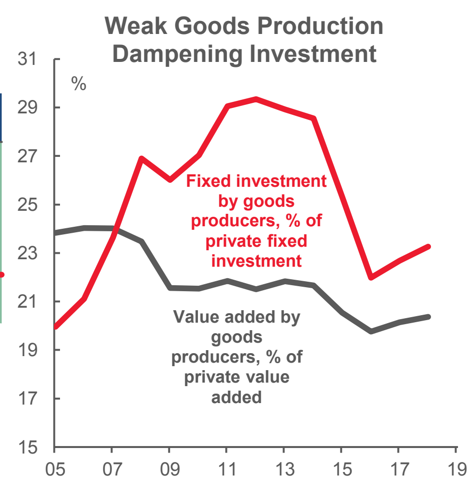
Sources: Scotiabank Economics, BLS, Bloomberg.

Chart 5



Sources: Scotiabank Economics, BEA.

Chart 6



Sources: Scotiabank Economics, BEA.

Table 1

Quarterly US Forecasts	2019	2020				2021			
	Q4e	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Economic									
Real GDP (q/q ann. % change)	1.9	1.3	1.6	1.6	1.8	1.8	1.9	2.0	2.1
Real GDP (y/y % change)	2.3	1.8	1.7	1.6	1.6	1.7	1.8	1.9	2.0
Consumer prices (y/y % change)	2.0	2.2	2.3	2.3	2.2	2.3	2.3	2.4	2.4
Total PCE deflator (y/y % change)	1.5	1.6	1.8	1.8	1.7	1.9	2.0	2.2	2.3
Core PCE deflator (y/y % change)	1.7	1.8	1.9	1.9	1.9	2.0	2.0	2.0	2.0
Financial									
Euro (EURUSD)	1.12	1.12	1.14	1.15	1.16	1.17	1.18	1.19	1.20
U.K. Pound (GBPUSD)	1.33	1.33	1.34	1.36	1.36	1.38	1.39	1.41	1.42
Japanese Yen (USDJPY)	108	107	107	105	105	103	103	102	102
Fed Funds Rate (upper bound, %)	1.75	1.75	1.75	1.50	1.50	1.50	1.50	1.50	1.50
3-month T-bill (%)	1.51	1.55	1.55	1.30	1.30	1.30	1.30	1.30	1.30
2-year Treasury (%)	1.57	1.60	1.55	1.50	1.55	1.60	1.65	1.65	1.65
5-year Treasury (%)	1.69	1.65	1.60	1.60	1.65	1.70	1.75	1.80	1.80
10-year Treasury (%)	1.92	1.80	1.75	1.75	1.80	1.85	1.90	1.95	2.00
30-year Treasury (%)	2.39	2.25	2.15	2.20	2.25	2.30	2.35	2.40	2.45

Sources: Scotiabank Economics, BEA, BLS, Bloomberg.

In particular, survey data imply that the US manufacturing sector as a whole started to underperform the rest of the American economy around the same time that trade policy uncertainty and White House protectionism began to ramp up (chart 7). Rather than engineering a manufacturing revival, US trade wars are generating a contraction in US manufacturing, with the PMI for the sector hitting in December its lowest level in a decade.

Going forward, following short-term dislocations from recent labour strikes and the Boeing production shutdown, the rate of manufacturing expansion is expected to pick up in 2021 once the lingering effects of trade-policy uncertainty have begun to dissipate.

Table 2

United States	2010–18	2018	2019e	2020f	2021f
	(annual % change, unless noted)				
Real GDP	2.3	2.9	2.3	1.7	1.8
Consumer spending	2.4	3.0	2.6	2.3	2.0
Residential investment	4.8	-1.5	-1.8	1.3	1.8
Business investment	5.2	6.4	2.3	1.0	2.5
Government	-0.3	1.7	2.3	1.8	1.6
Exports	4.1	3.0	0.0	1.3	2.2
Imports	4.9	4.4	1.7	2.6	2.9
Nominal GDP	4.0	5.4	4.1	3.4	3.8
GDP Deflator	1.7	2.4	1.8	1.7	2.0
Consumer price index (CPI)	1.8	2.4	1.8	2.3	2.4
Total PCE deflator	1.6	2.1	1.4	1.7	2.1
Core PCE deflator	1.6	1.9	1.6	1.9	2.0
Pre-tax corporate profits	4.6	3.4	-0.5	2.3	1.8
Employment	1.4	1.7	1.6	1.0	1.0
Unemployment rate (%)	6.5	3.9	3.7	3.8	3.8
Current account balance (USD bn)	-421	-491	-510	-525	-555
Merchandise trade balance (USD bn)	-754	-887	-881	-924	-976
Federal budget balance (USD bn)	-813	-779	-960	-1,008	-1,034
percent of GDP	-4.6	-3.8	-4.5	-4.6	-4.5
Housing starts (mn)	0.96	1.25	1.25	1.26	1.26
Motor vehicle sales (mn)	15.5	17.2	16.9	16.9	17.0
Industrial production	2.2	4.0	0.7	0.8	1.9
WTI oil (USD/bbl)	74	65	57	59	64
Nymex natural gas (USD/mmbtu)	3.39	3.07	2.53	2.39	2.63

Sources: Scotiabank Economics, BEA, BLS, Bloomberg.

CAPITAL-INTENSIVE INDUSTRIES TO DELAY INVESTMENT UNTIL 2021

While the US tax changes that came into effect in 2018 spurred an initial surge in investment, capex has disappointed so far in 2019, likely due to weaker investment spending by goods producers. Real machinery and equipment spending has been roughly flat since Q4-2018, while investment in structures has declined. The caution on the part of businesses comes despite the continued expansion of US corporate profits and a rebound in equity markets following uncertainty-induced declines at end-2018. Goods-producing industries are generally relatively more capital intensive and account for a disproportionate share of investment when set against their total contribution to US GDP, although the gap became less pronounced when mining and oil and gas firms cut capital expenditures after the 2014 oil price collapse (chart 6, again).

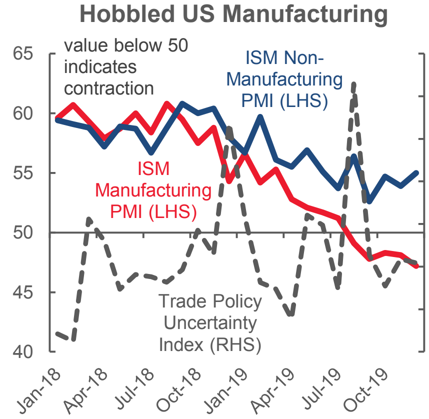
With a rebound in goods production likely to be delayed until uncertainty is lifted, business investment growth is set to remain subdued until 2021 (table 1, again). Mirroring the outlook for US manufacturers, subdued growth in business investment is expected to persist in 2020, averaging just 1.0% next year, before strengthening to 2.5% y/y in 2021. Capex growth is expected to receive a modest lift from a reduction in uncertainty following the November 2020 elections and lower costs of capital following the recently implemented and expected monetary stimulus.

RESIDENTIAL INVESTMENT TURNING A CORNER

In contrast with the gradual recovery expected for business investment, housing activity has already started to turn around. Residential investment expanded by 4.6% Q/Q SAAR in Q3-2019 following six straight quarters of declines, with housing starts reaching levels not seen since mid-2007 and housing prices showing persistent moderate gains. The housing market has been supported by gradually falling mortgage rates, which declined throughout 2019 on the back of the Federal Reserve's policy easing. In addition, strong employment gains in the second half of 2019 and personal disposable income growth above 4.0% have served to support housing demand (chart 8).

Chart 7

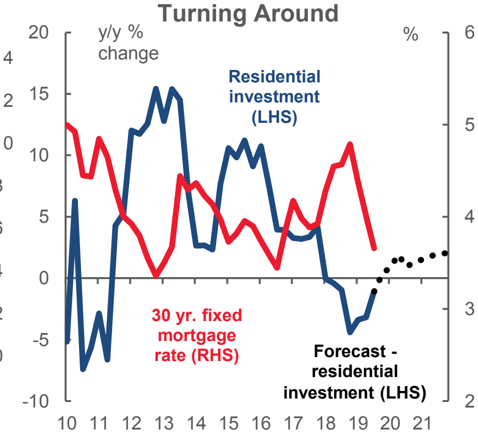
Rise of Trade Policy Uncertainty Hobbled US Manufacturing



Sources: Scotiabank Economics, ISM, PolicyUncertainty.com.

Chart 8

Residential Investment Turning Around



Sources: Scotiabank Economics, BEA, FMAC.