



ECONOMIC CURRENTS

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A Summer Blockbuster

Semi-Annual Economic Roundup

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My dad insisted we all go, even my grandmother who was less than thrilled. He drove what seemed like an eternity to the largest movie theater he could find. When we arrived, the parking lot was close to full, something I rarely saw growing up in the Detroit area in the 1970s. We were attending the opening of “Star Wars.”

I love summer blockbusters and their sequels, even when they do not manage to recreate the magic of the first film. Sequels provide a familiarity that is reassuring if nothing else. That is how I see the economy in its current state. There is a certain familiarity to watching the economic aggregates match or even exceed the performance of previous business cycles. A closer look at the data reveals that, much like movie sequels, the energy isn’t the same.

The recent drop in the unemployment rate to 3.8% in May, the lowest level since April 2000, provides an example. Unemployment fell partly because job gains were strong but also because fewer people were actively seeking employment. Some of the reduction in what we call the labor force participation rate is due to the aging of baby boomers into retirement. A more disturbing development is the shrinking number of prime-age (25–54) workers looking for jobs. The most dramatic shift, the loss of prime-age white men in the labor force, has been decades in the making and persists despite some improvement since the Great Recession.

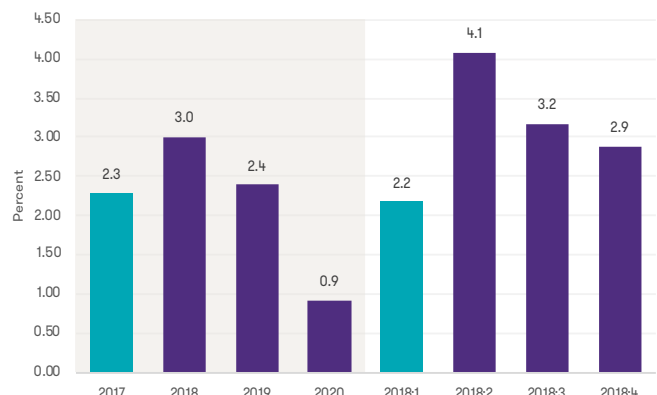
Labor force participation by prime-age women has also declined to a level that is below other major developed economies, including Japan. The reasons women stay out of the labor force differ from their male counterparts. Women often become full-time caretakers for children and elderly family members. Leaving that vital role in the family ecosystem is difficult, even though overall family earnings suffer. The payoffs for women working in low-income households, in particular, can include higher educational attainment of children, which can shift the entire family’s earning potential across generations.

The reasons for the loss in prime-age workers occupy a spectrum: the opioid crisis, skills erosion, disability insurance (although the ranks of the disabled have fallen), incarceration rates and the resulting number of people who have police records. Separately, many men who worked in traditionally male-dominated industries are reluctant to shift into jobs traditionally performed by women.

The lower rate of churn, or movement between jobs, and sluggish wage growth indicates that the labor market isn’t as tight as it was in 2000. While 3.8% unemployment is low, it does not deliver the same rewards for workers or the economy. The drop in participation by those with less than a high school degree was notably large in May, suggesting that tight labor markets have yet to reach many who were marginalized by the financial crisis or even earlier.

A broader measure of unemployment and underemployment (the U-6 rate) includes workers who are on the margins of the labor market and those forced to take part-time instead of full-time employment. The U-6 was 7.6% in May, more than one half of a percentage point above the 6.9% low we saw in April 2000.

Chart 1: 2018 Poised to be Strongest of Expansion
Real GDP Growth Rate



Annual growth are year-over-year, quarterly are annualized.

Source: BEA and Grant Thornton Economics

“Our forecast for the year is 3% which, if realized, would make 2018 the strongest year since 2005, the housing bubble peak.”

This edition of ECONOMIC CURRENTS takes a detailed look at the forecast for the rest of 2018 by sector, with special attention paid to the implications for wages, inflation, interest rates and financial markets. Federal Reserve Chairman Jay Powell has the unenviable duty to say “Last call!” and take away the punch bowl when Congress and the administration have just spiked it with stimulus in the form of new spending and tax cuts.

We will also discuss the risks of recession. There is a good chance that this economic expansion will continue through 2018 into 2019, but the probability of a recession is rising. The rocky conclusion to the Group of 7 meetings, with the U.S. refusing to sign the communique after initially agreeing, has upped the ante on a full-blown trade war. This is at the same time that debt-financed spending increases and tax cuts are boosting current growth at the expense of future growth and fiscal stability.

A Boom Year

Chart 1 lays out our forecast for 2018. We expect growth to rebound in the second quarter after faltering in the first quarter. Our forecast for the year is 3% which, if realized, would make 2018 the strongest year since 2005, the housing bubble peak.

Solid Consumer Spending

Consumer spending will rebound during the rest of the year after a lackluster start. Job gains will remain strong although the pace has slowed from earlier in the cycle. This is to be expected with the demographics of aging and curbs on immigration. The number of job openings in April actually exceeded the number of people actively looking for jobs, which suggests that employers cannot meet their needs with the current labor force unless they invest in training and equipment to help workers become more productive.

Wages are slowly accelerating but not as fast as we had hoped, given the drop in unemployment. Wage gains are more broad-based than earlier in the cycle as lower wage jobs have been boosted along with higher wage jobs. Many firms rely on one-time bonuses to compensate workers instead of permanent raises. Signing bonuses and offers to pay off student loans are being used to lure entry-level workers without getting stuck with higher fixed costs when the next recession hits. These are pluses for those households but do not show up as a big change in compensation.

Credit is easing, especially for home equity lines of credit. This is particularly beneficial for older homeowners who today hold an historically high share of all homeowner equity.

The saving rate is becoming a concern as it hovers at 3%; we expect it to fall further. This year we will easily reach the lows we saw during the housing bubble. That will encourage consumers to take on unsustainable debt levels, which could affect the pace of spending by year-end.

Housing Market Bound by Supply Constraints

Escalating costs for land, materials and labor have discouraged developers from moving downstream to build lower priced homes for first-time buyers. Millennials delayed buying homes but are now in the market. The shortfall in new construction, coupled with the increasing number of older homeowners who are repairing and remodeling instead of selling has left a severe shortage of homes in some of the strongest job markets. Rural areas in Nebraska and Iowa are experiencing even tighter housing markets than expanding urban and suburban markets.

In response, home prices are accelerating as interest rates are rising. The combination will contribute to a moderate increase in new construction but could also trigger a decline in the largest part of the housing market: existing homes for sale. Sharply reduced deductions for state and local taxes are undermining some of the country's hottest job markets.

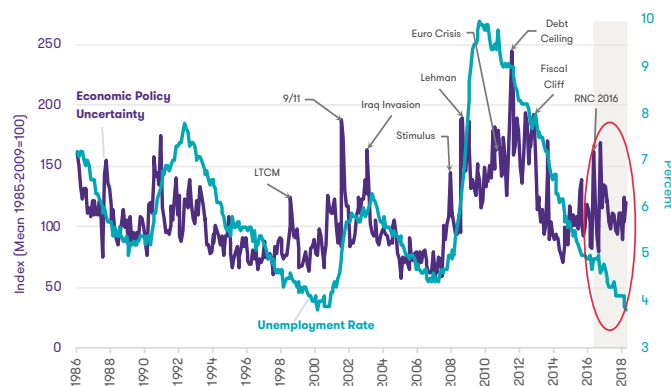
Investment Picks Up

A rebound in manufacturing activity and the rise in oil prices are fueling more business investment. Recent tax cuts include medium-term incentives to boost investment. So far, however, many firms are paying dividends, paring debt and looking for acquisitions.

Orders for heavy trucks and machinery were robust at the start of the year. Demand for machinery reflects a broadening of the manufacturing recovery beyond vehicles. Order backlogs are growing and inventories need to be replenished, which creates a tailwind for manufacturing overall.

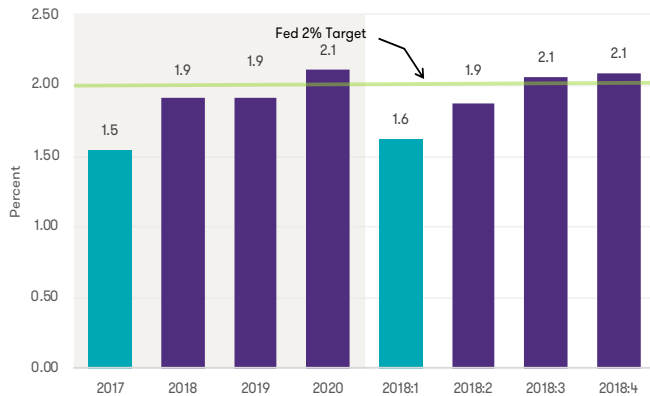
Commercial construction activity is expected to remain relatively strong despite the rise in rates. Industrial space—which includes warehousing for the likes of Amazon—continues to do well, with construction still lagging absorption. A rise in factory usage rates will encourage expansion in plants that produce building materials.

Chart 2: Uncertainty Remains Unusually High
Economic Policy Uncertainty Index and Civilian Unemployment Rate, 1986–2018



Source: BLS and Baker, Bloom, and Davis (2012)

Chart 3: Inflation Finally Moves Above 2%
Core PCE Price Index Growth



Annual growth rates are year-over-year, quarterly are 4Q growth rates.

Source: BEA and Grant Thornton Economics

The broader commercial construction market is being watched closely by the Fed because of concerns about asset bubbles. An influx of foreign funds, which slowed during the last year, raised some red flags.

Headwinds are picking up despite those improvements. Growth abroad is slowing. The dollar is strengthening, which undermines our competitiveness. New tariffs on steel and aluminum are already raising costs. Heavy manufacturers, mining firms and commercial developers say the tariffs are squeezing margins.

Government Spigots Flow Freely

The clock is ticking as the budget for fiscal year 2018 must be spent by the end of September. That points to a surge in spending on defense and social programs in the second quarter. The pace of federal spending will ease slightly but continue to drive growth in fiscal year 2019, which begins in October.

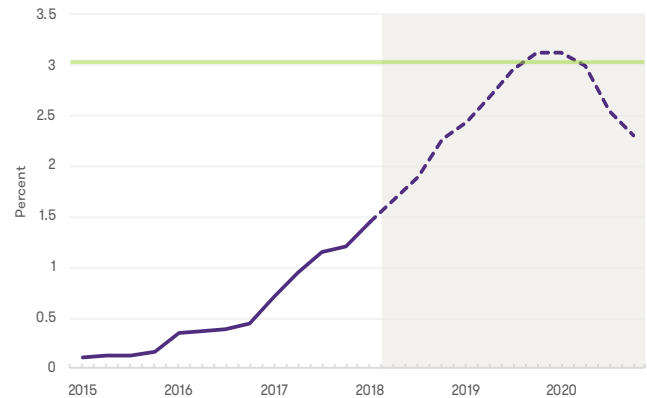
State and local government spending will remain tepid despite higher tax revenues. Pension obligations are beginning to crowd out other spending, most notably on badly needed infrastructure.

Trade Deficit Widens

Increased consumer spending will boost imports as slower growth abroad limits exports. The combination suggests that the trade deficit will widen more rapidly during the second half of this year. The offsetting factors are tariffs and the escalation of tensions with our largest trading partners. Trade wars constrain trade flows by raising prices and eroding both purchasing power and demand.

Risks. Federal budgets for fiscal years 2018 and 2019 have set the stage for a fiscal cliff, entailing a sharp drop in federal spending, in the fourth quarter of 2019. If Congress does not extend spending plans for fiscal year 2020, the U.S. economy will slip into what economists call a growth recession, which happens when growth is too weak to keep the unemployment rate from rising.

Chart 4: Rate Hikes Begin to Bite in 2019
Target Federal Funds Rate, 2015–2020



Source: Federal Reserve Board and Grant Thornton Economics

A full-blown trade war would move up the timing of a recession to early 2019. The impact of tearing up NAFTA would hit Canada and Mexico harder than the U.S. at first; then disruptions to the supply chain would hit trucking and rail.

The president has threatened a government shutdown starting October 1. Our Washington contacts say that is likely to happen despite an expected public backlash occurring just weeks before midterm elections.

The dollar's strength in recent months is pressuring emerging markets. Italy's ongoing problems and recent elections up the risk of contagion from a crisis. The hope is that we would not suffer the worst, but shifts in market sentiment are often hard to predict.

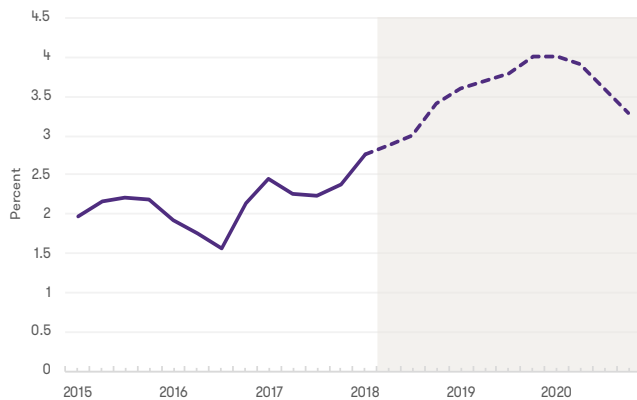
The combination of factors ups the uncertainty, which remains unusually high given the drop in the unemployment rate since the Republican National Convention in 2016. (See *Chart 2*.) Uncertainty causes hesitation in decision making. So far, the U.S. economy has been able to more than absorb the changes. We know, however, that higher levels of uncertainty reduce investment and increase the risk of a sharp correction in financial markets.

Inflation Heats Up

Chart 3 shows our forecast for the inflation measure watched most closely by the Federal Reserve. The PCE (personal consumption expenditures) index will move above the Fed's 2% inflation target in 2018 for the first time since 2012. Inflationary pressures include:

- Moderately rising wages
- Higher energy prices
- Tariffs on steel and aluminum
- Accelerating medical costs
- Sharp increases in home prices and rents

Chart 5. 10 Year Treasury Moves Well Above 3% Threshold Yield, 10 Year Constant Maturity Treasury, 2015–2020



Source: Federal Reserve Board and Grant Thornton Economics

Risks. Escalating trade tensions increase the likelihood of retaliation, which would result in higher inflation without accompanying wage increases. A stronger dollar will not be enough to offset higher import prices, especially if current threats of vehicle tariffs are realized.

Fed Gets More Aggressive

Chart 4 shows the forecast for the fed funds rate in 2018. We have held to our view that the Fed will have to raise rates four times, or double the level of short-term rates, in 2018. This is at the same time that the Fed is removing curbs on long-term rates by reducing the bond holdings on its balance sheet.

More importantly, the fed funds target is expected to rise above the Fed's long-term estimate of what is considered neutral. This means that rate hikes will bite to limit inflation and overall growth. The Fed's goal is to trigger what is known as a soft landing and avoid a recession.

Why is the Fed pulling back?

- Inflation is expected to heat up.
- Wages are starting to accelerate.
- Risks are rising for asset bubbles; the Fed has cited commercial real estate and equity prices.

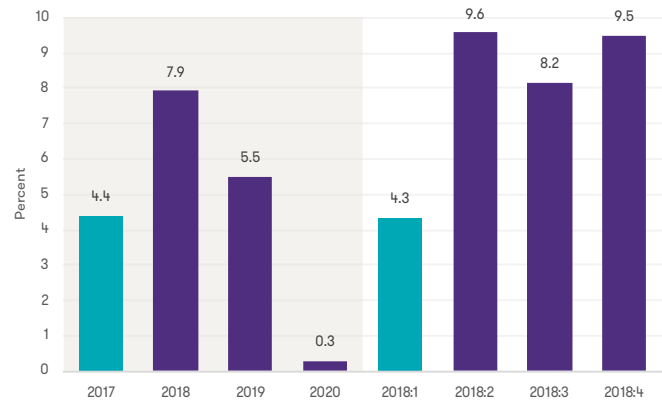
Our forecast for the fed funds rate includes an easing in 2020, when we expect the economy to weaken. The forecast is benign; reality rarely is.

Risks. As inflation heats up, the Fed will struggle with what the upward limit on rates should be. The greater challenge will be stimulating the economy once it falters, considering how low interest rates are likely to remain and the still bloated size of the Fed's balance sheet.

Treasury Yields Move Higher

Chart 5 shows our forecast for 10-year Treasury bond rates. Treasury yields are expected to move higher in 2018:

Chart 6. Boost from Tax Cuts Quickly Dissipates Corporate Profits After Taxes (Nominal)



Source: BEA and Grant Thornton Economics

- Inflation is finally warming instead of cooling.
- The Fed is committed to raising rates in the near term.
- Federal deficits and debts are rising, which will increase the supply of debt issued to support spending.

Risks. Political instability in Italy, threats to the European Union and the potential for an emerging market crisis could trigger a flight to safety; we saw that when yields fell below 3% in recent weeks.

Profit Margins Start to Erode

Chart 6 shows the forecast for year-over-year, after-tax profit growth. Tax cuts have buoyed profits in the near term. Slower growth, rising input costs—tariffs, wages and higher interest rates—and the fading effects of the tax cuts suggest those gains will be short-lived. In response, profit growth quickly dissipates. This sets the stage for more market volatility and a correction in equity prices in 2020, if not sooner.

Risks. An all-out trade war could move up and intensify that correction. Contagion from emerging markets and Italy's instability could also trigger a correction in financial markets. These types of risks have historically proven particularly difficult for financial markets to price.

Bottom Line

The reviews are out: We have a well-received expansion. One could even call it a summer blockbuster. The sequel doesn't have quite the magic of the original. The trade tensions following the recent G7 meeting are particularly alarming, but it's not over yet. There is still time for rewrites and changes in direction and there is always hope of a better ending. The fact that the president's most outspoken and ardent critic of trade apologised for disparaging Justin Trudeau, the Prime Minister of Canada—one of our closest allies and trading partners—represents a positive. Civility is a plot twist I welcome. It could even restore some of the luster lost in this sequel.

Economic forecast — June 2018

	2017(A)	2018	2019	2017:4(A)	2018:1(A)	2018:2	2018:3	2018:4	2019:1	2019:2	2019:3	2019:4
National outlook												
Chain-weight GDP ¹	2.3	3.0	2.4	2.9	2.2	4.1	3.2	2.9	2.3	1.9	1.5	1.3
Personal consumption	2.8	2.6	2.2	4.0	1.0	3.2	2.5	2.4	2.1	2.1	1.8	1.8
Business fixed investment	4.7	6.2	5.3	6.8	9.2	2.0	7.6	6.0	5.6	5.0	4.6	3.6
Residential investment	1.8	1.7	2.0	12.8	-2.0	2.7	3.5	1.4	0.5	1.9	3.6	3.4
Inventory investment	15.2	48.9	77.9	15.6	20.2	40.7	59.2	75.7	84.2	82.6	76.2	68.8
Net exports	-621.8	-649.7	-745.9	-653.9	-650.9	-621.6	-648.2	-678.3	-704.9	-731.0	-759.3	-788.3
Exports	3.4	5.5	5.9	7.0	4.2	7.7	6.5	5.9	5.0	5.8	6.3	6.9
Imports	4.0	5.2	7.9	14.1	2.8	1.8	8.9	8.8	7.5	8.0	8.6	9.0
Government expenditures	0.1	1.9	2.3	3.0	1.1	1.9	2.9	3.6	2.7	1.7	1.2	0.7
Federal	0.2	3.6	4.2	3.2	1.7	4.9	6.9	7.3	4.4	2.2	1.2	0.0
State and local	0.1	0.9	1.2	2.9	0.8	0.2	0.6	1.3	1.6	1.4	1.2	1.1
Final sales	2.4	2.8	2.2	3.4	2.1	3.6	2.8	2.5	2.1	2.0	1.7	1.5
Inflation												
GDP deflator	1.8	2.1	2.5	2.3	1.9	2.0	2.3	2.4	2.6	2.6	2.6	2.7
CPI	2.1	2.5	1.8	3.3	3.5	1.7	2.7	1.5	1.0	2.0	2.3	2.7
Core CPI	1.8	2.2	2.3	2.2	3.0	1.8	2.2	2.3	2.3	2.3	2.3	2.4
Special indicators												
Corporate profits ²	2.7	9.5	2.3	2.7	4.3	9.6	8.2	9.5	11.2	5.9	3.2	2.3
Disposable personal income	1.2	2.2	2.9	1.2	3.3	2.2	1.8	3.6	4.2	2.4	2.1	1.9
Housing starts (mil.)	1.2	1.3	1.4	1.3	1.3	1.3	1.3	1.4	1.4	1.4	1.4	1.4
Civilian unemployment rate	4.4	3.8	3.6	4.1	4.1	3.8	3.7	3.6	3.5	3.5	3.6	3.8
Total nonfarm payrolls (thous.) ³	2176.7	2546.5	1305.1	556.3	632.3	590.1	673.5	650.7	514.8	383.6	253.2	153.4
Vehicle sales												
Automobile sales (mil.)	6.3	5.5	5.4	6.3	5.7	5.4	5.6	5.4	5.5	5.4	5.4	5.3
Domestic	4.5	4.0	3.9	4.6	4.1	3.9	4.0	3.9	4.0	3.9	3.9	3.8
Imports	1.7	1.6	1.5	1.7	1.6	1.5	1.6	1.5	1.5	1.5	1.5	1.5
Lt. trucks (mil.)	10.9	11.5	10.7	11.5	11.5	11.6	11.5	11.3	11.0	10.7	10.7	10.3
Domestic	9.0	9.2	8.6	9.4	9.3	9.2	9.2	9.0	8.7	8.6	8.6	8.3
Imports	1.9	2.3	2.1	2.1	2.2	2.4	2.3	2.3	2.3	2.1	2.1	2.0
Combined auto/Lt.truck	17.1	17.0	16.8	17.8	17.2	17.1	17.1	16.7	16.5	16.1	16.1	15.6
Heavy truck sales	0.4	0.5	0.4	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.4	0.4
Total vehicles (mil.)	17.5	17.5	16.5	18.2	17.7	17.6	17.6	17.2	17.0	16.6	16.5	16.0
Interest rate/yields												
Federal funds	1.0	1.8	2.8	1.2	1.5	1.7	1.9	2.3	2.4	2.7	3.0	3.1
10-year treasury note	2.3	3.0	3.8	2.4	2.8	2.9	3.0	3.4	3.6	3.7	3.8	4.0
Corporate bond BAA	4.4	4.8	5.4	4.3	4.5	4.7	4.9	5.1	5.3	5.4	5.5	5.7
Exchange rates												
Euro/Dollar	1.1	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2
Dollar/Yen	112.1	107.7	103.9	112.9	108.3	108.4	107.5	106.7	105.6	104.3	103.4	102.4

¹ In 2016, GDP was \$16716.164 billion in chain-weighted 2009 dollars.

² Corporate profits before tax with inventory valuation and capital consumption adjustments, quarterly data represents four-quarter percent change.

³ Total nonfarm payrolls, quarterly data represents the difference in the average from the previous period. Annual data represents 4Q to 4Q change.

Quarterly data are seasonally adjusted at an annual rate. Unless otherwise specified, \$ figures reflect adjustment for inflation. Total may not add up due to rounding.



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