Economic Update

UNITED STATES

Federal Reserve Bank of Dallas

U.S. Economy Finishes the Year Strong

December 24, 2018

The U.S. economy continued its expansion in the fourth quarter, fueled in part by strong consumption and rising wage growth. Inflation remained at or around the Federal Reserve's 2 percent target. Volatility in financial markets persisted, but its effects on the near-term outlook remain murky.

Fourth-Quarter Growth Suggests Return to Normal Levels

Preliminary estimates suggest that output growth remains healthy but has slowed in the fourth quarter, following strong growth in the previous two quarters. Forecasts from the Survey of Professional Forecasters and the Atlanta and New York Federal Reserve Banks show fourth-quarter gross domestic product (GDP) growth of around 2.5 percent, a decline of nearly 1 percentage point from the third-quarter rate of 3.4 percent (third estimate). Weaker growth in the fourth quarter may be a result of the waning effects of the tax cuts enacted earlier this year and uncertainty surrounding current trade disputes.

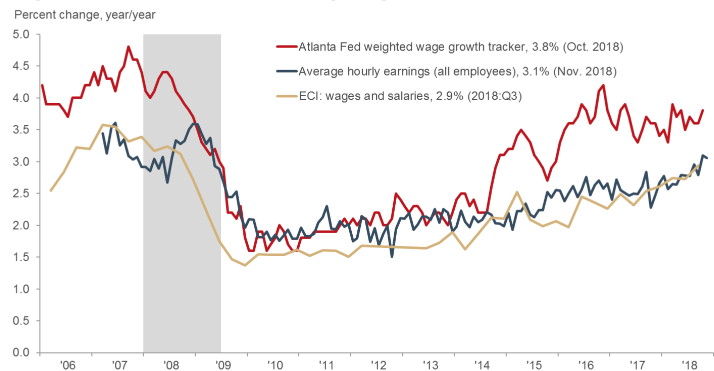
A decomposition of third-quarter GDP shows personal consumption expenditures (PCE) and inventory investment were strong positive contributors to output growth at 2.5 and 2.3 percentage points, respectively. Drags on output included net exports (exports minus imports) and residential investment.

Labor Market Tightens, Wages Rise

Unemployment remained at 3.7 percent for the third straight month in November. Total nonfarm payrolls increased by 155,000 in November compared with October's 237,000 gain. The Job Openings and Labor Turnover Survey (JOLTS) provides data on labor market conditions two months prior to its release. Using JOLTS, labor market tightness can be estimated and is typically measured as the number of job openings per unemployed person. This value reached 1.18 in October, its highest level since the early 1970s. The JOLTS "quits rate," which measures voluntary departures (typically due to workers switching jobs) as a fraction of total employment, was 2.3 percent in October, close to its highest rate on record since 2000. This elevated quits rate suggests workers are increasingly being poached, further pressuring wages.

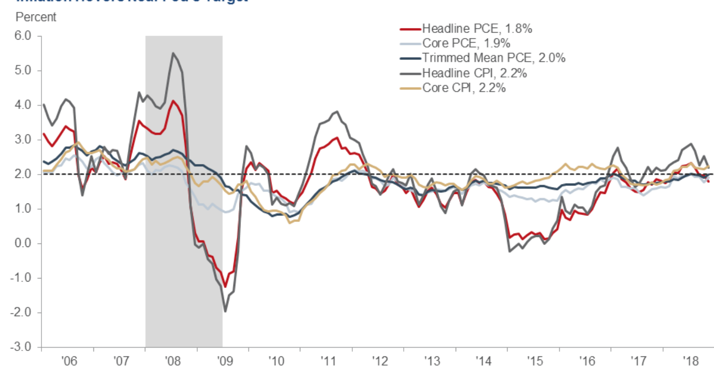
Wage growth continued its upward trajectory in November (*Chart 1*). Growth in average hourly earnings was 3.05 percent, near its October increase of 3.1 percent. October was the first time since the Great Moderation period (1985–2007) that growth in average hourly wages exceeded 3 percent. The Atlanta Fed Wage Tracker's three-month moving average and the Employment Cost Index, two other measures of wage growth, also saw slightly higher growth rates in their latest readings. Nominal wage growth is now outpacing inflation, indicating steady growth in real wages. After adjusting for inflation, the recent estimates of all three measures are about 1 percentage point above their 2008–13 averages.

Chart 1
Wage Growth Acceleration Consistent with a Tightening Labor Market



NOTES: ECI refers to the Employment Cost Index. Shaded area indicates National Bureau of Economic Research (NBER) recession.
SOURCES: Bureau of Labor Statistics; Federal Reserve Bank of Atlanta; NBER.

Chart 2
Inflation Hovers Near Fed's Target



NOTES: Shaded area indicates National Bureau of Economic Research (NBER) recession. CPI is consumer price index. PCE is personal consumption expenditures. Dashed line indicates Federal Reserve's target inflation rate.
SOURCES: Bureau of Labor Statistics; Bureau of Economic Analysis; Federal Reserve Bank of Cleveland; Federal Reserve Bank of Dallas; NBER.

Inflation Remains Near Fed's Target

Inflation remained at or close to the Federal Reserve's 2 percent target in November (*Chart 2*). The headline Consumer Price Index (CPI) experienced a modest decline, dropping from 2.5 percent in October to 2.2 percent in November. Similarly, headline PCE dipped to 1.8 percent in November from its October level of 2.0 percent.

Excluding energy and food from inflation estimates, rates were little changed from October to November. Core CPI inched up by 0.1 percent to 2.2 in November, while core PCE rose to 1.9 percent over the same period. Long-term inflation expectations remain stable as well. The Survey of

Professional Forecasters' five-year/five-year-forward median CPI expectation (expected average inflation over the five-year period beginning five years from now) remained at its third-quarter level of 2.2 percent in the fourth quarter.

Financial Sector Experiences Higher Volatility

In recent weeks, investors' unease has been reflected in Treasury note yield spreads. As of Dec. 14, the average 10-year Treasury yield for the month stands at 2.9 percent—its lowest monthly average since August. Similarly, yields of several other maturities have declined at varying rates during the past four weeks, leading to partial inversions of the yield curve. For instance, on Dec. 10, the difference between the five-year and three-year note yields turned negative. The 10-year/one-year and 10-year/two-year spreads have also seen steady declines since the beginning of the year and are currently hovering near 0.1 percent.

Financial markets pay close attention to yield-curve inversions due to their correspondence with a higher perceived probability of recession. The Federal Reserve Banks of Cleveland, Dallas and New York publish estimates on the probability of an impending recession (*Chart 3*). Though there has been an uptick in all three probability estimates, ranging from 1 to 17 percent, these values are still significantly below those observed prior to previous recessions. In addition, volatility in the financial sector has not yet spread to the real economy, though it does bear watching in the near term.

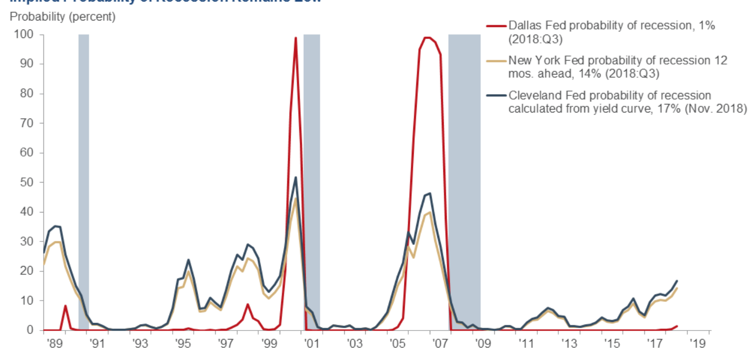
—Andrew Gross

....

About the Author

Gross is a research assistant in the Research Department at the Federal Reserve Bank of Dallas.

Chart 3
Implied Probability of Recession Remains Low



NOTES: Shaded areas indicate National Bureau of Economic Research (NBER) recessions. All series displayed give the probability of an impending recession.
SOURCES: Federal Reserve Bank of Dallas; Federal Reserve Bank of Cleveland; Federal Reserve Bank of New York; NBER.