Economy Statement for the Treasury Borrowing Advisory Committee of the Securities Industry and Financial Markets Association

May 1, 2017

The U.S economy slowed in the first quarter of 2017 – mostly a reflection of seasonal adjustment issues and transitory factors – with real GDP growth decelerating to an annual rate of 0.7 percent, following 2.1 percent in the final quarter of 2016. Personal consumption expenditures, usually an important driver of economic growth, softened considerably and made a scant contribution to growth this quarter; much slower inventory accumulation and falling expenditures at all levels of government directly subtracted from growth. On the positive side, private fixed investment rebounded sharply, and a slight upturn in net exports helped to support growth. In addition, labor market conditions remained strong. Although growth in payroll employment slowed in the first quarter relative to the fourth, job creation has continued at a healthy pace, drawing more workers into the labor force. In March 2017, the unemployment rate fell to 4.5 percent, its lowest level in nearly ten years, and well below the pre-recession norm of 5.3 percent. Looking ahead, the fundamentals of the economy are solid and point to an acceleration in the months ahead.

GDP Growth

According to the advance estimate of real GDP, which was released last Friday, the U.S. economy grew at an annual rate of 0.7 percent in the first quarter after rising at an annual rate of 2.1 percent in the fourth quarter. Consumer spending slowed significantly in the first quarter, likely owing to dampened utilities consumption in an unseasonably warm February, a modest pullback of light vehicle sales from a high level, and a delay in income tax refunds. Even so, this component continued to make a positive contribution to GDP growth. Real personal consumption expenditures grew at an annual rate of 0.3 percent in the first quarter, after robust growth of 3.5 percent in the fourth quarter. Private domestic final purchases – the sum of consumption, business fixed investment, and residential investment – grew in the first quarter at an annual rate of 2.2 percent, slowing from the 3.4 percent pace in the fourth quarter. This measure, which excludes government spending, exports, imports, and inventories, better portrays the strength of underlying private demand in the economy.

The recovery in business fixed investment that began last year took a major step forward in the first quarter of this year, surging to an annual rate of 9.4 percent, following a 0.9 percent increase in Q4. Contributions among subcomponents were quite solid. Equipment investment jumped 9.1 percent, accelerating from 1.9 percent in Q4, and outlays for intellectual property products grew 2.0 percent, up from the previous quarter's 1.3 percent gain. Spending on structures leapt 22.1 percent on an annualized basis, reversing from a 1.9 percent decline in Q4. The jump mainly reflected ongoing recovery in oil and gas drilling; the active rig count increased by 25 percent in the first quarter relative to the fourth quarter.

Private inventory investment, a volatile component, subtracted 0.9 percentage point from real GDP growth in the first quarter. Despite having added to growth in the previous two quarters, the change in private inventories has posed a sizeable drag on real GDP growth in six of the past eight quarters.

Residential investment grew for the second consecutive quarter, climbing 13.7 percent after a 9.6 percent advance in the fourth quarter. A variety of house price indices continued to rise at a solid pace in the first quarter, supported by a combination of strong demand and low inventories of homes available for sale. Although mortgage rates continued to trend higher, they remain relatively low from a longer-term perspective, and surveys of homebuilder confidence continued to convey high levels of optimism.

Government spending made a negative contribution to growth in the first quarter, compared with an essentially flat contribution in the previous quarter. State and local government spending declined by 1.6 percent, after a 1 percent increase in the fourth quarter, while federal outlays declined by 1.9 percent, after 1.2 percent decrease in the fourth quarter. Overall, government spending fell by 1.7 percent, compared with growth of 0.2 percent in the fourth quarter.

Net exports made a small positive contribution to growth in the first quarter, adding 0.1 percentage point to growth, after posing a significant drag in the fourth quarter. After declining in the fourth quarter, exports rebounded and posted a 5.8 percent increase in the first quarter. After surging by 9 percent in the fourth quarter, imports grew at a slower pace of 4.1 percent.

Labor Markets and Wages

During the first quarter of 2017, monthly job growth has averaged 178,000, slowing somewhat from the monthly pace of 187,000 in 2016. The unemployment rate declined to 4.5 percent in March, less than half its 2009 peak of 10 percent and well below the 2002-2007 average of 5.3 percent. Levels of initial claims for unemployment insurance, as well as continuing claims, remain near 40-year lows. Healthy labor market conditions have served to draw more workers into the labor force: the labor force participation rate stood at 63 percent in March, its highest level in about a year. The April employment report will be released this coming Friday.
Nominal wages and compensation have continued to improve, although rising inflation has eroded those gains in real terms. Nominal hourly earnings for private-sector production and nonsupervisory employees rose 2.3 percent over the year ending in March 2017, a few ticks below the average for 2016 but in line with the pace between 2013 and 2015. Growth in real terms was flat over the past twelve months, however. The Employment Cost Index for wages, salaries, and benefits in private industry has also picked up in recent quarters; in the year through March 2017, total compensation grew 2.3 percent, accelerating from its 1.8 percent rate from a year earlier. Notably, private wages and salaries grew 0.9 percent in Q1, the fastest quarterly pace in ten years, and by 2.6 percent over the year through March 2017, well up from the 2.0 percent rise in the year through March 2016.

Prices

Although higher oil prices have contributed to a pick-up in headline inflation, consumer price inflation remains moderate and core inflation remains stable. Despite a tick down in March, the Consumer Price Index (CPI) for all items has still increased 2.4 percent over the year ending in March, up from a 0.9 percent rate over the preceding twelve months. Energy prices were up 10.9 percent and gasoline prices surged 19.9 percent over the year ending in March. After a few months of year-over-year declines, food price inflation rose 0.5 percent in March. Excluding food and energy, the CPI was 2.0 percent higher over the year through March, decelerating a bit from the 2.2 percent rate over the twelve months ending in March 2016.
The Personal Consumption Expenditures (PCE) price index also showed headline consumer inflation accelerating but core prices remaining stable. The headline PCE rose 1.8 percent over the twelve months ending in March 2017, up sharply from the 0.8 percent pace observed a year earlier. Core PCE prices were up 1.6 percent over the twelve months ending in March 2017, unchanged from a year earlier.

Conclusion

The rate of real GDP growth slowed markedly in the first quarter of 2017, largely owing to transitory factors. Despite the slowdown, macroeconomic fundamentals remain solid and are expected to propel the U.S. economy to firmer ground over the rest of the year. The headline unemployment rate stands near a ten-year low, measures of consumer and business confidence remain near multi-year highs, and worker compensation continues to grow. These and other factors suggest that consumer spending, which accounts for two-thirds of the U.S. economy, will recover over the next few quarters. Private forecasters are currently projecting a growth rate of 2.2 percent for 2017 as a whole.