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

October 30, 2017

Despite a battering by three major hurricanes in August and September, the U.S. economy held a steady course and looks increasingly poised to enter its ninth straight year of economic expansion on a strong footing. Newly released data for the third quarter show real GDP growing at an annual rate of 3.0 percent, just a touch under the second quarter's 3.1 percent pace. Growth of personal consumption expenditures, although a bit slower than in the second quarter, remained the core driver of overall growth, while nonresidential fixed investment continued to advance and net exports made a significant contribution to growth. Residential investment declined for the second consecutive quarter, erasing the substantial gains made during the first quarter, but analysts expect that rebuilding efforts and a tempering of the effects of weather-related disruptions will help support residential sector activity in the fourth quarter. Meanwhile, total government spending had a neutral impact on third-quarter growth, as a decline in state and local outlays offset a sizeable increase in federal spending. Significantly, inventory accumulation was the second main driver of growth in the third quarter, after several quarters of mostly negative or neutral contributions. Overall labor market conditions improved, although a temporary, storm-related dip in payroll job creation lowered the third quarter's average monthly pace below that of the second quarter. Nonetheless, the unemployment rate fell to a fresh sixteen-year low and the labor force participation rate rose to its highest level in two years. In September 2017, the unemployment rate stood at 4.2 percent, more than a full percentage point below the pre-recession norm of 5.3 percent. Already-solid economic fundamentals, including confidence and household balance sheets, have strengthened further, suggesting healthy growth through the end of this year and into next year.

GDP Growth

According to the advance estimate of real GDP growth, which was released last Friday, the U.S. economy grew at an annual rate of 3.0 percent in the third quarter, edging down slightly from an annual rate of 3.1 percent in the second quarter. Although real personal consumption expenditures decelerated to an annual rate of 2.4 percent, from 3.3 percent in the second quarter, consumer spending again made the largest contribution to growth of any major component, adding 1.6 percentage points. Private domestic final purchases – the sum of personal consumption, business fixed investment, and residential investment – grew in the third quarter at an annual rate of 2.2 percent. This measure, which excludes government spending, exports, imports, and inventory changes, conveys the strength – and resilience – of underlying private domestic demand in the United States.

Business fixed investment grew 3.9 percent at an annual rate in the third quarter, moderating from the 6.7 percent advance in the second quarter, but remaining a key driver of growth with a 0.5 percentage point contribution to real GDP. Outlays for intellectual property products accelerated to an annual rate of 4.3 percent, up from 3.7 percent in the second quarter, and equipment investment grew for the fourth straight quarter, expanding 8.6 percent at an annual rate in the third quarter, just shy of the 8.8 percent surge of the second quarter. However, investment in structures reversed from a 7.0 percent increase in the second quarter to a decline of 5.2 percent in the third quarter. The slowdown largely reflected a storm-related pull-back in energy-sector investment, including for exploration, shafts, and wells.

A rebuilding of inventories was evident to a much greater degree in the third quarter. This component has generally weighed on real GDP growth in the past two years or so, having been down in six of the previous nine quarters, but in the latest quarter, it was the second-largest driver of growth. The change in private inventories contributed 0.7 percentage point to growth in the third quarter, after adding 0.1 percentage point in the second quarter.

Residential investment fell at an annual rate of 6.0 percent in the third quarter, extending a 7.3 percent drop in the second quarter. Part of the most recent decline, which subtracted 0.2 percentage point from growth, was very likely due to the regional devastation of the recent hurricanes. However, rebuilding efforts are expected to boost residential investment in the coming quarters. Meanwhile, house price appreciation, while still strong, has stabilized in recent months, against a backdrop of low inventories and still low, but rising, mortgage rates. Despite two consecutive quarterly declines in new residential investment, existing home sales rose in September for the first time in four months, and new home sales surged by just under 20 percent. Homebuilder confidence remained at a solid level in October. Although housing starts have been declining in recent months, largely due to the multi-family sector, total building permits have exceeded starts for the past seven months, suggesting a possible increase in housing activity in the near term.

Total government spending made an essentially neutral contribution to growth for the second consecutive quarter. Federal outlays grew 1.2 percent in the latest quarter, after increasing 1.9 percent in the second quarter. State and local government outlays fell by 0.9 percent in the third quarter, a bit less than the 1.5 percent decline in the previous quarter. Total government spending in the third quarter was 0.1 percent lower, after falling 0.2 percent in the second quarter. Overall, government spending continued to move sideways, as it has since early 2016.

Net exports made a 0.4 percentage point contribution to third-quarter growth, double the contribution of the second quarter, as exports grew 2.3 percent in the third quarter, while imports declined by 0.8 percent, after slowing for three consecutive quarters. As a result, the U.S. trade deficit narrowed significantly in the third quarter.

Labor Markets and Wages

During the third quarter of 2017, monthly job growth averaged 91,000, markedly lower than the second quarter’s monthly average of 187,000. However, a sharp, hurricane-related drop of 33,000 jobs in September weighed heavily on the quarterly average, and steady job creation is expected to resume in the fourth quarter. For the year through August, job growth averaged 171,000 per month, only modestly below last year’s monthly average of 187,000. The employment rate fell to 4.2 percent in September, a fresh sixteen-year low and more than a full percentage point below the 2002-2007 average of 5.3 percent. Headline unemployment remains at a level that is historically consistent with full employment, while the most comprehensive measure of labor market slack, which includes those marginally attached to the labor force or working part-time for economic reasons, fell to its lowest level since before the recession. Notwithstanding a temporary elevation in September owing to the storms, initial unemployment claims have returned to the near 40-year lows seen in recent months. Tightening labor market conditions have drawn more workers into the labor force, helping to offset the dampening effect of demographics: the labor force participation rate rose to 63.1 percent in September, its highest level in two years. The October employment report will be released this coming Friday.

Growth in nominal wages has edged up in recent months, although higher inflation relative to a year ago has eroded the gains in real terms. Nominal average hourly earnings for private-sector production and nonsupervisory employees rose 2.5 percent over the year ending in September 2017, slightly above the average for 2016 and a bit faster than the pace between 2013 and 2015. However, real average hourly earnings grew 0.2 percent over the twelve months through September, more than a full percentage point below the 1.4 percent pace seen a year earlier.

Prices

The pull-back in oil prices in the spring and summer, combined with idiosyncratic quality adjustments in several sectors (such as cell phone services and pharmaceuticals), has contributed to a general slowing of inflation in recent months. Although hurricane-related shutdowns in the energy sector led to a sharp rise of 10.1 percent in energy prices in September, relative to last September 2016, the Consumer Price Index (CPI) for all items increased a more moderate 2.2 percent over the year ending in September. This represents a definite firming from the 1.5 percent rate of a year earlier but is down from the 2.7 percent rate seen in February 2017. Over the past two quarters, rates of food price inflation have remained low and stable, with the food price index up 1.2 percent over the year ending in September 2017. Excluding food and energy, the CPI has held steady at 1.7 percent for five consecutive months, measured on a year-over-year basis, which is 0.5 percentage points below the 2.2 percent rate of a year earlier.

The Personal Consumption Expenditures (PCE) price index showed headline and core consumer inflation following a similar pattern to CPI in recent months. The headline PCE rose 1.6 percent over the most recent four quarters, slowing from 1.8 percent over the year through the first quarter, but up from the 1.4 percent pace observed a year earlier. Core PCE prices, however, continued to decelerate in recent months, advancing 1.3 percent over the most recent four quarters, slowing from the 1.8 percent pace of a year earlier as well as the 1.6 percent pace over the fourth quarters ending in March of this year.

Conclusion

Despite the intense, but mostly localized, effects of three hurricanes, the rate of real GDP growth in the third quarter compared favorably to the robust pace of the second quarter, growing 3.0

percent at an annual rate. Solid macroeconomic fundamentals, including multi-year highs in consumer sentiment, favorable business sentiment, and rising asset values, are expected to drive steady growth over the final quarter of this year and into next year, along with efforts to rebuild from storm-related damage. With the headline unemployment rate at a fresh sixteen-year low, improvements in broader measures of labor market slack, and early signs of a pick-up in nominal wage growth, conditions seem set for healthy private domestic demand in the months ahead. Private forecasters are currently projecting a growth rate of 2.3 percent for 2017 as a whole, and an identical increase in 2018.