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

January 29, 2018

The U.S. economy ended last year on a firm footing with real GDP growing at an annual rate of 2.6 percent in the fourth quarter. Over the course of 2017, real GDP grew 2.5 percent, much faster than the 1.8 percent pace over the four quarters of 2016, attesting to the economy's underlying momentum despite the disruption of the third quarter's multiple hurricanes and serious wildfires. The current expansion has now entered its ninth consecutive year and, as of this spring, will become the second-longest stretch of continued growth in the postwar period.

Consumption mostly drove the strong performance of the fourth quarter, although brisker business fixed investment also contributed. Notably, residential investment reversed the declines of the two previous quarters and posted a double-digit advance in the fourth quarter, the quickest since early 2016. Together these elements advanced private domestic final purchases (the sum of consumption, business fixed investment, and residential investment) by 4.6 percent in the fourth quarter, more than double the pace in the third quarter and the fastest in over three years. Total government spending made a solid positive contribution to growth in the final quarter as well, following four consecutive quarters of nearly neutral or negative impacts on real GDP. Offsetting these positive factors, net exports created significant drag in the fourth quarter, after adding to growth in each of the previous three quarters, while inventory investment backtracked from its gains in the third quarter. Looking forward, labor market conditions look likely to continue tightening, as the unemployment rate remained at a seventeen-year low of 4.1 percent in December, well below the pre-recession average of 5.3 percent. Consumer confidence levels also reached new highs last November, having retreated only modestly since then, while household balance sheets remain healthy, trends the coming boost in disposable income following the tax reform is likely reinforce. On these solid foundations, private estimates are predicting strong growth in the first quarter of 2018 as well as for the year as a whole.

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 2.6 percent in the fourth quarter, slowing from 3.2 percent in the third quarter. Growth in real personal consumption expenditures accelerated to an annual rate of 3.8 percent, from 2.2 percent in the third quarter, and added 2.6 percentage points to growth. Private domestic final purchases – the sum of personal consumption, business fixed investment, and residential investment – grew in the fourth quarter at an annual rate of 4.6 percent, more than double the 2.2 percent pace in the third quarter, attesting to faster underlying momentum in private demand.

Business fixed investment grew 6.8 percent at an annual rate in the fourth quarter, picking up smartly from the strong 4.7 percent advance in the third quarter and remaining a key driver of growth with a 0.8 percentage point contribution to real GDP. Outlays for intellectual property products in the fourth quarter slowed a bit to an annual rate of 4.5 percent annual rate, compared with a 5.2 percent increase in the third quarter, while equipment investment picked up to an 11.4 percent annual rate in the latest quarter, up from 10.8 percent in the previous quarter. Most noteworthy, however, was the reversal in structures investment: after falling 7.0 percent in the third quarter, largely due to a storm-related pull-back in energy sector investment, spending on structures rose 1.4 percent at an annual rate in the fourth quarter.

The cycle of rebuilding in inventories tailed off in the fourth quarter, after peaking in the third quarter when it made the second-largest contribution to growth. Over a longer timeframe, this component has weighed on real GDP growth in eight of the past thirteen quarters. The change in private inventories subtracted 0.7 percentage point from growth in the fourth quarter, after adding 0.8 percentage point in the third quarter.

Residential investment declined for two consecutive quarters before rebounding strongly in the fourth quarter, reflecting reconstruction efforts after the hurricanes in the third quarter. This component surged 11.6 percent at an annual rate in the fourth quarter, after falling by 4.7 percent in the third quarter and 7.3 percent in the second quarter. The recovery in residential investment added 0.4 percentage point to fourth quarter growth. House price appreciation has remained firm, or even accelerated by some measures, in recent months, as inventories have contracted further while mortgage rates have increased. Existing home sales fell in December, after two strong monthly increases, and sales were up 1.1 percent over the past year. New home sales also fell in December, after a double-digit surge in November, but they are up more than 14 percent over the past year. However, housing starts declined in December, largely reflecting a drop in single-family starts after two large gains in October and November. Total building permits also declined in December, but continued to exceed starts, suggesting additional gains in housing activity in the months ahead. Homebuilder confidence climbed to an eighteen-year high in December and hovered just below that level in January.

Total government spending in the fourth quarter was 3.0 percent higher, its fastest pace since the second quarter of 2015 and up noticeably from the 0.7 percent pace in the third quarter. Government spending had moved sideways from early 2016 onwards, but in the fourth quarter, it added 0.5 percentage point to real GDP growth. Gains at both the federal and state and local government levels contributed to the growth. Federal outlays grew 3.5 percent in the latest quarter, the fastest pace in more than seven years, after increasing 1.3 percent in the third quarter. State and local government spending grew 2.6 percent, much faster than the 0.2 percent rate in the previous quarter.

After adding to growth in the previous three quarters, the U.S. trade deficit widened substantially in the fourth quarter, as exports grew 6.9 percent, but imports jumped 13.9 percent. As a result, net exports posed a large drag on growth in the fourth quarter, subtracting 1.1 percentage points, following a 0.4 percentage point addition in the third quarter.

Labor Markets and Wages

During the fourth quarter of 2017, monthly job growth averaged 204,000, rebounding from the hurricane-dampened average of 128,000 in the third quarter. For the year as a whole, job growth averaged 171,000, slowing from the average monthly pace of 187,000 in 2016. The employment rate held steady at 4.1 percent in December, marking a seventeen-year low and putting it 1.2 percentage points 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 and those working part-time for economic reasons, is hovering just above the pre-recession low of 7.9 percent reached before the Great Recession began. Last year, initial unemployment claims remained near 40-year lows, posting the lowest annual average since 1973. Tightening labor market conditions have drawn more workers into the workforce, although employers, according to a variety of Federal Reserve and other surveys, have indicated difficulties in finding adequately skilled labor. The labor force participation rate reached a three-year high in September 2017 and has since edged down a bit, standing at 62.7 percent as of December 2017. The January employment report will be released this coming Friday.

Growth in nominal wages has softened in recent months, while a rise in inflation relative to a year ago continues to erode gains in real terms. Nominal average hourly earnings for private-sector production and nonsupervisory employees rose 2.3 percent over the year ending in December, slowing both from the 2.5 percent pace of a year earlier and from the rate seen over 2015. Real average hourly earnings grew 0.1 percent over the twelve months through December, slowing from the 0.5 percent pace seen a year earlier, a pace that itself represented a significant slackening from the 2.2 percent growth in real wages over the year through December 2015. Moreover, in selected jobs in some industries, nominal wage growth shows signs of a pickup, while recent announcements of worker bonuses and higher minimum wages suggest the potential for faster nominal wage growth across a number of large employers.

Prices

After running at 2.7 percent over the year ending in February 2017, headline consumer price inflation was considerably weaker during the remainder of last year, due to the pull-back in oil prices. Although energy prices have begun rising again more recently, the Consumer Price Index (CPI) for all items rose a moderate 2.1 percent over the twelve months through December 2017, matching the rate of a year earlier, but three times faster than the 0.7 percent rate posted over the year through December 2015. In contrast, food price inflation has accelerated in very recent months, with the food price index up 1.6 percent over the year ending in December 2017, after falling 0.2 percent over the previous year. Excluding food and energy, the CPI decelerated in the second half of 2017. Over the year through December 2017, core CPI rose 1.8 percent, or 0.4 percentage point below the 2.2 percent rate of a year earlier.

The headline Personal Consumption Expenditures (PCE) price index has generally slowed since hitting a high of 2.2 percent in February 2017, bottoming out over the summer and edging a bit higher in the fall. Headline PCE rose 1.7 percent over the most recent twelve months, just a touch below the 1.8 percent observed a year earlier, but up from the 1.4 percent pace observed over the summer. Core PCE price inflation has decelerated since early 2017, and in recent months has mostly remained in a lower range. Core PCE inflation advanced 1.5 percent over the most recent four quarters, slowing from the 1.9 percent reading posted a year earlier.

Conclusion

The economy's notable quickening over the past four quarters suggests that an already long expansion has gained new traction. The fourth quarter's 2.6 percent growth put the annual rate of growth last year at 2.5 percent, compared with 1.8 percent over the four quarters of 2016. Strong macroeconomic fundamentals, including multi-year highs in consumer sentiment, favorable business sentiment, robust employment growth, and record valuations in equity markets, will likely prove supportive of near-term economic activity. With the headline unemployment rate at a seventeen year low, continued absorption of labor market slack, and a pick-up in nominal wage growth in selected pockets of industry, conditions seem set for healthy private domestic demand in the months ahead. Private forecasters are currently projecting a growth rate of 2.5 percent in the first quarter of 2018, and of 2.6 percent for the year as a whole.

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