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

April 30, 2018

Over the past four quarters, real GDP has grown by 2.9 percent, the most rapid pace since early 2015. At nearly nine years old, the current expansion is set to become the second-longest stretch of continuous economic growth in the postwar period. Although the pace of U.S. economic growth moderated to an annual rate of 2.3 percent in the first quarter, compared with 2.9 percent in the fourth quarter, a rebound is expected in coming months and overall strong growth is forecast for the year as a whole.

A slowdown in consumption affected economic performance in the first quarter, partly owing to a return of durable goods spending to more normal levels after the hurricane-related surge of last fall. Business fixed investment made the largest contribution to real GDP growth, just ahead of consumption, while residential investment was roughly flat. All together, private domestic final purchases (the sum of consumption, business fixed investment, and residential investment) advanced by 1.7 percent in the first quarter. Other components added modestly to growth as well. Total government spending made a solid contribution, although smaller than in the fourth quarter. Net exports and inventory investment were also supportive of growth, after posing significant drags in the fourth quarter. As labor markets have tightened and the unemployment rate has remained at a seventeen-year low of 4.1 percent, there have been signs of faster growth in wages and gains in personal income, too. Measures of consumer sentiment remain at, or near, all-time highs, and household balance sheets remain robust. For the current quarter, and the year as a whole, private forecasters are predicting a return to strong growth.

GDP GROWTH

According to the advance estimate of real GDP, which was released last Friday, the U.S. economy expanded at an annual rate of 2.3 percent in the first quarter, slowing from 2.9 percent in the fourth quarter. Private domestic final purchases – the sum of personal consumption, business fixed investment, and residential investment – grew in the first quarter at an annual rate of 1.7

percent, following a 4.8 percent jump in the fourth quarter. Over the past four quarters, private domestic final purchases have grown at an average annual rate of 3 percent, attesting to the ongoing momentum of private demand.

Growth in real personal consumption expenditures decelerated to an annual rate of 1.1 percent in the first quarter, down from 4.0 percent in the fourth quarter when post-hurricane clean-up and motor vehicle replacement elevated spending. In the first quarter, outlays on consumer durables fell back to a more normal level, which led to a quarterly decline of 3.3 percent that weighed on overall consumption growth. Spending on nondurables was essentially flat, after a 4.8 percent gain in the fourth quarter. Although spending on durable and nondurable goods slowed, consumption of services held steady. On balance, real personal consumption expenditures added 0.7 percentage point to growth in the first quarter.

Business fixed investment grew 6.1 percent at an annual rate in the first quarter, only marginally lower than the fourth's quarter's 6.8 percent advance, and contributed 0.8 percentage point to overall growth. Notably, fixed investment in structures accelerated for the second consecutive quarter, nearly doubling to 12.3 percent at an annual rate from a 6.3 percent pace in the fourth quarter. Outlays for intellectual property products in the first quarter picked up, rising to 3.6 percent at an annual rate from 0.9 percent in the fourth quarter. On a slightly softer note, equipment investment slowed to 4.7 percent, following a surge of 11.5 percent in the previous quarter. The cycle of inventory accumulation turned up in the first quarter, adding 0.4 percentage point to growth, after subtracting 0.5 percentage point in the fourth quarter. This component of GDP is a volatile factor and tends to balance out over longer periods of time.

Residential construction edged up 0.1 percent at an annual rate in the first quarter, easing after a storm-related reconstruction bump of 12.8 percent in the fourth quarter. Consequently, it made an essentially flat contribution to growth. Nonetheless, the housing market is generally healthy, although tight supply remains a risk. New home sales rose in February and March and are now 8.8 percent higher over the past year. Existing home sales also increased in each of the past two months, although they were 1.2 percent lower over the year through March. Total housing starts rose in March, as a substantial advance in the volatile multi-family component helped offset a 3.7 percent decline in the larger single-family sector. Total building permits also rose in March, and continued to exceed starts, suggesting additional gains in housing activity in the months ahead. In the recent months through April, homebuilder confidence has hovered just below the eighteen-year high reached last December. Driven by low inventories and solid demand, house price appreciation has accelerated in recent months, even in the face of rising mortgage rates.

Total government spending rose 1.2 percent at an annual rate in the first quarter, following a rapid 3.0 percent pace in the previous quarter. After making an essentially neutral contribution to growth since early 2016, government spending has added an average 0.3 percentage point over the past three quarters. Gains at both the federal level and the state and local level continue to drive growth. Federal outlays grew 1.7 percent in the latest quarter, after the seven-year peak rate of 3.2 percent in the fourth quarter. State and local government spending grew 0.8 percent at an annual rate in the first quarter, roughly two-thirds the 2.9 percent pace in the previous quarter.

After widening substantially in the fourth quarter of 2017, the U.S. trade deficit narrowed in the first quarter, as export growth slowed to an annual rate of 4.8 percent while import growth slowed even more sharply to 2.6 percent. As a result, net exports made a 0.2 percentage point contribution to growth in the first quarter, reversing from a 1.2 percentage point drag in the fourth quarter.

LABOR MARKETS AND WAGES

During the first quarter of 2018, monthly job growth averaged 202,000, up from the 182,000 average for 2017 as a whole. In March, for the sixth consecutive month, the unemployment rate held steady at 4.1 percent, a seventeen-year low and 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. At the same time, 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, has dropped to 8.0 percent, a touch above the eleven-year low reached last October but more than a full percentage point below the pre-recession average of 9.1 percent. Initial unemployment claims have remained below 300,000 for more than three years, approaching the record stretch seen between 1967 and 1970, when total employment was less than half of current levels. Furthermore, more workers are entering the labor force, attracted by tightening labor market conditions. In March 2018, the overall labor force participation rate stood a tick below the three-year high reached last September, while that for prime-aged workers advanced to 82.1. percent, a gain of 0.4 percentage point relative to the year-earlier level. The April employment report will be released this coming Friday.

In the past few months, the pace of nominal wage growth has risen above year-ago levels. Nominal average hourly earnings for private-sector production and nonsupervisory employees rose 2.4 percent over the year ending in March, accelerating from the 2.2 percent pace in March 2017. Real average hourly earnings were flat over the same twelve months, a modest improvement over the 0.1 percent decline of a year earlier. Other measures exhibit an even stronger pick-up in earned income growth: over the year through March 2018, the Employment Cost Index for wages, salaries, and benefits in private industry showed the fastest growth since 2008. Private worker compensation grew 2.8 percent over the year through March 2018, the quickest pace since early 2008, and private industry wages and salaries rose 2.9 percent over the same period, marking the most rapid growth since early 2008.

PRICES

A moderate pullback in oil prices caused a deceleration in inflation starting in spring 2017, which continued for much of last year. More recently, inflation has begun to accelerate a bit. Over the twelve months through March 2018, the consumer price index (CPI) for all items rose 2.4 percent, matching the rate seen over the year through March 2017. Energy price inflation has slowed relative to year-ago levels, but food price inflation continues to run well above last year's rates. Excluding food and energy, the CPI edged up to 2.1 percent over the year through March 2018, above the 2.0 percent rate seen in March 2017.

The headline Personal Consumption Expenditures (PCE) price index slowed after hitting a high of 2.2 percent in February 2017, bottoming out over the summer and moving gradually higher in subsequent months. As of March 2018, headline PCE was up 2.0 percent over the past year, slightly above the 1.8 percent pace observed a year earlier, but well above the 1.4 percent pace observed in last summer. Similarly, core PCE price inflation decelerated through most of 2017 and remained in a lower range during the first two months of the year. In the latest March data, core PCE inflation picked up to 1.9 percent, returning to the rates observed in early 2017.

CONCLUSION

Similar to the pattern seen in recent years, U.S. economic growth slowed in the first quarter for idiosyncratic reasons but remains poised to accelerate in subsequent quarters, propelled by very strong underlying private demand. On a four-quarter basis, the economy's growth rate has strengthened in each of the past three quarters, suggesting that the long but relatively slow recovery following the crisis has shifted into a higher gear. Favorable economic conditions are in place, including lofty consumer optimism, healthy labor markets, faster growth in wages and household income, and positive business sentiment. The benefits of the first major tax reform in thirty years are also poised to underpin near-term consumption and investment. In short, the stage is set for a pick-up in growth over the near term. Private forecasters are currently projecting a growth rate of 3.1 percent in the second quarter of 2018, and of 2.8 percent on a fourth-quarter over fourth-quarter basis for the whole year.

###