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

July 30, 2018

U.S. economic growth surged in the second quarter of 2018 to 4.1 percent (annualized) – the fastest rate in four years and almost double that of the first quarter. Since the beginning of the year, real GDP has grown by 3.1 percent, which is the most rapid pace since 2015 and which marks the eighth straight quarter in which year-over-year growth has strengthened – a post-war record. Growth is expected to remain strong in the second half of 2018, as consumption remains buoyed by high employment, rising nominal wages, and healthy consumer balance sheets, and as business investment continues to respond to lower corporate tax rates, deregulation, and solid economic fundamentals.

A marked acceleration in consumption boosted economic performance in the second quarter, and this rebound in consumer spending was the primary driver of real GDP growth. Net exports made the second-largest contribution to second-quarter performance, followed by business investment. Although residential investment continued to decline in the second quarter, the loss was smaller, and its effect on real GDP growth was essentially neutral. Altogether, private domestic final purchases (the sum of consumption, business fixed investment, and residential investment) advanced by a strong 4.3 percent in the second quarter. Total government spending also increased in the second quarter, at the federal and at the state and local levels, resulting in a larger contribution to real GDP. The only component to pose an outright drag on the economy in the second quarter was private inventory accumulation, which subtracted a full percentage point from growth. This augurs well for inventory investment in the third quarter.

Labor markets have continued to tighten, with the number of job openings rising above the number of job seekers for the first time in history. As employment prospects have improved, workers have been drawn back into the labor force. This increase in labor force participation pushed up the unemployment rate in June to 4.0 percent, from an 18-year low of 3.8 percent in May. Against a backdrop of rising growth in nominal wages and personal income, healthy levels of job creation, and solid household balance sheets, measures of consumer and business sentiment remain near recent all-time highs. For the current quarter, and the year as a whole, private forecasters are predicting that growth will continue at a solid clip.

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 4.1 percent in the second quarter, stepping up sharply from 2.2 percent in the first quarter. Private domestic final purchases – the sum of personal consumption, business fixed investment, and residential investment – grew in the second quarter at an annual rate of 4.3 percent, following a 2.0 percent rise in the first quarter and a 4.4 percent increase in the fourth quarter. Over the past four quarters, private domestic final purchases have grown by 3.2 percent at an annual rate, above the average seen over the past two years.

Growth in real personal consumption expenditures rebounded in the second quarter, growing at an annual rate of 4.0 percent, after a soft reading of 0.5 percent in the first quarter. Outlays on consumer durables increased by 9.3 percent at an annual rate, a notable upswing from a 2.0 percent decline in the first quarter. Spending on nondurables was up 4.2 percent, after an essentially flat reading in the previous quarter. The acceleration in the consumption of goods was matched on the services side, as spending tripled to an annual rate of 3.1 percent in the latest quarter, from a 1.0 percent pace in the first quarter. On balance, real personal consumption expenditures added 2.7 percentage points to growth in the second quarter – the largest contribution from consumer spending in almost four years.

Business fixed investment grew 7.3 percent at an annual rate in the second quarter, building on an 11.5 percent jump in the first quarter and contributing 1.0 percentage point to overall growth. Since the start of 2017, real private nonresidential fixed investment has grown at a quarterly average of 7.3 percent, marking a return to the healthy pace seen in the early years of the recovery. Notably, fixed investment in structures again grew at a double-digit pace of 13.3 percent in the second quarter, after a 13.9 percent jump in the first quarter. Outlays for intellectual property products remained firm in the latest quarter, rising 8.2 percent after a 14.1 percent surge in the previous quarter. Equipment investment slowed to 3.9 percent in the second quarter, following an 8.5 percent increase in the first quarter. It bears noting, however, that since the start of 2017, equipment investment has grown at an average rate of 8.4 percent per quarter. After turning up in the first quarter, the cycle of inventory accumulation turned down again in the latest quarter, subtracting 1.0 percentage point from real GDP growth.

Residential construction declined 1.1 percent at an annual rate in the second quarter, improving on the 3.4 percent decline in the first quarter. This component made an essentially flat contribution to growth in the latest quarter, after posing a small drag in the previous quarter. Although housing demand remains generally healthy, tight supply and rising mortgage rates continue to pose risks, and recent data show that home sales, housing starts, and building permits have been declining. Existing home sales, which account for 90 percent of all home sales, have decreased in April, May, and June, and these sales were 2.2 percent lower over the past year through June. New home sales have fallen in two of the past three months, but as of June, were 2.4 percent higher than a year ago. Total housing starts declined 12.3 percent in June, reflecting a 9.1 percent decrease in the single-family sector but also a nearly 20 percent fall in the volatile multi-family component. Although total building permits have fallen in four of the past five months, they did continue to exceed starts in June, suggesting the possibility of firmer housing activity in the months ahead. Homebuilder confidence remains elevated, but as of July, stood 10 points below the 18-year high reached in December 2017. House price appreciation remains strong, exceeding core inflation and income measures, even as mortgage rates continue to climb.

Total government spending rose 2.1 percent at an annual rate in the second quarter, stepping up from a 1.5 percent pace in the previous quarter. After making an essentially neutral contribution to growth in most of 2016 and 2017, government spending has added an average 0.4 percentage point over the past three quarters. Federal outlays grew 3.5 percent in the latest quarter, after a 2.6 percent rise in the first quarter and a 7-year peak rate of 4.1 percent in the fourth quarter of last year. State and local government spending grew 1.4 percent at an annual rate in the second quarter, accelerating from the 0.9 percent pace in the previous quarter.

The U.S. trade deficit narrowed in the second quarter, as import growth slowed to an annual rate of 0.5 percent and export growth picked up to an annual rate of 9.3 percent. Goods exports, in particular, grew by 13.3 percent, the most since late 2013. As a result, the contribution of net exports to growth increased in the second quarter to 1.1 percentage point, after being neutral for growth in the first quarter.

LABOR MARKETS AND WAGES

During the second quarter of 2018, monthly job growth averaged 211,000, below the first quarter's average of 218,000 but still notably higher than the 182,000 monthly average for 2017. After reaching an 18-month low of 3.8 percent in May, the headline unemployment rate moved up to 4.0 percent in June, as more workers re-entered the labor force. 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, moved up by 0.3 percentage points to 7.8 percent in June, which is 1.3 percentage points below the pre-recession average of 9.1 percent.

Initial unemployment claims have remained below 300,000 for well over 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 June 2018, the overall labor force participation rate stood just shy of the three-year high reached in September, 2017. The participation rate for prime-aged workers (ages 25 to 54) advanced to 82.0 percent, a gain of 0.4 percentage points relative to the year-earlier level. The July employment report will be released this coming Friday.

Although the pace of nominal wage growth remains above year-ago levels, it has leveled off in the past few months, allowing rising inflation to erode real wage gains. Nominal average hourly earnings for private-sector production and nonsupervisory employees rose 2.7 percent over the year ending in June, accelerating from the 12-month pace of 2.3 percent through June 2017. However, real average hourly earnings declined 0.2 percent over the same twelve months, a reversal from the 0.8 percent gain of a year earlier. Other measures exhibit a somewhat 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. Data for the Employment Cost Index for the second quarter will be released tomorrow.

PRICES

Although moderate by historical standards, price inflation continues to strengthen according to a variety of measures. Over the twelve months through June 2018, the consumer price index (CPI) for all items rose 2.9 percent, up from the 1.6 percent pace seen over the year through June 2017. Sizeable increases in energy prices have driven some, but not all, of the pick-up from year-ago levels, while food price inflation has also picked up. Excluding food and energy, the

CPI increased 2.3 percent over the year through June 2018, above the pace of 1.7 percent through June 2017.

In recent months, the Personal Consumption Expenditures (PCE) price index, the index of most interest to the Federal Reserve, has also accelerated at both the headline and the core levels from the lower rates seen during the first two months of this year. Headline PCE rose 2.3 percent over the most recent twelve months, well above the 1.5 percent observed a year earlier and the 1.8 percent seen in the first quarter. Similarly, core PCE price inflation picked up to 2.0 percent, also well up from the 1.5 percent observed a year earlier and the 1.6 percent seen in the first quarter.

CONCLUSION

Headline real GDP growth surged in the second quarter to its fastest quarterly pace in four years, and underlying private demand remained strong. On a four-quarter basis, U.S. economic growth has accelerated for eight straight quarters, a notable performance for an economy in its ninth year of expansion. High levels of consumer and business sentiment, an increase in the pace of job creation, a return of workers to the labor force, and rising wages and incomes suggest the economy has found a firmer footing over the past year.