Principal Deputy Assistant Secretary Michael Faulkender Economy Statement for the Treasury Borrowing Advisory Committee of the Securities Industry and Financial Markets Association

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In July, the U.S. economic recovery entered its 121st month, becoming the longest expansion on record. The advance estimate for real GDP in the second quarter of 2019 showed economic growth at an annual rate of 2.1 percent, above market expectations, after a 3.1 percent annual rate in the first quarter and a 2.9 percent year-over-year advance in 2018. Especially noteworthy was the marked acceleration in private final domestic demand – a measure that provides a better signal of the economy's underlying growth trend – to 3.2 percent in the second quarter. Since the end of 2016, this measure has grown at an annual rate of 3.0 percent.

The second quarter also saw a quadrupling of growth in private consumption, a component which accounts for roughly two-thirds of the GDP, and a marked increase in government spending. Looking at other measures of performance: consumer and business sentiment remain near multi-year highs, while the housing sector continues to stabilize and home affordability is improving. Labor markets have exhibited strength in 2019: thus far in the year, employers have hired an average of 172,000 workers per month, pushing the total number of payroll jobs added since the November 2016 election to 6.1 million. At 3.7 percent, the June unemployment rate stands just above the 49-year low reached in April and May. Consistent wage gains, combined with slowing inflation, have helped boost workers' real purchasing power.

GDP GROWTH

Real GDP grew at an annualized rate of 2.1 percent in 2019 Q2, besting market expectations, and slowing only modestly from a rapid 3.1 percent annual rate in Q1. Slowing global economic growth and the drawdown of previous inventory investment subtracted from domestic GDP growth. However, it is notable that the pace of private domestic final purchases – the sum of personal consumption, business fixed investment, and residential investment – doubled to an annualized rate of 3.2 percent in the second quarter, an acceleration which augurs for more rapid growth in the second half of 2019.

The growth rate of real personal consumption expenditures quadrupled to 4.3 percent in the second quarter, slightly above expectations, marking the fastest rate of consumer spending since 2017 Q4. This followed an upwardly-revised 1.1 percent advance in consumption in the first quarter. Outlays on goods drove consumption in the second quarter, rising 8.3 percent at an annual rate and accounting for about four-fifths of overall GDP growth. Spending on durable goods climbed 12.9 percent in the second quarter, while nondurable goods expenditures were up 6.0 percent. Expenditures on services rose 2.5 percent in the second quarter. On balance, real personal consumption expenditures in Q2 made the largest contribution to growth, adding 2.9 percentage points.

Business fixed investment declined 0.6 percent in Q2, subtracting 0.1 percentage point from growth, but this followed a solid, upwardly-revised 4.4 percent advance in Q1. Equipment investment rose 0.7 percent in the second quarter, and the decrease in equipment investment in the first quarter was revised to a bare 0.1 percent. The slow equipment investment growth rate was significantly impacted by the grounding of the Boeing 737 MAX airplane; the Council of Economic Advisors estimates that the grounding alone subtracted 0.4 percentage point from Q2 GDP growth. Spending on structures fell 10.6 percent, partly reflecting decreased investment on oil and gas drilling rigs, but the decline followed a strong 4.0 percent advance in the first quarter. Fixed investment in intellectual property products grew 4.7 percent in the second quarter; growth in this category has risen at a double-digit pace in three of the last five quarters. After three consecutive quarters of positive contributions to growth, the cycle of inventory accumulation turned negative in the second quarter, subtracting nearly 0.9 percentage point from real GDP.

Residential investment retrenched for the sixth consecutive quarter in 2019 Q2, but the decline continued to taper relative to last year. Since Spring 2018, a sharp reduction in the value of construction put in place has driven overall residential investment expenditures lower. Even so, there are gathering signs of stabilization in the housing sector as well as ongoing improvements in affordability and inventories. Existing home sales, which account for 90 percent of all home sales, are almost 5 ½-percent higher on the year through June, and new single-family home sales have grown by nearly 15 percent over the first six months of this year. Total housing starts are up 6.2 percent over the twelve months ending in June, and for five of the past six months, total building permits have remained above total housing starts, pointing to a further pickup in homebuilding. Consistent with these signs, the National Association of Home Builder's home builder confidence index has trended higher during the first six months of this year, retracing almost half of last year's decline. Although inventories of home sales continue to trend higher, they remain relatively low compared to historical averages. Affordability has improved as well: monthly and 12-month measures of house prices have slowed considerably, though 12-month growth continues to exceed core inflation and income gains. In addition to slower growth in home prices, mortgage rates have declined over a full percentage point from levels seen last fall, also contributing to greater affordability.

Total government spending rose 5.0 percent at an annual rate in the second quarter, following a 2.9 percent advance in the first quarter. Over the past six quarters, government spending has added 0.4 percentage points, on average, to GDP growth, stepping up from essentially neutral contributions in 2016 and 2017. Federal outlays rose 7.9 percent in the second quarter, the fastest pace in ten years, following a 2.2 percent increase in the first quarter. State and local government spending has been growing more consistently since the end of 2017 and increased 3.2 percent in the second quarter of 2019, close to the 3.3 percent advance in the previous quarter. Altogether, government spending added 0.9 percentage point to real GDP growth in the second quarter.

The U.S. trade deficit widened in the second quarter of 2019, as export growth turned sharply negative, declining 5.2 percent, and import growth edged up 0.1 percent. After making a large, 0.7 percentage point contribution to growth in the first quarter, net exports subtracted almost 0.7 percentage point from real GDP growth in 2019 Q2, posing significant drag from growth.

LABOR MARKETS AND WAGES

The unemployment rate stood at 3.6 percent in April and May, a 49-year low, before edging up in June to 3.7 percent as more workers entered the labor force. Looking beyond the headline, unemployment rates in June for Hispanic-Americans and African-Americans remained very slightly above the historic lows reached during the second quarter, and the unemployment rate for Asian-Americans fell to a series low in June. During the second quarter, the unemployment rate for women fell to its lowest level since 1953, and the unemployment rate for workers 55 years and older fell to its lowest point in thirteen years. The most comprehensive measure of labor market slack, which includes those marginally attached to the labor force as well as those working part-time for economic reasons (the U-6 rate), declined to 7.1 percent in May, the lowest level since November 2000 (and 2.0 percentage points below the pre-recession average of 9.1 percent), before edging up to 7.2 percent in June.

Labor force participation rates remain very healthy, despite downward pressure from demographics. The overall labor force participation rate (LFPR) rose to 62.9 percent in June, two-tenths below the five-year high reached earlier this year, and the LFPR for prime-age workers also edged up in June towards the nine-year high reached in March. Notably, the LFPR for prime-age women stands very close to the ten-year high seen in January. Even so, many employer surveys show that labor shortages continue to pose a major challenge: since mid-2017, roughly half of small businesses have reported few or no qualified applicants for their job openings, and quality of labor has been the most cited problem facing small businesses since January 2018. The employment report for July will be released this Friday, August 2.

The durability of rapid wage growth is a hallmark of the many benefits of the Administration's tax reform. For private-sector production and nonsupervisory workers, nominal wages grew 3.4 percent over the year ending in June 2019, and year-over-year growth has held at or above a 3 percent pace for eleven consecutive months. Moreover, the deceleration of inflation over the past several months has translated into strong real wage growth and improved consumer purchasing power. After growing by 2.1 percent last January and February, the fastest pace in over three years, real wages for private-sector production and nonsupervisory workers advanced 1.9 percent over the year through June 2019, contrasting sharply with the 0.2 percent decline a year earlier. Another measure of wage and salary growth, the Employment Cost Index, showed that private wages and salaries grew by 3.0 percent year-over-year in the first quarter, right below the eleven-year high reached in the previous quarter. Data for the Employment Cost Index for the second quarter will be released this Wednesday, July 31.

PRICES

Consumer price inflation has been slowing at the headline level for over a year, mainly reflecting lower energy prices. Over the 12 months through June 2019, the Consumer Price Index (CPI) for all items rose 1.7 percent, well below the 2.8 percent pace a year earlier. Energy prices have fallen significantly since last summer; over the year through June 2019, energy prices dropped 3.4 percent, compared to a 12.2 percent jump a year earlier. On the other hand, food price inflation has picked up from last year, rising 1.9 percent over the 12 months through June, a half percentage point faster than the 12-month pace through June 2018. In contrast, core inflation has held relatively steady. Excluding food and energy, core CPI was 2.1 percent over the year through June, slowing slightly from 2.2 percent a year earlier.

Headline inflation, as measured by the Personal Consumption Expenditures (PCE) Price Index (the preferred measure for the FOMC's 2 percent inflation target), first slipped below the target in November 2018. The 12-month headline PCE inflation rate slowed further to 1.5 percent over the 12-months through May 2019, down from 2.3 percent in May 2018. Core PCE inflation was 1.6 percent over the year through May 2019, decelerating from the 2.0 percent pace over the year-earlier period. The data for PCE in June will be released on Tuesday, July 30.

CONCLUSION

Despite the modest slowdown in overall growth, the second quarter was especially noteworthy for a significant acceleration in private consumption, a component which accounts for two-thirds of U.S. GDP, and a surge in private final domestic demand, a measure which tends to provide a better signal of the subsequent quarter's growth. The benefits of the Tax Cuts and Jobs Act of 2017 (TCJA) and the Administration's deregulatory efforts continue to accrue and enhance the expansion, which entered its 121st month in July and became the longest on record. Moreover, downside risks in the second half of 2019 appear to be lessening. Although headwinds from slowing global growth persist, fiscal uncertainty has faded and a slowdown in manufacturing may be transitory. Private forecasters predict real GDP growth of 2.2 percent in 2019 on a Q4-over-Q4 basis and 1.7 percent in 2020. According to the President's FY 2020

Budget, the Administration is predicting growth nearing 3 percent for the next few years, based on the investment and productivity improvements incentivized by the TCJA.