January 14, 2016

U.S. ECONOMY ENDED 2015 ON A WEAK NOTE, BUT FUNDAMENTALS STILL STRONG

Highlights

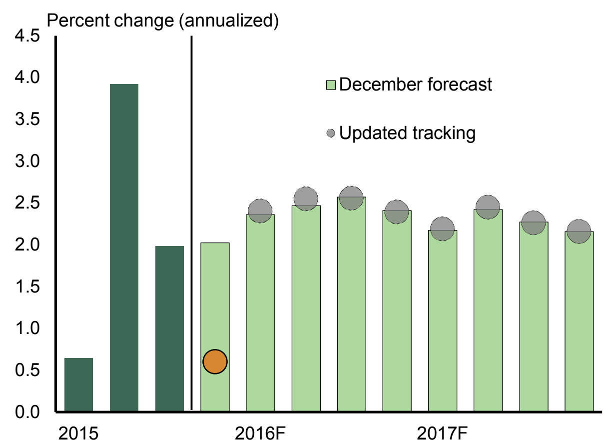
- Recent economic data has led us to lower our tracking for fourth quarter real GDP growth to just 0.6% (annualized) from 2.0% previously. Much of the weakness is due to a larger-than-expected inventory adjustment and weak net-exports, but domestic demand (spending by households, businesses and governments) has also decelerated.
- Growth patterns do not move in a straight line and the fourth quarter should prove to be a blip in the trajectory rather than a detour. Importantly, job growth has maintained momentum and in combination with weak inflation has led to strong real income growth that will sustain domestic demand in the 3% range over the next year.
- While a soft external environment and lofty dollar will remain key headwinds, we continue to expect the economy to grow at a modestly above-trend rate over the next year, allowing the Federal Reserve to continue gradually normalizing monetary policy.

Financial markets have had a rough start to 2016. Much of the angst has revolved around poor data in China, which has set off further declines in equity markets that have rippled around the world. But, U.S. economic indicators have not been much better. Economic data have disappointed expectations and, in combination with downward revisions to previously reported data, have led us to revise down our tracking for fourth quarter real GDP growth to just 0.6% (annualized) from our previous expectation of 2.0% (Chart 1).

With the Federal Reserve's recent interest rate hike pinned on an improving economic environment, the stalling in growth may appear troublesome. A deeper look at the numbers suggests that the American economy is doing better than the headline number suggests. Domestic demand, while slowing from its recent pace of around 3.0%, is still seeing decent growth just shy of 2.0%. This would be even better if not for a decline in utilities consumption due to warmer-than-usual weather.

Given the continued strength in the labor market, there is good reason to look past the soft headline number in the fourth quarter. We continue to expect the economy to grow at an above-trend rate of around 2.5% over the next year (fourth quarter to fourth quarter), allowing the Federal Reserve to continue gradually normalizing monetary policy.

CHART 1: REAL GROSS DOMESTIC PRODUCT



Forecast by TD Economics. Source: Bureau of Economic Analysis

Trade & inventories weigh on economic growth (again)

The disappointing outturn for fourth quarter real GDP growth is in part due to the usual suspects – exports appear to have fallen,

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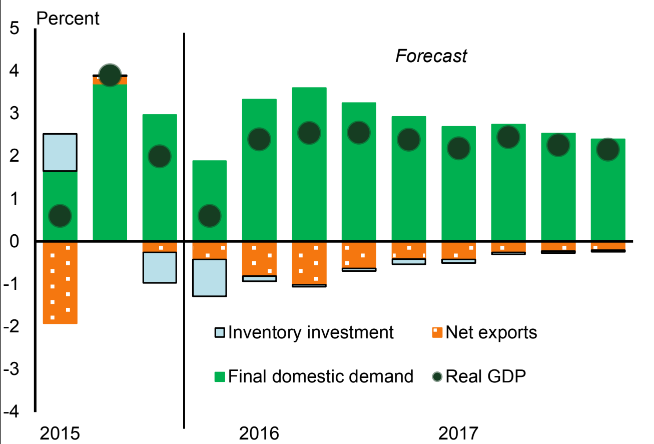
CHART 2: CONTRIBUTION TO REAL GDP GROWTH



Forecast by TD Economics. Source Bureau of Economic Analysis

while imports rose. Together this implies a drag on real GDP growth from net-exports of around 0.5 percentage points (pp). This is not new, nor is it expected to improve over this year. We anticipate net exports to cut 0.6 percentage points from growth in 2016. Nonetheless, international trade data has come in weaker (both new data and revisions) that has made the drag in the fourth quarter larger than previously projected.

Importantly, our expectation for net exports is premised on the dollar reaching a peak in the first quarter of 2016 and edging down modestly over the remainder of the year (please see our December outlook for more details). This is a key risk to the outlook. Should the dollar's rise continue unabated, the drag from net exports will increase and achieving above trend growth will be increasingly difficult.

Another culprit to soft fourth quarter growth is inventory investment. The slow sales environment at the start of the year, especially for the external sector, resulted in an accumulation in inventories relative to sales that has had to be worked off in the second half of the year. As a result, inventory investment subtracted 0.7 percentage points in the third quarter and looks to subtract another 0.9 pp from economic growth in the fourth.

Unlike net-exports, inventories are unlikely to continue to drag on growth to the same degree going forward. Over history the contribution to economic growth from inventory investment has been extremely volatile, but roughly flat on average. The soft external environment and strong U.S. dollar will continue to be a drag on foreign sales of American products and will see some U.S. production displaced by imports, but this will be offset by greater domestic demand. In addition to the slowdown in inventory accumulation over the second half of the 2015, faster sales growth will help move the inventory-to-sales ratio lower. As a result we anticipate only a modest drag on overall growth (-0.1 pp over the course of 2016).

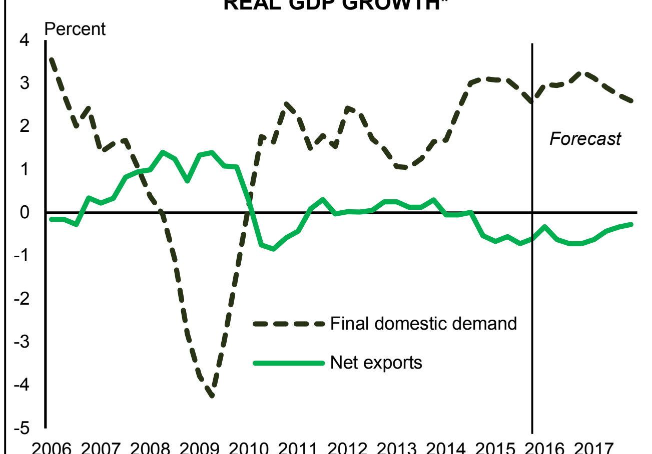
Domestic demand has a hiccup, but underlying fundamentals remain firm

We have long argued that domestic demand will be the key to maintaining above-trend economic growth so we must admit that not all of the disappointment can be hinged on external demand and inventories. Data on consumer and government spending, as well as construction have also come in weaker than anticipated. Given the flow of monthly data, final domestic demand (FDD) growth – spending by domestic households, businesses and governments – is tracking 1.8% in the fourth quarter, down from 2.9% in the third quarter and below our December expectation for 2.4%.

Some of the anticipated weakness in FDD is on the government side, which is anticipated to have slowed to around 0.5%. The weakness in government spending has been telegraphed in construction data where public construction spending contracted in both October and November. Uncertainty about funding by federal agencies and state and local governments due to congressional gridlock likely contributed to weak outlay growth in the fourth quarter.

The outlook for government spending over the next year is better. The passing of the Bipartisan Budget Act of 2015 in November removed a significant source of uncertainty and downside risk from the outlook. In addition to contin-

CHART 3: CONTRIBUTION TO REAL GDP GROWTH*



Forecast by TD Economics. Source: Bureau of Economic Analysis ued improvement in the balance sheets of state and local governments, this should allow for continued investment and hiring over the next year. There are already signs of this in other indicators. December's jobs report showed strong growth in government hiring at all levels. Job growth at the state and local level has been relatively consistent over the last two years, adding 85k in 2014 and 82k in 2015 to nonfarm payrolls.

In terms of private spending, consumer expenditure data through November suggests growth of around 2.0%. One of the weak spots for consumer spending has been services, which includes spending on utilities, including natural gas and electricity. Abnormally warm weather in October through November led to a steep decline in utilities consumption, big enough to have a noticeable impact on overall consumption growth. Excluding spending on utilities, consumption would be tracking 2.4% in the quarter. The contribution of utilities consumption to growth is basically flat over time, suggesting that this will reverse course next year. Unless the weather suddenly worsens beyond historical norms, falling utilities consumption should also be a boost to household purchasing power over the course of the next year.

On the investment side of the equation, weakness has been concentrated in construction. As it was earlier in the year, declining investment in oil and gas structures explains some of this weakness. However, it also appears to extend to other structures as well. Even housing investment appears to have decelerated in the quarter. This is more likely an aberration than the start of a new trend. Housing starts continue to trend upward, especially single-family starts, which hit a new high in November.

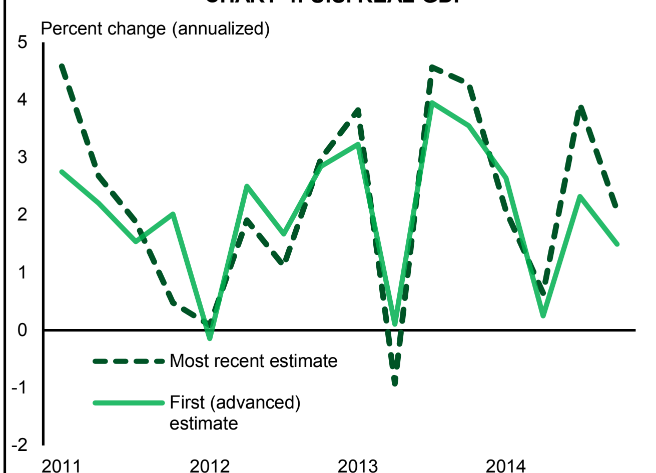
The weakness in residential investment is in part due to a fall in existing home sales that, according to the National Association of Realtors, is a consequence of increasing closing times related to new "Know Before You Owe" rules from the Consumer Protection Financial Protection Bureau. Home sales should rebound in the quarters ahead as the industry adjusts to the new paradigm, offsetting the weakness in the fourth quarter. Importantly, the softness in construction spending is not echoed in employment in the sector, which grew strongly in the quarter (up 6.3% annualized).

Good reasons to look past bad real GDP growth

Beyond the calculus of each sector's contribution to growth, there are a number of reasons to look past one (or even two) quarters of weak real GDP growth. For one, advanced estimates of GDP are prone to significant revision. Over the past four years, revisions have on average been positive, raising real GDP growth by a little over 0.4 percentage points (annualized). In the current environment where the earliest available data is for good sectors more exposed to weak external demand and the rising dollar, there is a greater chance of earlier data painting a more dour picture of the state of the economy. When the full scope of data on the services sector is tabulated the economy will likely look better than the current tracking suggests.

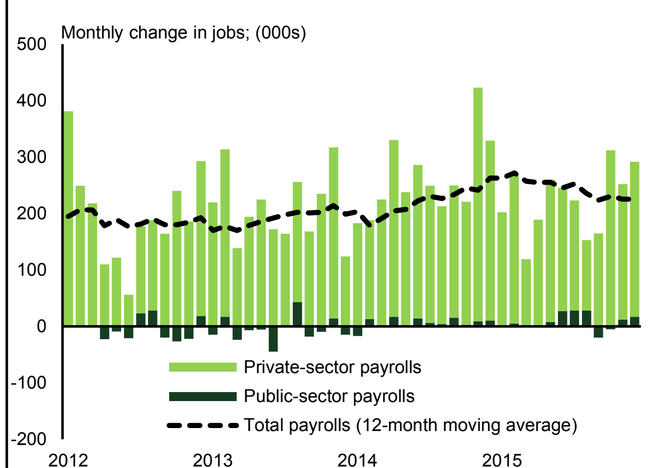
Another reason to look past the soft print for growth is that labor market recovery has shown no signs of slowing down and in fact accelerated in the final quarter of the year. Job growth through the final quarter averaged 284k a month, well over the 194k that it has averaged since the recession's end. This number may overstate slightly the strength of the

CHART 4: U.S. REAL GDP



Source: Bureau of Economic Analysis

CHART 5: U.S. EMPLOYMENT



Source: Bureau of Labor Statistics

labor market. The growth in construction employment was probably boosted by mild weather and there was a small uptick in the share of part-time employment. Total labor hours did not grow quite as fast as employment, but were still up a healthy 2.1% (annualized) compared to 2.4% for payrolls. Still, there is no denying that the job market is running well ahead of its potential rate. Given population aging, trend growth in the labor force is below 100k a month. America, in other words is generating three times the amount of jobs necessary to put downward pressure on unemployment.

The discrepancy between strong job growth and soft GDP is explained by weak labor productivity growth. This is not a new phenomenon. Labor productivity in the business sector has averaged just over 0.5% over the past five years. Raising productivity growth is a long-term challenge. In the short-term, the Federal Reserve's concern will remain on the strength in the labor market.

A final reason to discount the weakness in GDP growth is that measured by the growth in the purchasing power of income, Americans are doing better. Due to the rise in the value of the dollar, import prices are falling more than exports and every dollar Americans earned goes that much further. The Bureau of Economic Analysis calls this growth in the purchasing power of production "command-basis GDP" and calculates it by deflating both nominal exports and imports by domestic prices.

In the fourth quarter we estimate that command-basis GDP grew 0.6 percentage points faster than real GDP (so around 1.3%). For 2015 as a whole, command-basis GDP grew by 3.0% (annual average) compared to 2.4% for real GDP. It is this growth in real income that is important for wage and profit growth, and it is what will sustain the continued above-trend rate of domestic demand growth that we forecast over the next year.

Bottom line

The economy is performing better than the headline GDP number suggests. Growth patterns do not move in a straight line and the fourth quarter should prove to be a blip in the trajectory rather than a detour. The deceleration in domestic demand growth in the fourth quarter is notable, but is in part due to idiosyncratic factors that will reverse course going forward. Importantly, job growth has maintained momentum and in combination with weak inflation has led to strong real income growth that will sustain domestic demand in the 3% range over the next year. Even with continued drag from the weak external environment, the American economy is in good stead to grow by around 2.5% over the next year, allowing for the Fed to continue raising interest rates likely as early as March.

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