OBSERVATION

TD Economics

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US ECONOMY TO SHAKE OFF Q1 GROWTH SLUMP

Highlights

- Concern has crept into the U.S economic outlook after a string of disappointing data. This Friday, real GDP data is expected to show that the economy grew by less than 1% (annualized) in the first quarter, at odds with sentiment indicators, which have been painting a rosy picture of economic activity.
- Economic reality is likely somewhere in the middle of these two extremes. Sentiment indicators are likely too optimistic, while underlying momentum is better than the start-of-year growth figures imply. We expect the idiosyncratic factors weighing on activity in Q1 to reverse in the second quarter, propelling real GDP growth above 3%.
- Quarterly GDP growth is a noisy indicator and initial estimates are prone to significant revision. Looking at a broader range of measures, the American economy continues to perform well. Barring any unforeseen shocks, growth is expected to run at a slightly better than 2% pace over the next couple of years.

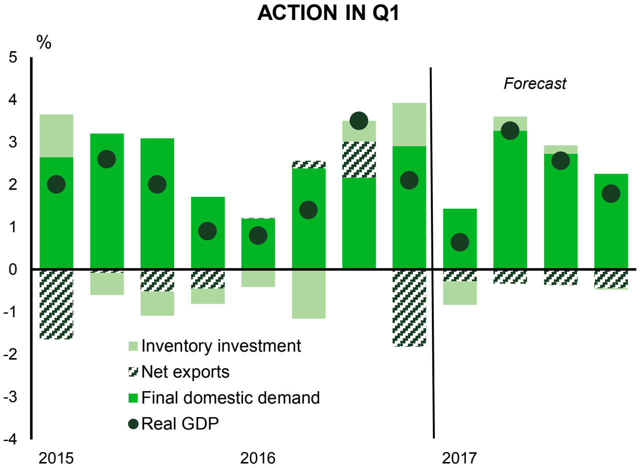
A string of disappointing economic data has raised concern that the U.S outlook is faltering. Perhaps most concerning, consumer spending declined in the first two months of this year, led by auto sales, which are down 10% from December. Broadening fears that the economy is losing momentum, payroll growth in March slowed to just 98 thousand jobs.

Taken together, the data so far suggest that real GDP in the first quarter of this year grew by less than 1% (annualized). That will follow a moderate 2% pace in the prior quarter, marking the U.S. as one of the slowest performing economies within the G7. And yet, seemingly at odds with this narrative, sentiment indicators are riding high and paint a much more optimistic picture.

Economic reality likely rests somewhere in the middle of these two extremes. Sentiment indicators appear to be building in overly optimistic expectations about the near-term prospects for growth-inducing policies from Washington, while disappointing GDP growth captures seasonal effects and idiosyncratic factors that understate economic momentum. Among the temporary setbacks weighing on first quarter growth are an inventory slowdown, lower utilities spending due to the mild winter and a giveback in auto sales after a blistering pace in the latter half of 2016. These one-off factors are estimated to have subtracted more than a percentage point from first quarter GDP growth.

Complicating matters, real GDP estimates appear to be perennially impacted by “residual seasonality,” whereby growth in the first quarter is estimated to be much slower than the remainder of the year. Removing these temporary factors and

CHART 1: DOMESTIC DEMAND MISSING IN ACTION IN Q1



Source: Bureau of Economic Analysis, forecast by TD Economics.

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accounting for additional seasonality, we should see real GDP growth pop above 3% in the second quarter.

In any case, real GDP is a noisy indicator and initial estimates are frequently imprecise. Looking at a broader swath of measures, the economic outlook continues to rest on a sturdy foundation. Even as spending pulled back early in the year, personal income growth accelerated. With the unemployment rate at or below its long-run sustainable level, further wage gains are likely forthcoming, giving support to future spending growth. This is echoed in the Fed's latest Beige book, which noted widening labor shortages and a nascent pickup in wage growth in districts across the country.

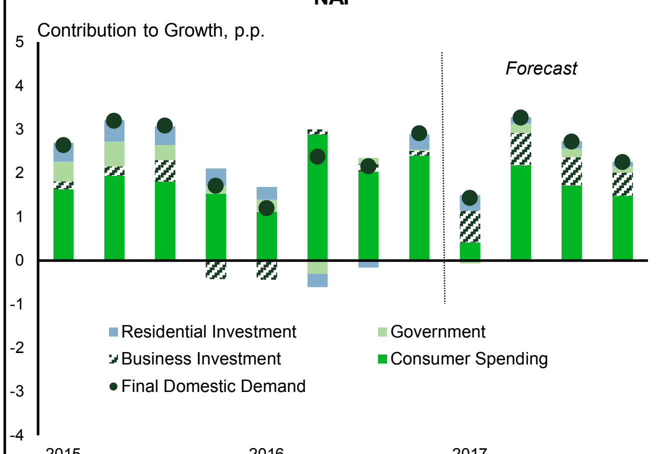
Just as important, the global economy is looking firmer than it did at this time last year. While financial volatility had spiked in recent weeks, the relatively benign outcome of the French presidential election has eased concerns in Europe and financial conditions have since improved. With strong gains in equities and home prices over the past year, household balance sheets are in excellent shape, even as debt service costs continue to hover near historic lows.

All told, absent a black swan event, we expect the U.S. economy to chug along at slightly better than 2% over the next few years as outlined in our latest forecast.

Inventories a key piece of the puzzle

When looking at the various components of GDP, inventory investment tends to be the swing voter from one quarter to the next. But, over the long-term, inventory swings neither subtract nor contribute very much to economic growth. Over the last thirty years, inventory investment has added an average of just 0.1 percentage points to annual economic growth.

CHART 2: CONSUMERS TOOK A LONG WINTER'S NAP



Source: Bureau of Economic Analysis, forecast by TD Economics.

In the short-run, however, this means that after a period in which inventory investment adds to growth, it subsequently subtracts. This dynamic is expected to be a factor in the first quarter. Non-farm inventories added one percentage point to real GDP growth in the fourth quarter of 2016, and look to subtract slightly more than half a percentage point from growth this quarter (see Chart 1).

The good news is that this drag is unlikely to continue. Relative to sales, inventory levels have fallen in recent months from peak levels set last year. The decline in the inventory-to-sales ratio is observable across manufacturing, retail, and wholesale industries, suggesting little risk of an overhang.

Consumers tightened their purse strings in January and February

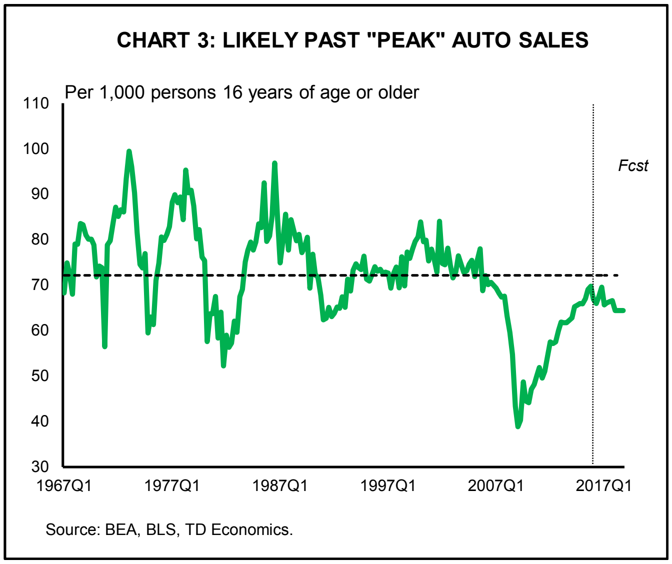
In short, there is little need to worry about inventories as long as the outlook for demand remains solid. This puts the pullback in consumer spending in January and February in focus. With the poor start to the year, consumer spending is likely to come in at an anemic 0.6% (annualized) in the first quarter (Chart 2). That is significantly short of the booming 3.6% average rate over the past three quarters, or even the more moderate 2.4% quarterly annualized pace over the past six years.

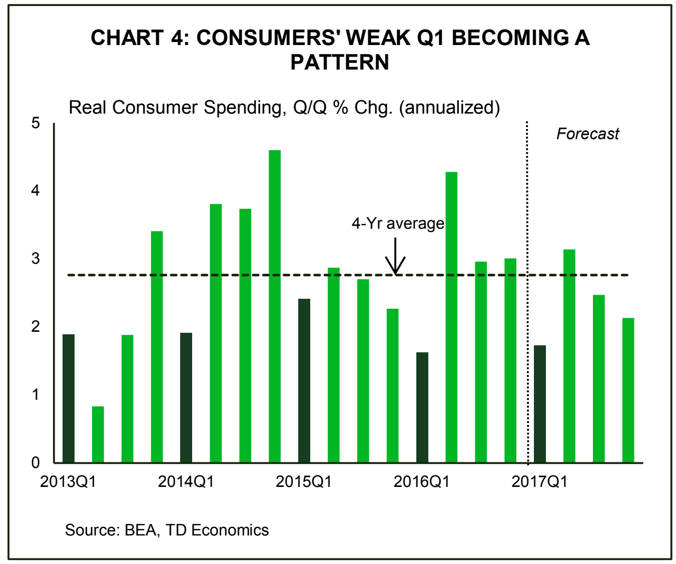
Looking at the details, one component flashes red: energy consumption and home heating. The past winter was mild in January and February, resulting in a sizeable drop in energy expenditures. Indeed, between 40-50% of the spending shortfall is accounted for by lower-than-expected energy expenditures.

We can be quite confident this will be reversed in the months ahead. Utilities production was up a whopping 8.6% in March, following steep declines in January and February. This suggests consumption of energy services normalized in the final month of the first quarter, providing a strong handoff to growth in the second quarter.

The other half of the missing spending was a drop in durable goods consumption, most notably auto sales. The drop in auto sales, however, comes after sales growth had averaged an unsustainable 18% (annualized) over the past two quarters. That durables spending binge in was instrumental in driving up personal consumption expenditures (PCE) well above trend in the latter half of 2016.

Pent-up demand for autos appears to be largely sated (see Chart 3). As consumer lending rates rise, we would expect growth in durable goods spending to return to a mid-single





digit pace, more in line with longer-term averages. Still, the correction in the first quarter reduces the risk of further growth disappointments in the quarters ahead.

Finally, PCE growth seems particularly prone to the residual seasonality phenomenon. Over the past four years, growth has averaged 2% in the first quarter and above 3% over the remainder of the year (see Chart 4). This divergence cannot be explained by warmer-than-usual winters. Gradually this issue should be dealt with by the BEA's seasonal adjustment process, but for now this "x factor" seems to have played a role once again in first quarter weakness.

Understanding the idiosyncratic nature of the disappointment in consumer spending to start the year leads us to expect growth to accelerate firmly in the second quarter. However, it is no guarantee for robust growth beyond the quarter-to-quarter gyrations. Still, underlying conditions are favorable for consumer spending to grow at a 2% to 2.5% pace over the medium term, in line with growth in personal income. In fact, personal income growth has accelerated over the past year, from around 3.5% to 4.5% (year-on-year) – well above the rate of inflation. If this continues, it suggests upside risk to our consumer spending outlook.

Labor market indicators still look good, weather contributed to March slowdown

One reason to be cautious on the outlook for income growth is the apparent slowdown in job growth in March. Following average growth of 217 thousand in January and February, payroll growth slowed to 98 thousand in March.

However, the March payroll tally also looks to have fallen victim to the weather on two fronts. Unusually warm weather in January and February likely pulled forward activity in the construction sector. And, Bureau of Labor Statistics (BLS) data on curtailment of hours due to bad weather was nearly ten times larger than average in March, impacting hours worked, earnings and potentially hiring.

Other labor market indicators continue to point to labor market running on all cylinders. The unemployment rate fell 0.2 percentage points in March to 4.5% – in line with the Fed's long-run estimates. While in the past a falling unemployment rate has been attributable to people leaving the labor market, this was not the case in March. Rather, the measure of employment growth used to calculate the unemployment rate advanced a robust 472 thousand in the month. While household employment is a more volatile measure, the gains appeared wide spread across age groups, sending the core working-age (25 to 54) employment-to-population ratio to a new cyclical high. Meanwhile, the job openings rate has remain near recent historic highs and weekly jobless claims continue to hover at historic lows, suggesting little deterioration in underlying labor demand among employers.

The proximity of the unemployment rate to its long-run neutral level does suggest a slower rate of job growth than we have seen over the past several years. Still, with continued progress in drawing people on the fringes of the labor market back in, there is good reason to expect job growth to accelerate from the rate set in March. We expect monthly job growth around 170 thousand over the remainder of this year.

Housing market giving reassuring signals

The housing market has provided further evidence that the economy has started to shake off its first quarter slump.

Existing home sales bounced back in March after some volatility over the winter months and building permits point to further strength in housing starts headed into the spring. A buoyant housing market will contribute directly to economic growth and also typically boosts housing-related purchases.

All told, we are confident the U.S. economy will shake off its slump in the second quarter. But, looking ahead both hiring and consumer spending growth are headed for a more mature pace of growth. Eight years into the expansion, pent-up demand is becoming less of an influence on spending growth and rising interest rates will temper some of the past enthusiasm for big-ticket purchases.

Typical cyclical warning signs aren't flashing

If you think the preceding assessment is Pollyanna-ish to the risks out there in the global economy, you are right. There are plenty of shocks that could trigger the next recession. And the farther we get from the last recession, the more worried forecasters become that one is lurking around the corner.

Given the data at hand, however, we do not think we are at a turning point in the U.S. cycle. Metrics that have a decent track record at signaling economic stress all remain in the "safe zone" at the moment. One is the yield curve – as measured by the yield on the 10-Year Treasury less the 1-Year Treasury rate – has gone negative before the past nine recessions. That metric now stands around 147 basis points, well above the negative reading typically presaging recessions.

Other recession signals show few signs of financial stress. Valuations in equity markets are looking stretched, perhaps reflecting some irrational exuberance about the economy's prospects under the new President. And, the risk of an equity market correction this year is real. However, equity market corrections are far more frequent than recessions, and don't necessarily cause them. During the past eight years of the current economic expansion, there have been four periods in which the S&P500 has fallen by 10% or more.

Having said that, we will continue to let the data speak for itself. If the rebound in consumer spending disappoints in the second quarter, we would revisit our expectations for a resilient consumer. Further weakness in durable goods spending could signal that households are more sensitive to interest rate hikes than anticipated. Moreover, our forecast calls for business investment to pick up through 2017. If the lack of policy progress in Washington translates into investment delays, that part of our forecast would similarly require a rethink.

The bottom line

Despite the mixed signals coming from the sentiment indicators versus readings of U.S. GDP growth, we judge that underlying growth is humming along at slightly better than 2%. Given that many forecasters are predicting a disappointing growth tally in the first quarter, investors are likely to look past the ugly GDP print next week, as will the Federal Reserve, which has also pointed out the noisiness in GDP readings. Growth a little better than 2% is fast enough to absorb economic slack, and should still see the Fed hike rates twice more this year.

That said, nothing is a sure bet and the landscape is riddled with unknowns. It will be important for the new U.S. administration to start to deliver on some of its promised domestic economic policies in order for business and household confidence to be sustained at current levels. Across the pond, there are ongoing risks to financial market confidence related to further euro-skepticism in Europe or a heightened global conflict, to name only two. We are watching risks like these closely, but none of them threaten our base case outlook at this point.