March 24, 2015

U.S. OUTLOOK: CONSUMERS IN THE DRIVER'S SEAT

Highlights

- In a pattern similar to last year, unseasonably cold weather and record snowfall in parts of the country combined to slow economic activity at the start of this year. As it did in 2014, growth will bounce back in the quarters ahead.
- For the year as a whole, we expect economic growth to accelerate to 3.0% in 2015, up from 2.4% in 2014. With the unemployment falling to 5.0% and the Federal Reserve beginning to normalize monetary policy, economic growth will edge down to 2.8% in 2016.
- Consumer spending is at the center of the economic outlook. We expect personal consumption expenditures to grow by 3.4% in 2015, accounting for the bulk of the acceleration in economic growth. Our optimism on the path of spending is grounded in rising income growth, which will continue to be supported by job gains and steadily increasing wages.
- The rise in domestic spending will benefit the rest of the world, as the high dollar makes imports cheaper and exports less competitive. The downside is that the U.S. trade deficit will widen. Net-exports are expected to subtract 0.4 percentage points from real GDP growth over the next year.
- With the lofty dollar keeping downward pressure on inflation, the Federal Reserve can be cautious in moving interest rates higher. The fed funds rate is likely to end 2015 at 0.75%, rising to 1.25% by the end of 2016.

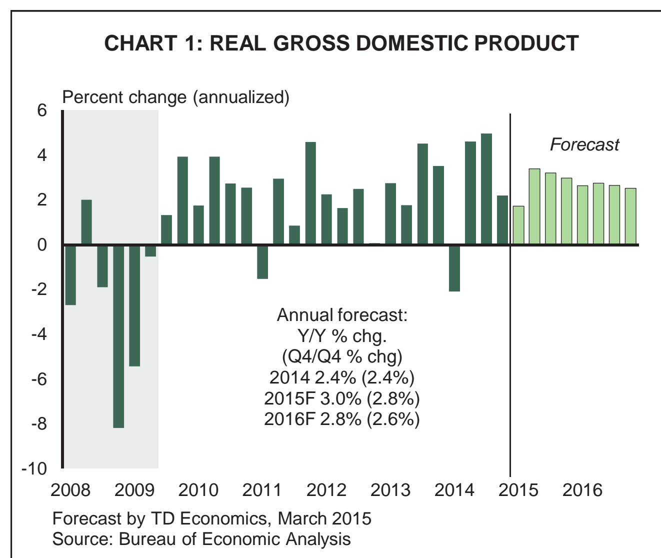
Looking out on the American economy at the start of 2015, one can't help but get a feeling of déjà vu. Just as it was a year ago, the weather is once again leading to downward revisions to economic growth estimates. And, just as it was a year ago, global concerns are weighing on the outlook for growth.

Despite the similarities, today's economy stands on its own. Two factors make the situation different than it was a year (or two years) ago. The first is the job market, where the acceleration in job growth (the fastest in 15 years) is only the tip of the iceberg. Job openings have risen across sectors, while small and medium sized businesses are increasingly expecting to raise wages. At 5.5%, the unemployment rate has moved to a level that can no longer be disassociated from broadening and convincing strength in the economic foundation.

The second factor is the fall in inflation due to the decline in energy prices and sky rocketing dollar. Consumer price inflation has slipped into negative territory. With dollar strength likely to continue, price pressures will remain subdued over the remainder of this year.

The result of a buoyant job market and falling consumer inflation is robust gains in real disposable income. These gains provide the foundation for strengthening consumer spending. The rise in domestic demand will benefit the rest of the world, as the high dol-

CHART 1: REAL GROSS DOMESTIC PRODUCT



Forecast by TD Economics, March 2015
Source: Bureau of Economic Analysis

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lar makes imports cheaper and exports less competitive. The downside is that net-exports will subtract from economic growth in America. Nonetheless, the lofty dollar also gives the Federal Reserve room to remain accommodative, despite an unemployment rate that is approaching its long-run goals.

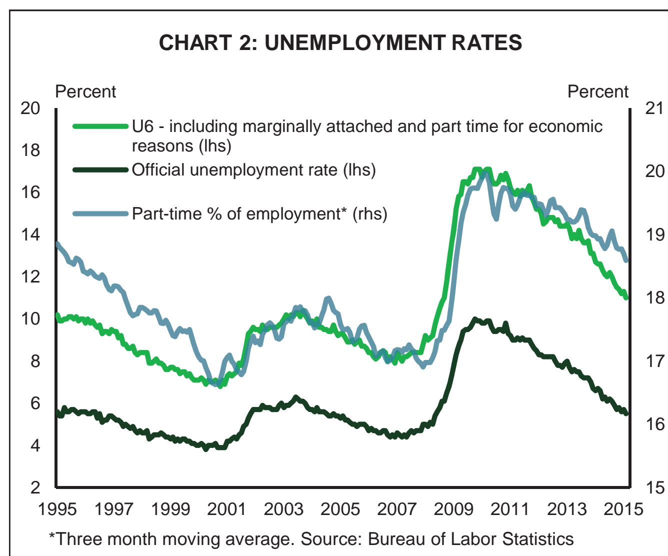
All told, we expect the economy to grow by 3.0% in 2015, up from 2.4% in 2014. With the Federal Reserve slowly beginning to normalize monetary policy and with the unemployment rate falling to 5.0% in 2016, economic growth is expected to edge down to 2.8%.

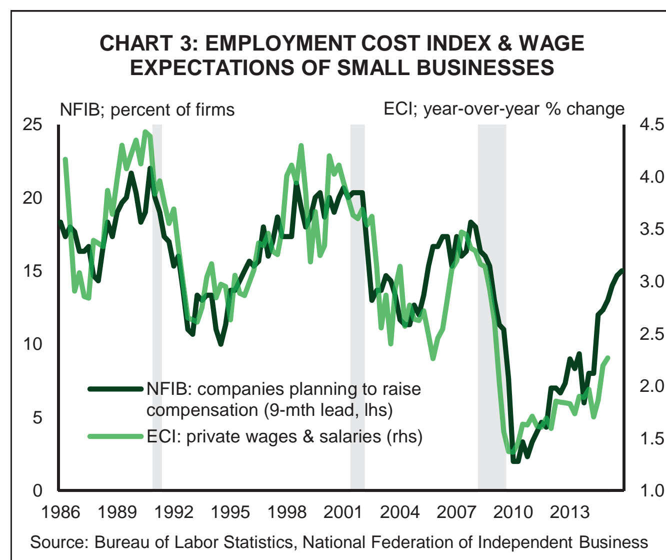
Income growth will fuel faster consumer spending

Consumer spending is at the center of the economic outlook. We expect personal consumption expenditure (PCE) to grow by 3.4% in 2015, accounting for the bulk of the acceleration in economic growth. Our optimism on the path of spending is grounded in rising income growth. Over the twelve months ending in January, real disposable personal income has grown by 4.2% – the fastest rate in over two years. However, unlike two years ago, the growth in income is not distorted by changes in taxation. It is, instead, a function of steady increases in employment and falling inflation.

Income growth is likely to remain strong over the forecast horizon alongside steady gains in employment, average hours worked, and wages. Regarding employment, the recent pace of around 300k jobs a month will likely begin to give way to a more sustainable pace. Over the remainder of this year, we expect job growth to average 220k a month.

The constraint on future job growth is not on the demand side, but rather on the supply side. A falling unemployment rate means job growth is exceeding labor force growth.



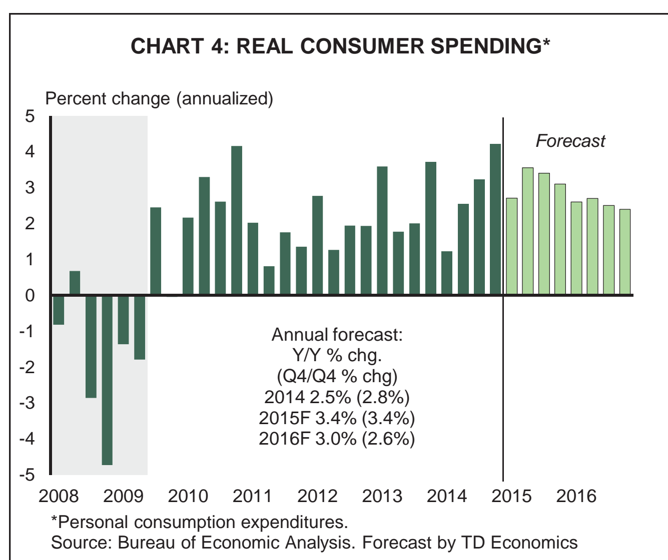


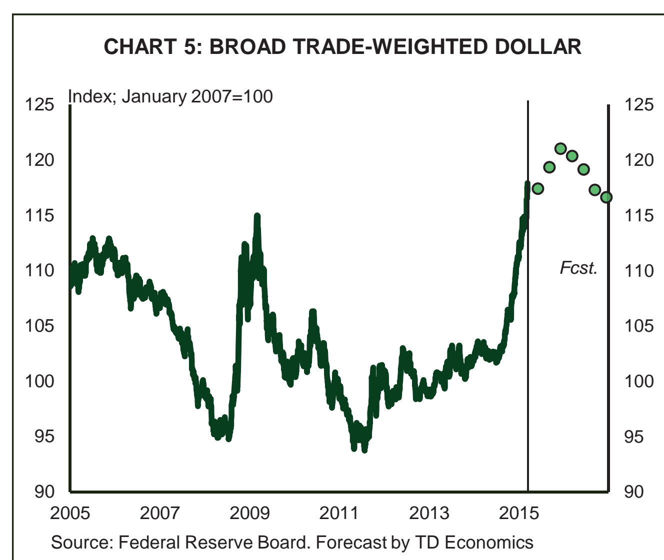
But, with the unemployment rate nearing its natural rate (of roughly 5%), the pool of available workers is rapidly diminishing. Future job growth is likely to entice workers not just from the "officially unemployed" pool, but also from the pool of discouraged and marginally attached workers who had previously given up the job search. While this will slow the decline in the official unemployment rate, it will still imply a reduction in labor market slack.

Diminishing labor market slack should lead to increases in average hours worked. In particular, the share of part-time employment is still elevated relative to its pre-recession level (Chart 2). Moving more people to full-time work will raise average hours and support income growth.

The other part of the equation is wage growth. This has admittedly been the disappointing element of recent payroll reports. In February, average hourly wage growth decelerated to 1.9% from 2.2%. The good news is that with consumer price growth falling to zero, this still translated into accelerating real wages. Nonetheless, nominal wage growth is likely to rise going forward. Small and medium sized businesses are already anticipating raising wages. Historically these survey responses have translated into actual increases with a lag of 9 months (Chart 3). Beyond this, faster wage growth will follow from the inescapable logic of supply and demand. Elevated job openings amidst falling unemployment will mean a higher price for labor.

In terms of the profile for growth, the weakness in consumer spending in the first quarter is due in large part to poor weather. This is evident in the fall in sales at weather-sensitive retail stores like motor vehicle and building materials. As it was last year, this is likely to be made up in the





months and quarters ahead.

Importantly, the improvement in spending growth will not require a substantial rise in leverage (see Conditions Are Ripe for American Consumers to Lead Economic Growth). While some of the rise in the personal saving rate associated with forestalled purchases early in the year is likely to be unwound, for the year as a whole, the saving rate is expected to average 5.0% in 2015, up from 4.9% last year. Households increasingly have the capacity to take on debt – the financial obligations ratio is at its lowest level in 34 years (the history of the series). A continued improvement in credit conditions that allows for greater household borrowing represents upside risk to our outlook for spending.

An island of economic strength in a sea of global weakness

At the other end of the spectrum is the economic drag stemming from America's trade account, as its domestic economy continues to set itself apart from much of the rest of the world. Over the past two years, U.S. economic growth has outperformed its European partners and has been matched or surpassed only by commodity-rich countries like Canada and Australia. With commodity prices plunging, the lead pack is thinning – Canada and Australia will see growth decelerate even as America's picks up.

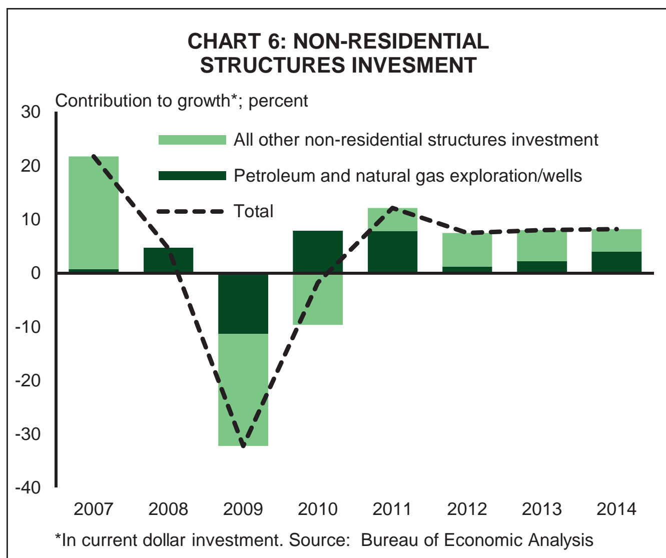
Fortunately, Europe is beginning to look better – it has exited recession and is being supported by ongoing central bank stimulus. This should result in acceleration in growth over the next two years. One of the key reasons for optimism on Europe's prospects is the falling value of the euro. Over the last year, the euro has fallen more than 24% against the dollar – to its lowest level since 2003. The falling euro is a positive for the region's exporters, who will benefit not only by exporting more to the United States, but also by taking market share from U.S. producers in other parts of the world. Nonetheless, while increasing, the growth rate in the euro area will fall below that of the United States, at 1.4% in 2015 and 1.8% in 2016.

Unfortunately, the good news stories are few and far between elsewhere in the world. In both Asia and South America, growth is set to decelerate over the next year. China will continue to slow over the next several years as policy makers reconfigure their economic growth model and try to stem imbalances. In many emerging economies, the eventual tightening in U.S. monetary policy will put continued downward pressure on currencies and require tighter domestic policy rates, further weighing on growth.

The net result is a global outlook that, on a trade-weighted basis, is only modestly better than the past several years. With little in the way of additional foreign demand growth, the rising dollar will put considerable downward pressure on American exporters. We expect the rise in imports to outpace export growth over the next two years, causing net exports to subtract 0.4 percentage points from economic growth in 2015 and another 0.2 percentage points in 2016.

Oil and gas sector will weigh on investment

The other factor directly weighing on economic growth is the reduction in investment and production within the country's oil and natural gas sector. As a share of GDP, oil and natural gas production is relatively small, representing under 2.0% of overall economic activity. However, within certain



*In current dollar investment. Source: Bureau of Economic Analysis

areas of the economy the contribution is more substantial. Within non-residential structures, for example, investment in oil and natural gas represents 30% of activity. It is even more important in terms of growth. Since 2010, over 40% of the growth in non-residential structures has been within the oil and gas sector (Chart 6). As a share of total fixed business investment (including equipment and intellectual property products), investment in oil and natural gas structures has represented close to 10% of growth.

Unfortunately, the magnitude of the decline in energy prices suggests investment in oil and natural gas exploration could fall more than 30% over the next year. However, there are two sides to the coin. Other sectors will benefit from the reduction in energy prices (just as households do) and take up the slack. Investment intentions among small businesses have risen alongside confidence, suggesting upside to equipment investment. Within structures investment, commercial real estate will get a tailwind from the improvement in office-using employment and the rise in consumer spending. Putting all the investment pieces together, the reduction in oil and gas investment will slow the pace of business investment relative to 2014, but it will still contribute (albeit modestly) to economic growth.

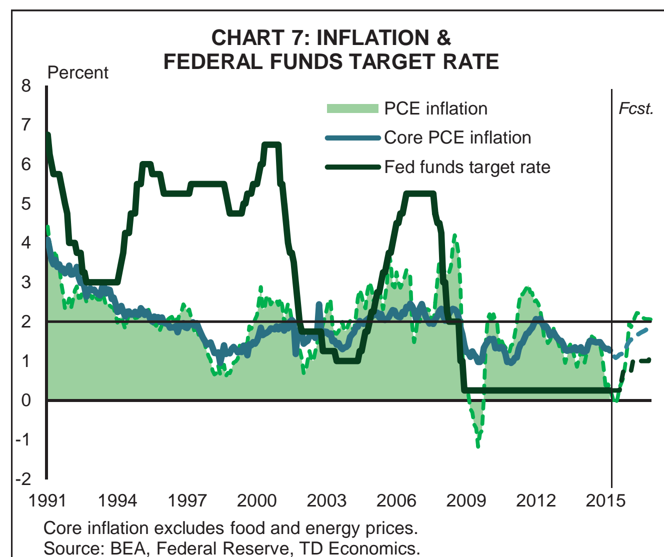
Fed is trading patience for flexibility

The task for the Federal Reserve is how to manage the continued economic recovery and normalization on both sides of their dual mandate (maximum employment and price stability). On the employment side, the unemployment rate is approaching its longer-run goals. The Federal Reserve's recently released Summary of Economic Projections shows a range for the unemployment rate in the "long-run" (post-2016) at 5.0% to 5.2%. This is just 0.4 percentage points from its current value. The Fed (along with us) expects it to reach this level by the end of this year.

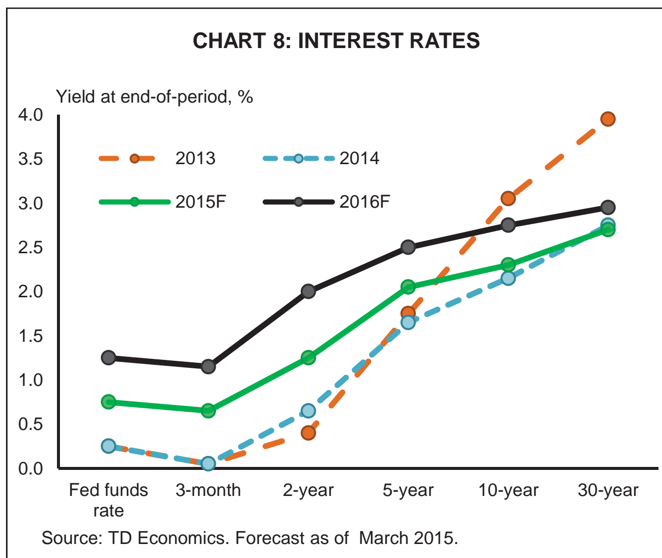
Staying the Fed's hand is the other side of its mandate – inflation. If it was just the fall in energy prices that was bringing down inflation, the Fed would look past it. However, it is not just energy prices. The lofty dollar has cut dramatically into import prices, and at least some of these declines are being passed through to consumer goods. Core goods prices, excluding food and energy, fell 0.8% year over year in January, the biggest decline in over a decade.

Falling prices are not necessarily negative to the outlook – falling energy prices in particular have been associated with accelerating real wage gains. However, with a mandate of price stability, downward revisions to the Fed's outlook for inflation will be a factor in their decision-making process. With much of the rest of the world easing monetary policy, a more hawkish Fed will only push up the dollar's value further – magnifying disinflationary pressures.

Although the Fed has removed patience from its vocabulary, it will continue to have flexibility in raising rates. With a slow move back to their inflation target, the Fed will be comfortable in remaining on hold through the June meeting. Even more important than this, however, is the pace at which they increase rates once the tightening cycle begins. This is likely to be slower than it has been in the past. We anticipate only 100 basis points of hikes through the end of 2016, leaving several meetings where rates will remain on hold.



Core inflation excludes food and energy prices.
Source: BEA, Federal Reserve, TD Economics.



Bottom line

The soft spot for economic growth that took place early last year proved to be a temporary phenomenon. Growth bounced back soundly, with real GDP averaging 4.9% in the second and third quarters of the year. This year, the weather impact does not appear to be as severe, and like last year, the soft patch in growth is unlikely to last.

The American economy is in an enviable position relative to much of the rest of the world. At the end of the day, the decline in energy prices is an income transfer from producers to consumers, and America has many more of the latter than the former. Combined with a strengthening job market, this suggests strong real income gains will set the stage for consumer spending to lead growth higher. This will benefit not only America, but also the rest of the world.

U.S. ECONOMIC OUTLOOK:

Period-Over-Period Annualized Per Cent Change Unless Otherwise Indicated

	2014				2015				2016				Annual Average			4th Qtr/4th Qtr		
	Q1	Q2	Q3	Q4	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F	14	15F	16F	14	15F	16F
Real GDP	-2.1	4.6	5.0	2.2	1.7	3.4	3.2	3.0	2.6	2.7	2.6	2.5	2.4	3.0	2.8	2.4	2.8	2.6
Consumer Expenditure	1.2	2.5	3.2	4.2	2.7	4.0	3.7	3.1	2.9	2.7	2.6	2.4	2.5	3.4	3.0	2.8	3.4	2.7
Durable Goods	3.2	14.1	9.2	6.0	3.2	8.4	7.7	5.5	4.5	4.3	3.9	3.6	6.9	6.8	5.1	8.0	6.2	4.1
Business Investment	1.6	9.7	8.9	4.8	2.6	5.7	5.4	5.5	5.1	4.6	3.8	3.5	6.3	5.3	4.9	6.2	4.8	4.3
Non-Res. Structures	2.9	12.6	4.8	5.0	-1.3	5.1	3.1	2.7	3.1	2.9	2.6	2.8	8.1	3.4	3.0	6.2	2.4	2.8
Equipment & IPP*	1.2	8.9	10.1	4.8	3.8	5.9	6.0	6.4	5.8	5.2	4.2	3.7	5.8	5.9	5.5	6.2	5.5	4.7
Residential Construction	-5.3	8.8	3.3	3.3	-0.1	6.6	11.3	13.3	14.4	13.5	13.1	10.1	1.6	5.0	12.7	2.4	7.7	12.8
Govt. Consumption & Gross Investment	-0.8	1.7	4.4	-1.8	0.5	1.0	0.9	1.1	0.8	0.9	0.8	0.7	-0.2	0.8	0.9	0.9	0.9	0.8
Final Domestic Demand	0.7	3.4	4.1	3.2	2.2	3.8	3.6	3.4	3.2	3.0	2.8	2.6	2.4	3.3	3.2	2.8	3.3	2.9
Exports	-9.2	11.0	4.6	3.2	-1.8	3.6	4.2	4.9	5.1	5.8	5.7	5.6	3.1	2.9	5.1	2.1	2.7	5.5
Imports	2.2	11.3	-0.9	10.1	1.3	6.7	7.3	6.7	6.5	5.7	5.3	5.1	4.0	5.3	6.3	5.5	5.5	5.7
Change in Private Inventories	35.2	84.8	82.2	88.4	84.4	88.1	91.2	87.6	77.4	70.3	65.1	64.5	72.7	87.8	69.3	---	---	---
Final Sales	-1.0	3.2	5.0	2.1	1.8	3.3	3.1	3.1	2.9	2.9	2.8	2.5	2.3	2.9	3.0	2.3	2.8	2.8
International Current Account Balance ($Bn)	-466	-440	-443	-443	-434	-420	-451	-493	-539	-575	-608	-642	-448	-449	-591	---	---	---
% of GDP	-2.7	-2.5	-2.5	-2.5	-2.4	-2.3	-2.5	-2.7	-2.9	-3.0	-3.2	-3.3	-2.6	-2.5	-3.1	---	---	---
Pre-tax Corporate Profits including IVA&CCA	-32.6	38.3	12.8	-13.2	-12.6	4.4	4.2	3.7	2.9	2.9	2.9	2.7	-1.3	-1.0	3.3	-2.3	-0.4	2.8
% of GDP	11.4	12.2	12.3	11.8	11.4	11.3	11.3	11.3	11.2	11.2	11.1	11.1	11.9	11.3	11.2	---	---	---
GDP Deflator (Y/Y)	1.4	1.6	1.6	1.2	1.1	1.0	1.2	1.6	2.0	1.9	1.9	2.0	1.5	1.2	2.0	1.2	1.6	2.0
Nominal GDP	-0.8	6.8	6.4	2.3	2.4	5.5	5.3	4.8	4.7	4.7	4.7	4.6	3.9	4.2	4.8	3.6	4.5	4.7
Labor Force	2.1	-0.5	1.0	0.7	2.3	1.0	1.0	1.1	1.2	1.2	1.1	1.1	0.3	1.2	1.1	0.8	1.3	1.1
Employment	1.6	2.3	2.2	2.5	2.5	2.0	1.9	1.7	1.6	1.6	1.5	1.4	1.9	2.2	1.7	2.1	2.0	1.5
Change in Empl. ('000s)	545	795	744	850	868	701	654	608	580	589	545	502	2,629	3,081	2,377	2,934	2,831	2,215
Unemployment Rate (%)	6.6	6.2	6.1	5.7	5.5	5.4	5.2	5.1	5.1	5.0	5.0	5.0	6.2	5.3	5.0	---	---	---
Personal Disp. Income	4.8	5.5	3.6	3.3	3.9	4.1	4.3	4.4	4.5	4.6	4.6	4.5	3.9	4.0	4.5	4.3	4.2	4.6
Pers. Saving Rate (%)	4.9	5.1	4.8	4.7	5.4	5.2	4.8	4.6	4.5	4.5	4.4	4.4	4.9	5.0	4.5	---	---	---
Cons. Price Index (Y/Y)	1.4	2.1	1.8	1.2	0.1	-0.3	0.2	1.2	2.5	2.8	2.6	2.5	1.6	0.3	2.6	1.2	1.2	2.5
Core CPI (Y/Y)	1.6	1.9	1.8	1.7	1.6	1.5	1.5	1.6	1.7	1.9	2.0	2.1	1.7	1.6	1.9	1.7	1.6	2.1
Housing Starts (mns)	0.93	0.99	1.03	1.07	1.03	1.08	1.14	1.21	1.27	1.33	1.38	1.42	1.00	1.11	1.35	---	---	---
Productivity: Real Output per hour (y/y)**	0.6	1.1	1.2	-0.1	1.1	0.8	0.3	1.3	1.7	1.6	1.6	1.6	0.7	0.9	1.6	-0.1	1.3	1.6

*Intellectual proprty products. **Non-farm business sector. F: Forecast by TD Economics, March 2015

Source: U.S. Bureau of Labor Statistics, U.S. Bureau of Economic Analysis, TD Economics

INTEREST RATE OUTLOOK	2014				2015				2016			
	Q1	Q2	Q3	Q4	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
Fed Funds Target Rate (%)	0.25	0.25	0.25	0.25	0.25	0.25	0.50	0.75	1.00	1.00	1.00	1.25
3-mth T-Bill Rate (%)	0.05	0.04	0.02	0.04	0.05	0.20	0.50	0.65	0.70	0.85	0.95	1.15
2-yr Govt. Bond Yield (%)	0.44	0.47	0.58	0.67	0.65	0.90	1.10	1.25	1.40	1.65	1.90	2.00
5-yr Govt. Bond Yield (%)	1.73	1.62	1.78	1.65	1.55	1.75	1.95	2.05	2.10	2.30	2.45	2.50
10-yr Govt. Bond Yield (%)	2.73	2.53	2.52	2.17	1.95	2.15	2.25	2.30	2.35	2.55	2.70	2.75
30-yr Govt. Bond Yield (%)	3.56	3.34	3.21	2.75	2.60	2.65	2.70	2.70	2.75	2.85	2.95	2.95
10-yr-2-yr Govt. Spread (%)	2.29	2.06	1.94	1.50	1.30	1.25	1.15	1.05	0.95	0.90	0.80	0.75

F: Forecast by TD Economics, March 2015; All forecasts are for end of period; Source: Bloomberg, TD Economics

FOREIGN EXCHANGE OUTLOOK		2014				2015				2016			
Currency	Exchange Rate	Q1	Q2	Q3	Q4	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
Canadian dollar	CAD per USD	1.11	1.07	1.12	1.16	1.24	1.25	1.27	1.30	1.33	1.27	1.22	1.18
Japanese yen	JPY per USD	103	101	110	120	120	121	123	125	125	125	127	127
Euro	USD per EUR	1.38	1.37	1.26	1.21	1.10	1.05	1.00	0.96	1.00	1.00	1.05	1.05
U.K. pound	USD per GBP	1.67	1.71	1.62	1.56	1.47	1.42	1.37	1.39	1.45	1.47	1.48	1.48
Swiss franc	CHF per USD	0.88	0.89	0.96	0.99	0.91	0.95	1.00	1.04	1.00	1.00	0.95	0.95
Australian dollar	USD per AUD	0.93	0.94	0.87	0.82	0.78	0.77	0.76	0.75	0.75	0.74	0.72	0.70
NZ dollar	USD per NZD	0.87	0.88	0.78	0.78	0.77	0.76	0.73	0.72	0.70	0.67	0.64	0.62

F: Forecast by TD Economics, March 2015; All forecasts are for end of period; Source: Federal Reserve, Bloomberg, TD Economics

GLOBAL ECONOMIC OUTLOOK					
Annual per cent change unless otherwise indicated					
	2013 Share*		Forecast		
Real GDP	(%)	2013	2014	2015	2016
World	99.9	3.4	3.3	3.5	3.8
North America	20.0	2.1	2.4	2.9	2.9
United States	16.5	2.2	2.4	3.0	2.8
Canada	1.5	2.0	2.5	1.9	2.2
Mexico	2.0	1.1	2.1	3.1	3.6
European Union (EU-28)	17.2	0.2	1.4	1.8	2.1
Euro-zone (EU-17)	12.3	-0.4	0.9	1.4	1.8
Germany	3.4	0.1	1.6	1.7	1.7
France	2.5	0.3	0.4	1.0	1.5
Italy	2.0	-1.9	-0.4	0.4	1.2
United Kingdom	2.3	1.7	2.6	2.8	2.5
EU accession members	2.7	1.4	2.5	2.8	3.0
Asia	41.3	5.5	5.2	4.9	5.2
Japan	4.6	1.5	-0.1	0.9	1.6
Asian NIC's	3.4	2.8	3.3	3.5	3.5
Hong Kong	0.4	2.9	2.3	2.8	3.1
Korea	1.7	3.0	3.4	3.5	3.5
Singapore	0.4	3.9	2.9	3.3	3.3
Taiwan	1.0	2.1	3.7	3.8	3.6
Russia	3.4	1.3	0.5	-4.5	-1.0
Australia & New Zealand	1.2	2.4	2.8	2.4	3.4
Developing Asia	28.7	7.0	6.9	7.0	6.8
ASEAN-4	4.6	5.2	4.4	5.2	5.4
China	15.8	7.7	7.4	6.9	6.5
India**	6.6	6.9	7.4	8.3	8.7
Central/South America	6.7	3.2	0.8	0.6	1.9
Brazil	3.0	2.5	0.1	-0.4	0.5
Other Developing	13.7	3.5	3.0	3.5	4.0
Other Advanced	1.0	1.9	2.3	2.0	2.3

*Share of world GDP on a purchasing-power-parity basis.
Forecast as at March 2015. **Forecast for India refers to FY.
Source: IMF, TD Economics.

ECONOMIC INDICATORS FOR THE G-7 AND EUROPE				
		Forecast		
	2013	2014	2015	2016
Real GDP (Annual per cent change)				
G-7 (32.7%)*	1.5	1.7	2.2	2.3
U.S.	2.2	2.4	3.0	2.8
Japan	1.6	-0.1	0.9	1.6
EZ	-0.5	0.9	1.4	1.8
Germany	0.1	1.6	1.7	1.7
France	0.4	0.4	1.0	1.5
Italy	-1.7	-0.4	0.4	1.2
United Kingdom	1.7	2.6	2.8	2.5
Canada	2.0	2.5	1.9	2.2
Consumer Price Index (Annual per cent change)				
G-7	1.3	1.5	0.4	2.1
U.S.	1.5	1.6	0.3	2.6
Japan	0.4	2.7	0.7	1.1
EZ	1.3	0.4	0.0	1.4
Germany	1.6	0.8	0.5	1.8
France	1.0	0.6	0.4	1.6
Italy	1.3	0.2	0.3	1.4
United Kingdom	2.6	1.5	0.3	1.8
Canada	0.9	1.9	0.4	2.1
Unemployment Rate (Per cent annual averages)				
U.S.	7.4	6.2	5.3	5.0
Japan	4.0	3.6	3.5	3.4
EZ	12.0	11.6	11.1	10.6
Germany	5.2	5.0	4.7	4.5
France	10.3	10.2	10.1	9.9
Italy	12.2	12.7	12.5	12.1
United Kingdom	7.6	6.2	5.4	5.1
Canada	7.1	6.9	6.8	6.8

*Share of 2013 world gross domestic product (GDP)
Forecast as at March 2015
Source: National statistics agencies, TD Economics

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