Capital Risk
Economics

First Quarter 2018

**United States**

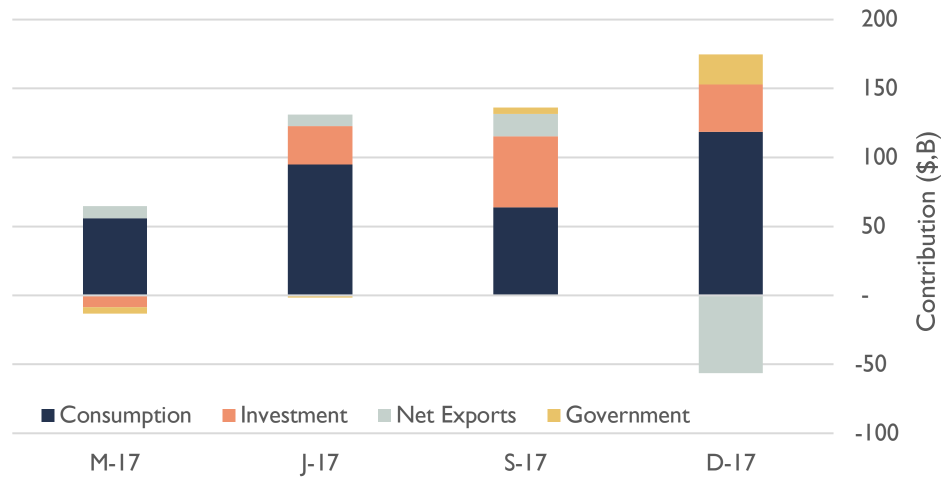
# Economic Outlook

- Real GDP growth for 2018 is expected at 2.5%.
- CPI and Core CPI inflation for 2018 are forecast at 2.2 and 2.1%.
- While Import growth continues to reflect a healthy consumer, it detracts from overall growth calculation.
- Accelerating investment growth to supports a rebound in the commodity complex and will contribute to growth.

The economic environment in the US continues to show a stable consumer, rebounding investment, and supportive fiscal policy. The lone detractor from growth is the continuing drag from net exports, but this is merely an accounting identity. A high level of imports of consumer goods and services indicates a healthy economy. This drag on the GDP growth rate is not expected to reverse since a strong consumer will continue to spend.

The risks to growth are minimal for the year as it would take a material change in consumption to alter the course. That does not imply that there are not risks: Chinese rebalancing may fail and cause a credit contraction, trade wars may escalate, and the Federal Reserve may not adequately manage its exit from the monetary stimulus. Domestic and Chinese credit are the canaries in the coal mine for danger. Near-term these risks are trivial given the economic momentum in the US, but given the political environment, the course can change quickly.

## Table 1. GDP Contribution by Component




*Source: Federal Reserve Economic Database, CRM Calculations*

## Forecast Summary

The GDP growth forecast for the quarter is at a healthy rate of 3.2% driven by an acceleration of investment. The growth rate is currently running below this level of growth as net exports detract, and investment contributes less than expected. The slower growth may result in a modest reduction of the forecast of GDP growth for 2018 of 0.1-0.2% once final quarterly data is available, but outlook is still on track, for now.

### Table 1. GDP and Component Forecast

| | Real Gross Domestic Product | | | | |
|---|---|---|---|---|---|
| 2017 April | Total | Consumption | Investment | Government | Net Exports |
| **Current Level ($, B)** | **17,286** | **12,035** | **3,011** | **2,922** | **-654** |
| **Forecast (%, Q/Q)** | **3.2** | **2.9** | **10.8** | **0.5** | **-671** |
| **Forecast (%, Y/Y)** | **2.5** | **2.9** | **5.0** | **0.5** | **-725** |
| Quarterly Change (%) | 2.0 | 2.7 | 2.3 | 1.0 | -2.6 |
| Semi-Annual Change (%) | 1.4 | 2.0 | 2.3 | 1.5 | -16.5 |
| Yearly Change (%) | 2.3 | 2.4 | 3.9 | 0.9 | -4.8 |

* Changes are annualized rates. 2018 Q1 data is estimated. CRM calculations.

Inflation of 2.1%, measured by the core inflation rate over the last year, is breaching the FED's target level and indicates that future rate hikes will remain on course. The continuing pressure from a tight labor market ensures that wage inflation will drive all measures of inflation higher. The primary risk to higher inflation is energy prices, which is up 7% over the last year. The expectation is for them to moderate as the current impact on core measures of inflation is negligible.

### Table 2. Consumer Price Index ex Food & Energy Forecast

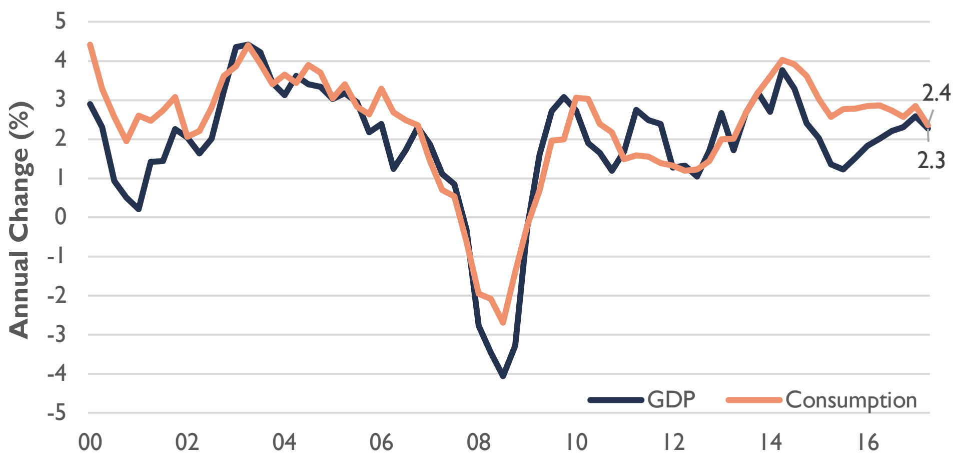
| | Consumer Price Inflation | | | | |
|---|---|---|---|---|---|
| 2018 April | Total | Core | Food | Energy | PCE |
| **Index Level (Nov 2018)** | **249.5** | **256.2** | **252.4** | **215.0** | **114.3** |
| **2018Q1 Forecast (%, Q/Q)** | **2.5** | **1.9** | | | |
| **2018 Forecast (%, Y/Y)** | **2.2** | **2.1** | | | |
| Quarterly Change (%) | 2.5 | 2.9 | 1.3 | 1.0 | 2.3 |
| Semi-Annual Change (%) | 2.5 | 2.6 | 1.3 | 3.8 | 2.2 |
| Yearly Change (%) | 2.4 | 2.1 | 1.3 | 7.0 | 2.0 |

* Changes are annualized rates. CRM calculations.

## GDP Components

Gross Domestic Product continues is at a healthy pace with the Consumer leading the way. Gains in wages and the steady expansion of payrolls will support growth at these levels for the remained of the year. With the commodity complex now adding rather than detracting, from growth, investment will begin to add to overall growth. The challenge is new exports: a weak dollar supports exports, but a robust consumer pulls imports. The net effect will determine the growth trajectory for the economy.

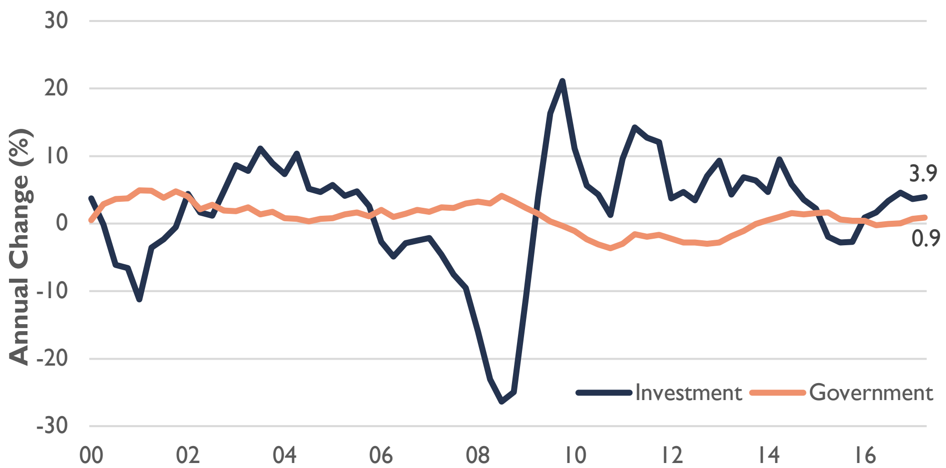
### Exhibit 1. Real GDP and Consumption (y/y, %)




*Source: Federal Reserve Economic Database*

Investment is returning after the bust in the Oil patch delivered a retrenchment in 2015-16. The trouble is the growth rate is at a level that was the bottom of the prior range. This growth rate provides room for expansion but is worrisome in the context of a robust economy. Government expenditures continue at their modest pace, which at a level below that of consumption and investment, slows overall growth.

### Exhibit 2. Investment and Government Expenditures




*Source: Federal Reserve Economic Database*

## Consumption

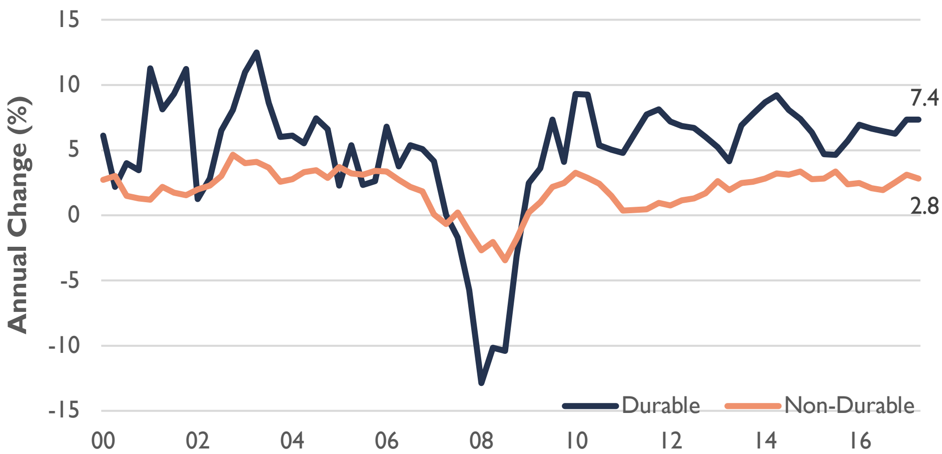
The consumer is evidently in a good position: goods consumption remains at a cycle high and reflects the steady job and wage growth. Services consumption growth, the substantial proportion, continues to slow. Healthcare and financial services costs are leading consumption higher, while below trend housing, transportation, and food services are moderating the impact of services growth.

### Exhibit 3. Consumption, Goods and Services


*Source: Federal Reserve Economic Database*

The hallmark of a healthy consumer is durable goods purchases, which are leading overall goods purchases higher. The consumer is safely putting the Great Recession behind them. The combination of a large household formation cohort with the Millennial generation and a tight labor market provides substantial evidence that the trend in durable goods consumption will continue for an extended period.

### Exhibit 4. Consumption, Durable and Non-Durable Goods

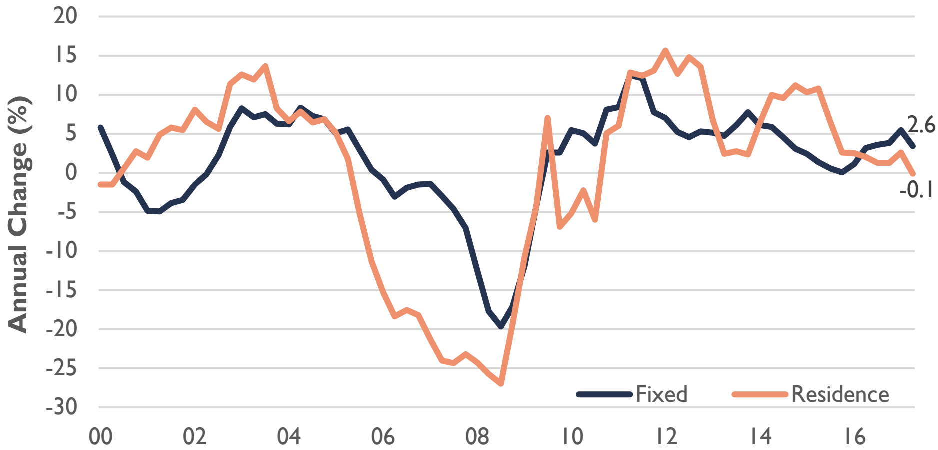



*Source: Federal Reserve Economic Database*

## Investment

Fixed investment in the most variable component of the signficant GDP accounts and indicates the expectation of business for the future. Fixed investment is recovering from the commodity complex retrenchment over the last few years. With oil prices steady, the investment category will continue to improve. Particularly important is a constrained labor market, which will provide an incentive for business to deploy capital to enhance productivity. Residential structures are slowing but are not as worrisome since housing demand is expected to remain firm.

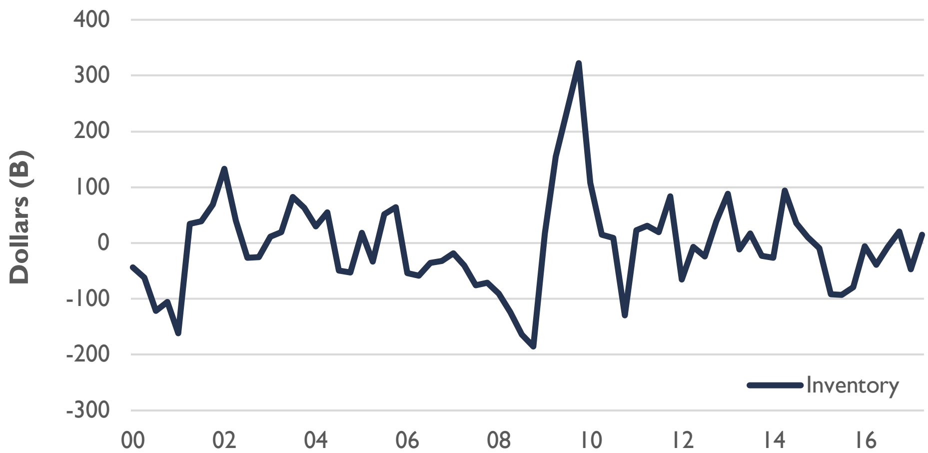
### Exhibit 5. Investment, Non-Residential and Residential Structures




*Source: Federal Reserve Economic Database*

Low levels of a buildup of inventories is a good signal that business is meeting demand. The current level show that demand growth is stable with little inventory drawdown. Given the modest reduction of inventories in 2015-16 and the robust consumption market, a continual rebuilding of inventories is additive for GDP growth.

### Exhibit 6. Inventories




*Source: Federal Reserve Economic Database*

## Government

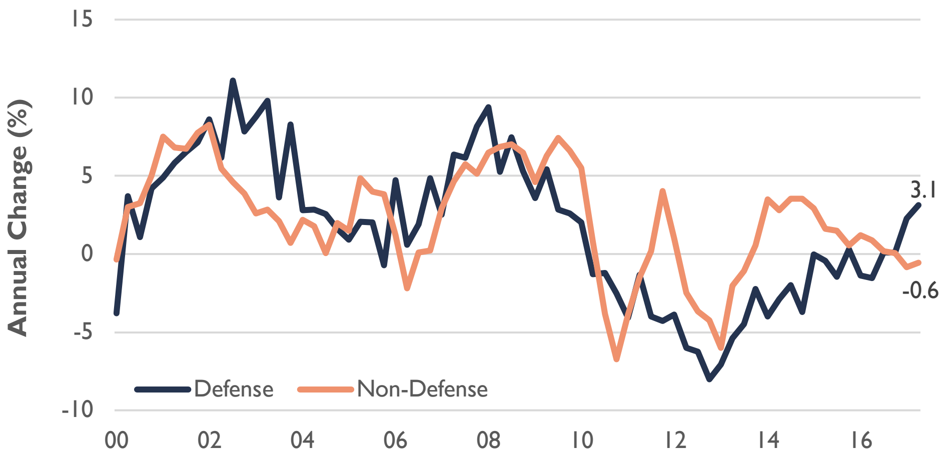
The passing of the recent federal fiscal legislation will continue to support modest levels of growth in government. The challenge is that government expenditures are dominated by the State & Local levels, which continue to face funding cuts to balance their budgets. This action is an ominous sign given the high levels of current employment, and close monitoring is required given the size of the sector in GDP.

### Exhibit 7. Federal and State Government


*Source: Federal Reserve Economic Database*

The Federal government continues its expansion, primarily in defense spending. With non-defense expenditures in a modest decline, any decline in defense expenditures will detract from growth. The low level of growth in non-defense spending is an insignificant detraction from overall growth but does supply a means to deliver fiscal stimulus if the case is warranted.

### Exhibit 8. Government Spending: Defense & Non-Defense




*Source: Federal Reserve Economic Database*

## Exports & Imports

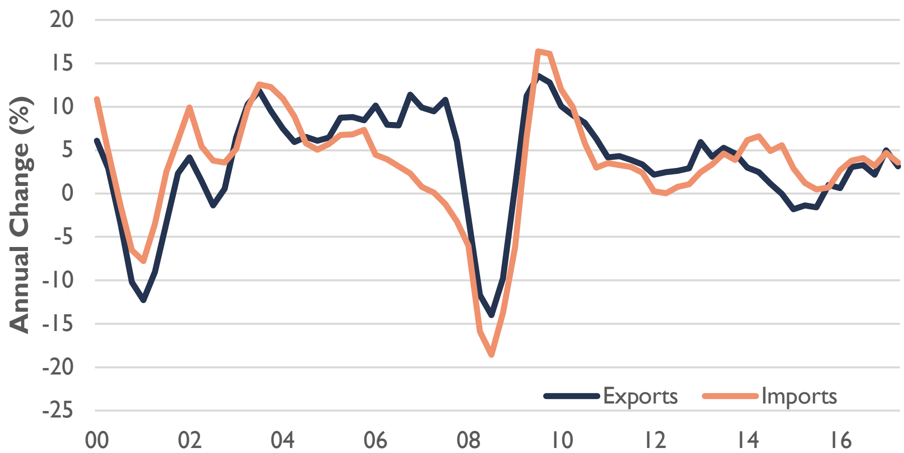
There is no better sign of a content consumer then negative net exports. High commodity prices drove prior changes in net exports, this time they are supporting domestic consumption with inexpensive consumer goods, which is a positive sign for the domestic economy. The high level of imports comes at the cost of exported jobs. For GDP growth, the net export deficit masks strong domestic growth in the US.

### Exhibit 9. Net Exports


*Source: Federal Reserve Economic Database*

The challenge for the US is on the export side. Since imports are about 25% larger than exports, the same growth rates deliver a widening trade deficit. Exports are dependent on the foreign demand, which is enjoying stable growth globally. The challenge is that the US provides two significant exports: food commodities that are declining in price and high-value goods and services that require developed economies. With much of the marginal growth in the world coming from emerging economies, it may be difficult to narrow the gap in the near term.

### Exhibit 10. Government Spending: Defense & Non-Defense




*Source: Federal Reserve Economic Database*

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