RSQE FORECASTS

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The U.S. Economic Outlook for 2017–2018
Executive Summary: March 2017

Optimism and Job Gains Up, but For How Long?

Real GDP expanded by 1.6 percent in 2016, with the fourth quarter growing at a 1.9 percent annualized pace, slightly slower than the average since 2010. Final sales to domestic purchasers—a less volatile measure of the underlying health of the domestic economy—grew at a healthier 2.6 percent pace in the final quarter of 2016.

Measures of consumer and business optimism skyrocketed in December 2016 and remain high. At 97.6 in March, the University of Michigan's Consumer Sentiment Index is the fifth highest monthly reading in the past 16 years. The National Federation of Independent Business's Small Business Optimism Index sits near levels seen only during two years out of the past thirty, in 2003–04.

Nonfarm payroll job gains have sped up in 2017, averaging over 236,000 in January–February. We see those gains as being above trend, possibly reflecting an unusually warm winter and some catch-up growth from a relatively weak gain of 170,000 jobs per month in the fourth quarter of 2016.

Investors are also optimistic. The main equity indices—the S&P 500, the Dow Jones Industrial Average, and the NASDAQ Composite—are near all-time highs.

Full Employment Draws Nigh

The unemployment rate is currently at the Congressional Budget Office's estimate of the natural rate of unemployment, 4.7 percent. The labor force participation rate has climbed from 62.6 to 63.0 percent since November 2016, drawing people into the labor market against demographic pressures. Initial unemployment claims as a proportion of employed workers are at an all-time low. Wage growth has improved more slowly, but the 2.8 percent 12-month increase in average private nonfarm hourly earnings recorded in February was nonetheless an improvement over 2016's average pace of 2.6 percent.

Inflation pressures appear to be picking up. Breakeven inflation on 5-year Treasury Inflation-Protected Securities rose from 1.3 percent in September to 1.9 percent in February. January saw a broad-based spike in the core Personal Consumption Expenditures price deflator to 3.6 percent at an annual rate, the strongest in 10 years. We believe the latest monthly inflation readings are above the underlying trend, and that inflation will retreat over the near term. Nonetheless, the tightening labor market is likely to boost inflation over the medium term.

Light Vehicle Sales Still in High Gear

Light vehicle sales are strong, but unlikely to improve further. An all-time record was set in 2015 with 17.4 million vehicles sold, which was narrowly surpassed in 2016 with sales of 17.5 million units. Fueled by high inventories and strong incentives, light vehicle sales closed the fourth quarter of 2016 on a turbocharged pace of 18 million units annually. Sales have since down-shifted to a pace of 17.5 million units on average in January and February.

The industrial sector shows improvement. After averaging a barely expansionary 51.5 in 2016, the Institute for Supply Management's manufacturing index improved to 56.0 in January and 57.7 in February, its highest levels since December 2014. The Federal Reserve's index of industrial production for manufacturing has been climbing since August 2016. The subindex for oil and gas well drilling has been increasing since bottoming out in May 2016.

With oil prices roughly stable for the past 10 months, the oil extraction sector has been on the mend. The number of active rotary rigs and the Fed's index of industrial production for the oil and gas well drilling sector have both been increasing since bottoming out in May 2016. After contracting for seven consecutive quarters, investment in mining exploration, shafts and wells finally expanded in 2016q4. Between October and early March, domestic oil production expanded by 0.5 million barrels per day.

The Fed Eases off the Accelerator

At its March meeting the Federal Reserve raised the target range for the federal funds rate by 25 basis points (bps) to 75–100 bps. That increase was the third of the current tightening cycle, and reflects Fed officials' confidence in the strength of the economic expansion and increasing inflationary pressures.

We project two more rate increases in 2017, after the September and December FOMC meetings, although we would not be surprised if the second rate increase of the year were to occur after the FOMC's June meeting rather than the September meeting. We expect the Fed to continue to react to the incoming data rather than adhere to a calendar-based rule.

Near-Term Fiscal Uncertainty

With no major laws passed so far, we are still in the dark about the balance of power in the new Congress. The fate of the Republican healthcare legislation will be the first concrete signal of things to come. We currently anticipate that modifications to the Affordable Care Act (ACA) will slow the growth of federal transfer spending and eliminate some ACA taxes. We also anticipate lower federal personal and corporate taxes. Slower tax receipt growth and steady expenditure growth will widen the federal budget deficit from a projected 3.5 percent of GDP in fiscal 2017 to 3.9 percent in fiscal 2018.

The 2017–2018 Outlook

Our outlook is for a marginal acceleration in real GDP growth, from a 1.9 percent pace during 2015–16 to a 2.2 percent pace during 2017–18. Recovery of business fixed investment from the recent oil-related drag explains the bulk of the upshift in the pace of expansion. Growth in consumption expenditures is the primary driver of GDP over our forecast horizon, contributing 1.6 percentage points on average.

The housing sector continues to contribute to overall economic growth as higher prices spur an expansion in residential investment. Annual housing starts grow from 1.18 million units in 2016 to 1.26 million units in 2017 and 1.32 million units in 2018.

Employment and Inflation

The unemployment rate falls to 4.6 percent in 2017 and 4.5 percent in 2018. As labor markets tighten, we expect average monthly job gains to slow to 193,000 jobs in 2017 and 168,000 in 2018.

In 2017, a moderate increase in calendar-year average gasoline prices pushes headline inflation up to 2.5 percent, just ahead of core inflation for the first time since 2011. Energy price inflation slows in 2018, and core inflation, at 2.2 percent, runs ahead of all-item inflation, which remains at 1.9 percent.

	Actual		**RSQE Forecast**	
	2015	2016	2017	2018
GDP (billions of current $)	18036.6	18565.6	19340.2	20196.6
Real GDP (billions of chained 2009 $)	16397.2	16659.8	17009.5	17409.6
% change: year-over-year	2.6	1.6	2.1	2.4
% change: 4th-qtr-to-4th-qtr	1.9	1.9	2.2	2.2
Nonfarm payroll employment (millions)	141.8	144.3	146.6	148.6
Civilian unemployment rate (%)	5.3	4.9	4.6	4.5
Capacity utilization, total industry (%)	76.7	75.4	75.5	76.0
Inflation (private nonfarm GDP deflator, % change)	1.1	1.3	2.0	2.0
Inflation (CPI-U, % change)	0.1	1.3	2.5	1.9
Inflation (core CPI, % change)	1.8	2.2	2.2	2.2
Light vehicle sales (millions)	17.4	17.5	17.4	17.3
Private housing starts (thousands)	1108.2	1176.2	1256.7	1316.5
3-month Treasury bill rate (%)	0.1	0.3	0.9	1.6
10-year Treasury note rate (%)	2.1	1.8	2.7	3.1
Conventional mortgage rate (%)	3.9	3.6	4.4	4.8
Real disposable income (billions of chained 2009 $)	12343.2	12685.9	12999.9	13401.7
% change	3.5	2.8	2.5	3.1
Corporate profits after tax (billions of current $)	1583.8	1645.6	1719.3	1821.0
Value of U.S. $ (FRB broad index), % appreciation	12.5	4.7	3.7	0.5
Current account balance (NIPA basis, billions of current $)	–477.4	–477.6	–563.8	–587.4
Federal surplus (FY, NIPA basis, billions of current $)	–589.7	–629.0	–662.9	–785.3