ECONOMIC OUTLOOK
REGIONS
December 2016

U.S. Economy: Off To The Races?

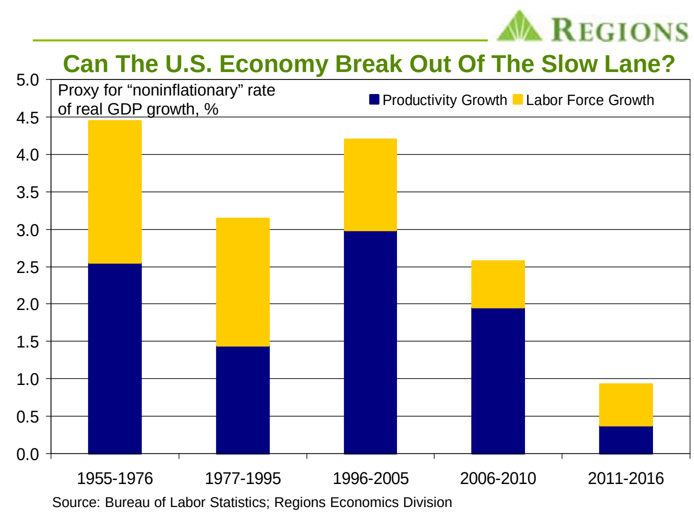
Well, it sure seems that way. The weeks since the election have seen sharp increases in market interest rates, a rally in equity prices, and a stronger U.S. dollar. Republican control of the White House and both houses of Congress has raised the prospect of tax reform, regulatory relief, and higher federal government spending on infrastructure and defense. Expectations that this policy mix will result in a sharp acceleration in U.S. economic growth and at least some acceleration in inflation have drawn investors to risk assets and away from bonds. Yields on 10-year U.S. Treasury notes have gone from 1.83 percent, on the day before the election, to around 2.40 percent and the yield curve has become considerably steeper.

So, the question is whether, come 2017, the U.S. economy will be off to the races. We actually think this is the wrong question. We'll concede that, yes, the economy will be off to the races, but we think the relevant question is whether it will be a marathon or a sprint. After all, the only race the U.S. economy has resembled since the end of the 2007-09 recession is a marathon at an octogenarian Olympics. With the current expansion set to become the third longest on record and yet remain the slowest on record, this seems like an apt comparison. And, while there seems to be great anticipation that the economic equivalent of performance enhancing drugs, i.e., expansive fiscal policy and meaningful regulatory relief, will turn that marathon into something more akin to the 100-meter dash with the U.S. economy playing the role of Usain Bolt, it could be that expectations are outrunning what will prove to be reality. If so, asset prices and the U.S. dollar could see a sudden and significant reversal of course.

Just to be clear, we do think the combination of expansionary fiscal policy and regulatory reform poses upside risks to our baseline outlook. At the same time, we think trade policy, at least based on what we've heard so far, poses downside risks. At present, however, it's all mere speculation and until we have a complete set of policy proposals to work with, it isn't really possible to quantify the net impact on U.S. economic growth. Our sense is that, given the policy mix we anticipate, the upside risks to our baseline outlook outweigh the downside risks, but we also think that will be more apparent in 2018 than in 2017. In other words, when all is said and done, our forecast for 2017 may not look too different than it now looks, i.e., real GDP growth of 2.1 percent, the same middling rate of growth we've all come to know but not necessarily love since the end of the 2007-09 recession.

Longer term, we question whether any policy-induced lift to growth will be as powerful and as lasting as many now seem to expect. As for those who argue that policy changes can deliver a sustained period of real GDP growth of 3.0-to-4.0 percent, well, no. Really, we'd love to be wrong on this and if we are we'll be happier than anyone, but we just don't think we will be. Our skepticism is based in part on what we expect to be a gap between the promise and reality of policy changes and in part on the reality that there are structural headwinds to growth that, even to the extent they can be impacted by policy, won't abate quickly.

Those structural headwinds come in the form of what has been anemic labor productivity growth and notably slow growth in the labor force. We know of no better way to illustrate our point than with what, to our regular readers, is by now a familiar chart. The chart below shows the economy's noninflationary "speed limit," or, how rapidly the economy can grow without fostering inflation pressures. The economy's speed limit can be approximated by taking the sum of the rate of growth of the labor force and the rate of labor productivity growth.



As seen in the chart, at present the economy's speed limit is distressingly slow (note we delineate the different time periods on the basis of productivity growth cycles, not calendar years). It would seem that understanding and addressing these structural headwinds to growth would be a starting point in any discussion of how rapidly the economy can grow on a sustained basis. At least it would seem that way to us, though not all agree. Try as we might, we cannot forget an exchange on financial talk TV the morning aftrer the election in which, on the way to declaring the U.S. economy off to the races, one of the correspondents brushed aside concerns over anemic productivity and labor force growth as nothing more than theoretical concerns of academic economists.

Thank goodness for financial talk TV because, really, you can't get expert insight like that from the *Home Shopping Network*. To be sure, academic economists have many theoretical concerns that have little, if any, connection to the actual world. For instance, fretting over the choice between a quadratic utility function or an iso-elastic utility function as the basis for modeling intertemporal consumption in a world in which there is a single good available for consumption would seem to fit that bill. In the actual world,

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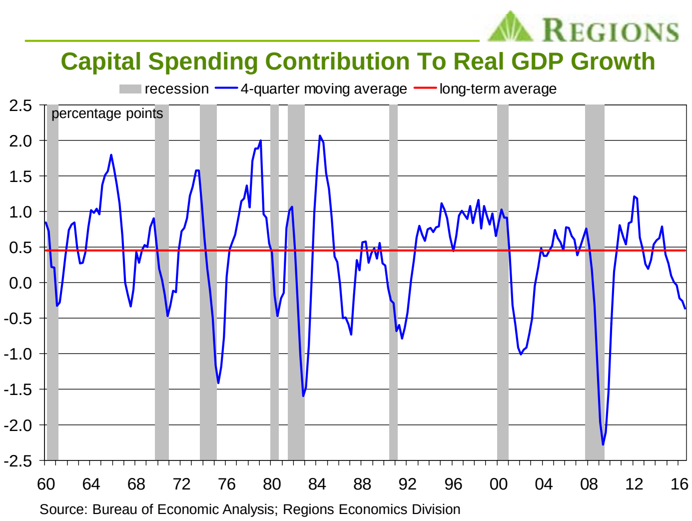
however, actual economic growth is actually determined by actual factors such as the growth rates of the labor force and labor productivity. But, sure, for the record, iso-elastic is the way to go.

The economy's extraordinarily low speed limit is a topic we spend quite a bit of time discussing and writing about, so we won't rehash a lot of the details here. Suffice it to say demographics are the key driver of the rate of labor force growth, and what we are seeing, in the U.S. and in much of the world, is an aging population acting as a binding constraint on labor force growth. We have also argued that while there are measurement issues resulting in productivity growth being understated, we think the magnitude of any mismeasurement is relatively small and that the biggest factor behind an anemic trend rate of productivity growth is underinvestment on the part of U.S. firms.

Business investment spending has been notably weak over the course of the current expansion, which is a story we have been telling for years. Real business investment in equipment and machinery has declined in each of the past four quarters, which is highly unusual during an economic expansion. But, the weakness in business investment extends well beyond the past four quarters, as can be seen in the following chart which shows the contribution, in terms of percentage points, of business investment in plant and equipment to top-line real GDP growth.



The situation is even worse than it looks in the above chart. In the early stages of the current expansion, growth in business investment spending was highly concentrated in the energy sector, while in the prior expansion construction related investment was a main driver. And, sure, it's valid to point out that declines in business investment spending over recent quarters reflect steep pullbacks in energy-related investment, but even after accounting for energy, broader business investment spending has been alarmingly weak. In other words, investment in what we would think of as "traditional" capital equipment has been even thinner than the above chart implies. This has resulted in a capital stock that is older than has been the case through much of history, and we think it plausible to argue this aged capital stock has acted as a material drag on labor productivity growth.

Again, the slow speed limit should be the starting point in any discussion of the economy's capacity to achieve a sustained period of growth at a rate significantly faster than the 2.1 percent average rate seen since the end of the 2007-09 recession. This is not to say anemic labor force or productivity growth is set in stone, and we do, in fact, believe there is some scope for policy changes to push up the economy's speed limit.

Indeed, go back to our first chart showing the economy's speed limit – the more widely used term in discussions on this topic is the economy's "potential" rate of growth. We steadfastly refuse to use that term, for the simple reason that we believe there to be a difference between the economy's current speed limit and what the economy is capable of, thanks in large part to regulatory and fiscal policy inefficiencies. While we don't think that gap is wide enough to warrant belief in the possibility of a sustained period of growth between three and four percent, we do think the economy can grow at a faster rate than implied by the chart on Page 1.

For instance, it is possible that lower corporate tax rates and a provision to enable firms to fully expense capital outlays in the year of purchase could prompt a sharp rebound in business investment outlays. This would not only contribute to faster growth in the present, but over time would also help increase the economy's speed limit via improved productivity growth. This latter effect, however, won't come quickly, nor is it likely to sustain productivity growth at a rate anywhere near the 3.0 percent average that prevailed between 1996 and 2005.

While a faster underlying rate of economic growth would support increased demand for labor on the part of firms, there is less latitude for policy to directly impact labor force growth. If anything, the policy chatter we've heard thus far suggests the opposite. A less friendly immigration policy would contribute to an even slower inflow of labor force entrants, and a foolish refusal to expand the H1B visa program would have the added effect of depriving U.S. firms of skilled labor, which has been hard enough for firms to find of late. As such, any policy induced increases in the economy's speed limit are likely to come in the form of faster productivity growth as opposed to faster labor force growth.

As a side note, this is one area in which comparisons between our present day situation and the early 1980s, comparisons which have become popular in some circles, fail to hold. On the heels of a deep and painful recession (technically two recessions according to the NBER), the combination of significant tax cuts and regulatory relief helped spark a seven-year period from 1983 through 1989 in which average real GDP growth was 4.4 percent. One key difference between then and now is that in the 1980s labor force participation amongst females was rising strongly, offsetting declining male participation and pushing the overall labor force participation rate higher. At present, participation amongst both males and females is falling, reflecting demographic factors, and this decline is not likely to be significantly impacted by present day fiscal and regulatory policy. This simply goes back to our point that structural headwinds to growth matter.

The Same Party, But Are They Singing From The Same Hymnal?

These structural headwinds do not mean there is no capacity for policy changes to contribute to a faster rate of economic growth on a sustained basis; instead it is a matter of degree, and we think there is upside potential from the body of prospective policy changes. Fiscal and regulatory policy represent potential upside risks to our baseline growth outlook. Lower individual and corporate tax rates are expected to be components of comprehensive reforms to the tax code, with corporate tax reform also addressing the tax basis of foreign earnings and changes in depreciation rules. Potential offsets could come in the form of an all-out elimination of individual and corporate deductions, though limiting the scope of available deductions seems the more likely (though not more desirable) outcome. On balance, individual and corporate tax reform should help stimulate consumer and business spending. Further fiscal stimulus is expected to come in the form of greater federal government spending, with defense and infrastructure likely areas of higher spending.

Potential changes to regulatory policy could cover a wide swath of the economy, including health care, finance, transportation, energy, and the labor market. A diminished regulatory burden could easily contribute to faster economic growth, in part by reducing compliance and manpower burdens on U.S. corporations. We have often referred to regulation as the silent killer of economic growth, and we think that has been more pronounced over the past several years.

To be sure, we not amongst those who think any and all regulation is inherently evil. Where we do take issue, however, is the Keystone Cops manner in which regulatory policy has often been applied. In other words, regulation after regulation is passed with no cost/benefit analysis or any assessment of how a given regulation will impact the economy in conjunction with other regulations. Perhaps one reason is that in many cases regulatory changes seem to be made on the basis of political, not economic, calculations. At least with an objective analysis there would be a basis on which to assess economic and non-economic costs and benefits of any proposed regulatory change, and on this basis an informed decision can be made. And, sure, that same standard should be applied to repealing, as well as passing, regulations. But, really, is there anyone who honestly believes that, had such an analytical framework been in place from day one, the body of regulatory policy would be exactly what it is today, or even close?

Trade policy represents a potential downside risk to our baseline growth outlook. To be sure, there is a divide between campaign rhetoric and governance, but in the case of trade policy the wider that divide, the better. Curtailed trade flows due to the U.S. withdrawing from global trade pacts and/or imposing tariffs on imports of foreign goods would be a drag on overall growth, while tariffs would also push inflation higher. Amongst the many disturbing comments we've heard is that "imports make us poorer" which apparently stems from the manner in which GDP is calculated. Yes, spending on imports is deducted from expenditures in the calculation of GDP, and sure, if imports were zero GDP would be higher, if nothing else were to change. Which means we'd be richer, right? Wow, okay, no.

Keep in mind GDP is not a measure of richer or poorer, it is a measure of the value of all final goods and services produced in an economy in a given point in time. Hence, the deduction of imports. Also keep in mind that the counterpart to a deficit in the trade account is a surplus in the capital account, as the only way the U.S. can persistently run a trade deficit is if foreigners are willing to finance that deficit. That, at least in theory, means a higher level of domestic investment which, over time, actually can make us richer, though that relies on our making judicious use of foreign savings. Let's just say that, on that count, the jury is still out, which is about the most charitable assessment we can offer.

Another dubious premise on which opposition to trade seems to be based is that the U.S. need not worry about moves to restrict imports being countered by similar moves abroad; moves that would mean diminished volumes of U.S. exports (which, by the way, doesn't do much for the GDP math discussed above). There are those who think this doesn't matter because, after all, exports account for "only" about 13 percent of GDP and, really, U.S. manufacturers who can't sell their goods abroad can simply divert production to those goods no longer being imported into the U.S., can't they? Once again, wow, okay, no.

Despite our obvious concerns on the trade front, we think that on balance there is more upside than downside from prospective changes to fiscal and regulatory policy. But, on top of the structural headwinds discussed above, there are reasons why the lift to growth may fall well shy of what some are promising and others are expecting. For one, while on the surface there would seem to be a wide agreement on the course of fiscal and regulatory policy between the incoming Administration and the incoming Congress, there are areas of potential disagreement, particularly in terms of additional federal government spending. While we've seen estimates of an additional $1 trillion of infrastructure spending floating about, it is unlikely Congressional Republicans would go along with anything close to that figure, and they are also likely to be wary of being seen as issuing a blank check to Mr. Trump.

After all, many Republicans were voted into office having campaigned on a platform of cutting government spending and getting control of federal government budget deficits, a stance that seemingly puts them at odds with Mr. Trump on the potential for expanded federal government spending. Moreover, the budget blueprint approved by, you guessed it, House Republicans, earlier this year calls for cumulative deficit reduction of $7 trillion relative to current projections over the next decade mainly via, you also guessed it, spending cuts. It could be that, when it comes to government spending, Mr. Trump will be more closely aligned with Congressional Democrats in a battle against Republicans.

One early sign as to how closely aligned the new Administration and Congressional Republicans are on spending priorities will come in the form of the federal government debt ceiling. Having been suspended since late-2015, the debt ceiling is set to be reinstated in March 2017 and the current debt limit will be hit sometime around mid-year. Whether Congress agrees to raise the ceiling, and the extent to which they raise it, will be a signal of the potential for conflict over any expansion in federal government spending. Let's just say we're not exactly expecting this to yield any kumbaya moments for the new Administration and Congress.

There are also timing issues that will help determine when policy changes have an impact on the economy. The legislative process seldom moves rapidly, and if there is indeed comprehensive reform of the tax code that will be a drawn-out process, in terms of drafting a plan and steering it through both houses of Congress.

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While the President has some unilateral authority on regulatory policy, the possibility of legal challenges to regulatory changes cannot be ruled out, nor can the possibility that those who have become entrenched in the various regulatory agencies will fight against what they perceive to be infringements on their turf by the Executive branch. Also, regulatory reforms that require Congressional action, such as repeal and/or reform of the Affordable Care Act and Dodd-Frank, are sure to be lengthy processes. It should be noted that the one area in which we see potential downside risks, i.e., trade policy, is the area in which the Executive branch has the most latitude to move unilaterally.

Even if the new Congress and the new Administration get along swimmingly and muster the collective wisdom to pass a set of uniformly pro-growth policies (oh come on, if you can't dream, why even get out of bed in the morning), there are still obstacles to a prolonged period of significantly faster growth. For instance, in the weeks since the election, we've seen significant increases in market interest rates and the exchange value of the U.S. dollar. Neither, at least as we understand it, is a positive for economic growth. Higher interest rates make it more expensive for firms, households, and governments to service their debts, and the housing market is vulnerable to increases in mortgage rates. In addition to dampening growth in U.S. exports by making U.S. produced goods more costly in global markets, a stronger U.S. dollar also diminishes foreign profits of U.S. corporations.

We do not see the recent increases in market interest rates or the exchange value of the U.S. dollar as being fatal to the expansion, but should these increases be added to over coming months, then there will be cause for concern. For instance, we have often stated our belief that, given what has been rapid house price appreciation over the past several quarters, notably low mortgage interest rates have acted as a buffer between price appreciation and affordability, but as mortgage rates move higher, that buffer will become thinner and thinner. Moreover, higher mortgage rates could dampen transaction activity more in the current cycle than in past cycles as a greater number of homeowners who have either purchased a home or refinanced their mortgage in recent years may feel "locked in" to their home by their low mortgage rate. If so, they will be less likely to trade homes if doing so entails taking on a significantly higher mortgage interest rate.

As far as market interest rates go, an additional factor to consider is that, to the extent lower tax rates hold down growth in government tax revenues and this is accompanied by higher government spending, larger budget deficits would mean the federal government would have to issue more debt in order to finance these deficits. This, in turn, would put even further upward pressure on market interest rates, thus increasing the risk that higher rates act as a material drag on overall economic activity.

It is true that faster overall economic growth would mean faster income growth, which would offset at least some of the impact of higher market interest rates. But, over recent weeks we've already gotten a significant increase in market interest rates and a stronger U.S. dollar while actual changes in policy are still some away. As such, it will be worth watching housing market activity and export growth in the interim to see whether, or to what extent, economic activity which is sensitive to interest rates and/or exchange rates has been impacted.

Also, one cannot overlook the role of the FOMC in any assessment of how changes to fiscal, regulatory, and trade policy will impact economic growth. For some time now the FOMC has been messaging their intent to normalize the Fed funds rate target range at a very gradual pace. Whether or not they can remain on such a path, however, depends on the extent to which inflation and inflation expectations respond to the ultimate policy mix pursued by the new Administration and the new Congress. We've already seen inflation expectations increase, and it is generally assumed actual inflation will run faster, but this is no certainty.

Many seem to focus on what will likely be faster growth in aggregate demand and assume that would result in faster inflation. The hole in this thinking, however, is that it ignores any supply side response. In other words, if there is also a response on the supply side, i.e., an increase in the economy's speed limit, that will serve to blunt inflation pressures. Of course, there are timing issues, i.e., any pickup in demand will likely materialize faster than any increase in supply, and there are also questions as to the relative degrees of any growth in supply and demand, so it does seem that on this basis it is reasonable to assume at least some acceleration in inflation. But, to the extent we see further appreciation of the U.S. dollar, that will prolong what, for over three years now, has been persistent goods price deflation. Well, at least assuming imported goods are still allowed into the U.S. But, as noted above, if there are tariffs imposed on imports, that will in and of itself lead to higher goods prices.

The point here is that nothing is clear cut, but for the FOMC that only complicates their job. To make matters even more difficult for the FOMC, the new Congress and the new Administration are likely to press for more oversight of FOMC decision making and there are some who worry that the FOMC may become more prone to political pressures. It may just be us, but we can't see any way that would end well. For instance, in what could be a more charged-up political environment, would the FOMC hesitate to take what they see as proper policy steps if they sense that inflation is on the verge of accelerating, perhaps sharply? Should they act as they think proper, what sort of backlash will they face? What sort of message will that send through the global financial markets? And, how will that impact the value of U.S. dollar denominated assets? Wow, those are questions to which we seriously hope we don't actually learn the answers.

So, if nothing else, 2017 is looking far more interesting than was shaping up to be the case prior to the November elections. Again, it will take time, perhaps considerable time, until specific policies are proposed, debated, reshaped through the legislative process, and finally approved, and then further time before any policy changes have an impact on the economy. As such, at this point our working assumption is that it won't be until sometime around Q4 2017 before we see any material effects in the economic data. One thing we could see is business investment being pulled forward if firms are confident enough in the prospects for tax and regulatory relief and, more importantly, believe these policy changes will result in a sustained period of faster growth. All in all, though, at this point our baseline forecast for 2017 calls for real GDP growth around 2.1 percent. While we do believe there is upside potential to our baseline outlook, we find it highly unlikely we will see a sustained period of growth between three and four percent. Here's hoping we're wrong, but we don't think so.

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Q2 '16 (a)	Q3 '16 (a)	Q4 '16 (f)	Q1 '17 (f)	Q2 '17 (f)	Q3 '17 (f)	Q4 '17 (f)	Q1 '18 (f)		2014 (a)	2015 (a)	2016 (f)	2017 (f)
1.4	3.2	2.1	2.0	1.8	2.1	2.1	2.0	Real GDP[1]	2.4	2.6	1.6	2.1
4.3	2.8	3.0	2.1	2.0	2.2	2.4	2.2	Real Personal Consumption[1]	2.9	3.2	2.7	2.5
								Business Fixed Investment:				
1.7	-2.4	3.3	3.2	2.8	2.4	2.1	2.1	Equipment, Software, & IP[1]	4.8	4.0	0.0	2.2
-2.1	10.1	-3.2	3.0	3.5	1.5	2.1	1.7	Structures[1]	10.3	-4.4	-3.2	2.2
-7.8	-4.4	4.5	5.6	1.6	2.0	3.9	6.4	Residential Fixed Investment[1]	3.5	11.7	4.5	1.9
-1.7	0.2	0.9	1.1	0.8	1.1	1.3	1.2	Government Expenditures[1]	-0.9	1.8	0.8	0.7
-558.4	-521.0	-547.9	-561.0	-578.0	-587.8	-595.6	-607.9	Net Exports[2]	-425.7	-540.0	-548.4	-580.6
1.159	1.145	1.184	1.161	1.129	1.143	1.168	1.197	Housing Starts, millions of units[3]	1.001	1.108	1.160	1.150
17.1	17.5	17.7	17.2	16.6	16.3	16.2	16.1	Vehicle Sales, millions of units[3]	16.5	17.4	17.4	16.6
4.9	4.9	4.8	4.7	4.7	4.7	4.6	4.6	Unemployment Rate, %[4]	6.2	5.3	4.9	4.7
1.8	1.7	1.6	1.4	1.4	1.2	1.1	1.1	Non-Farm Employment[5]	1.9	2.1	1.7	1.3
1.2	1.3	1.4	1.7	1.5	1.6	1.7	1.8	GDP Price Index[5]	1.8	1.1	1.3	1.6
1.0	1.0	1.4	1.8	1.8	1.9	2.0	2.0	PCE Deflator[5]	1.5	0.3	1.1	1.9
1.1	1.1	1.6	2.4	2.3	2.4	2.3	2.2	Consumer Price Index[5]	1.6	0.1	1.2	2.3
1.6	1.7	1.8	1.8	1.8	1.9	2.0	2.1	Core PCE Deflator[5]	1.6	1.4	1.7	1.9
2.2	2.2	2.3	2.2	2.3	2.4	2.3	2.3	Core Consumer Price Index[5]	1.7	1.8	2.2	2.3
0.38	0.38	0.42	0.63	0.67	0.88	0.93	1.13	Fed Funds Target Rate, %[4]	0.13	0.14	0.39	0.77
1.75	1.56	2.10	2.43	2.51	2.58	2.64	2.70	10-Year Treasury Note Yield, %[4]	2.54	2.14	1.83	2.54
3.59	3.45	3.81	4.16	4.29	4.36	4.42	4.48	30-Year Fixed Mortgage, %[4]	4.17	3.85	3.65	4.31
-2.6	-2.7	-2.8	-2.9	-3.0	-3.1	-3.2	-3.4	Current Account, % of GDP	-2.3	-2.7	-2.8	-3.2

a = actual; f = forecast; p = preliminary

Notes:
1 - annualized percentage change
2 - chained 2009 $ billions
3 - annualized rate
4 - quarterly average
5 - year-over-year percentage change

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