The Outlook for the U.S. Economy: Sunny Skies But Developing Storm Clouds?

The Financial Executives Networking Group

Des Peres, MO

FEDERAL RESERVE BANK of ST. LOUIS

Kevin L. Kliesen

Business Economist and Research Officer

March 28, 2018

CENTRAL TO AMERICA'S ECONOMY®

Disclaimer

The views I will express today are my own and do not necessarily reflect the positions of the Federal Reserve Bank of St. Louis or the Federal Reserve System.

DATA HEAVEN RESIDES HERE!

FRED®

ECONOMIC DATA | ST. LOUIS FED

The Big Picture

- We're into the 8th year of expansion . . . The average expansion lasts about 5 years.
- Real GDP growth during this expansion has averaged about 2.25% per year. Historically, growth has averaged about 3% per year.
- There are many reasons for weaker growth: Deleveraging, tighter access to credit, reregulation, higher taxes, demographics, and less innovation.
- Inflation has been below the FOMC's 2% target for most of the past five years.

Forecasting Basics

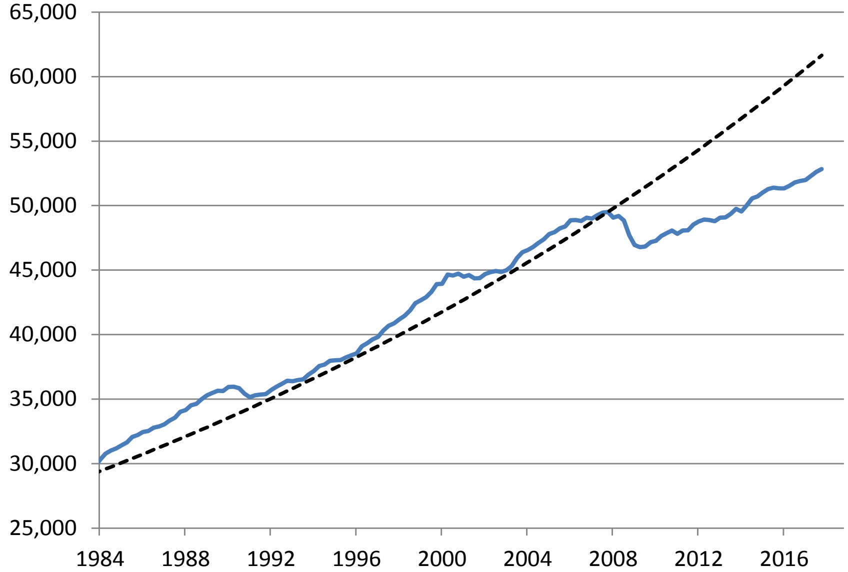
- Joke of the Day! Economic forecasting is an imprecise exercise.
- Forecasters have a lot of hurdles to overcome: Imperfect data and models, assumptions about economic policy, unexpected developments (shocks) can't be accounted for.
- So, we assume—to a large degree—that the past is prologue, but recognize that households, firms, and governments can change their behavior. Incentives matter!
- Bottom line: Look at long-run trends and then attempt to assess where the economy is currently relative to trend.

So Many Questions!

- Is 2.25% economic growth still the norm?
- Or, will tax reform boost the economy's short- and long-term prospects?
- How should we think about the increase in the budget deficit due from tax cuts and increased spending?
- How will the new international trading framework affect the U.S. and world economies?
- Is inflation temporarily low?
- If so, what does that imply for the economy and monetary policy?

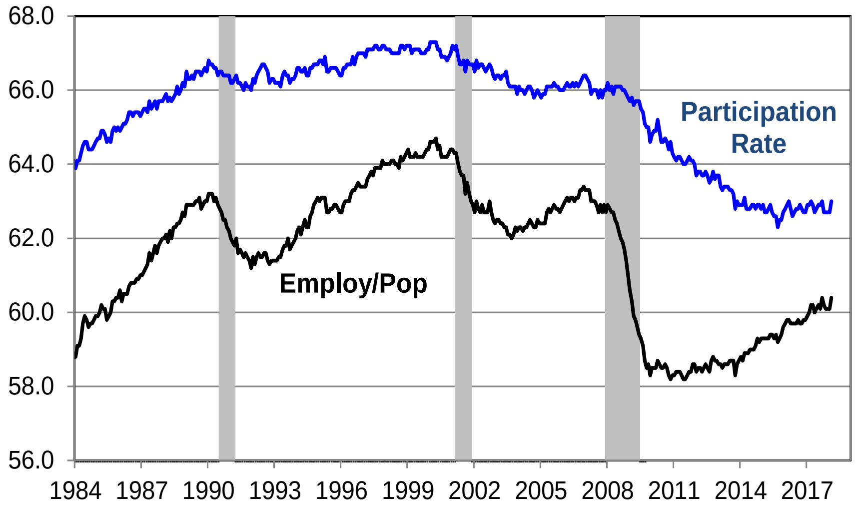
The Future Ain't What it Used to Be?

Per Capita Real GDP, 1984 to Present
Billions of $2009



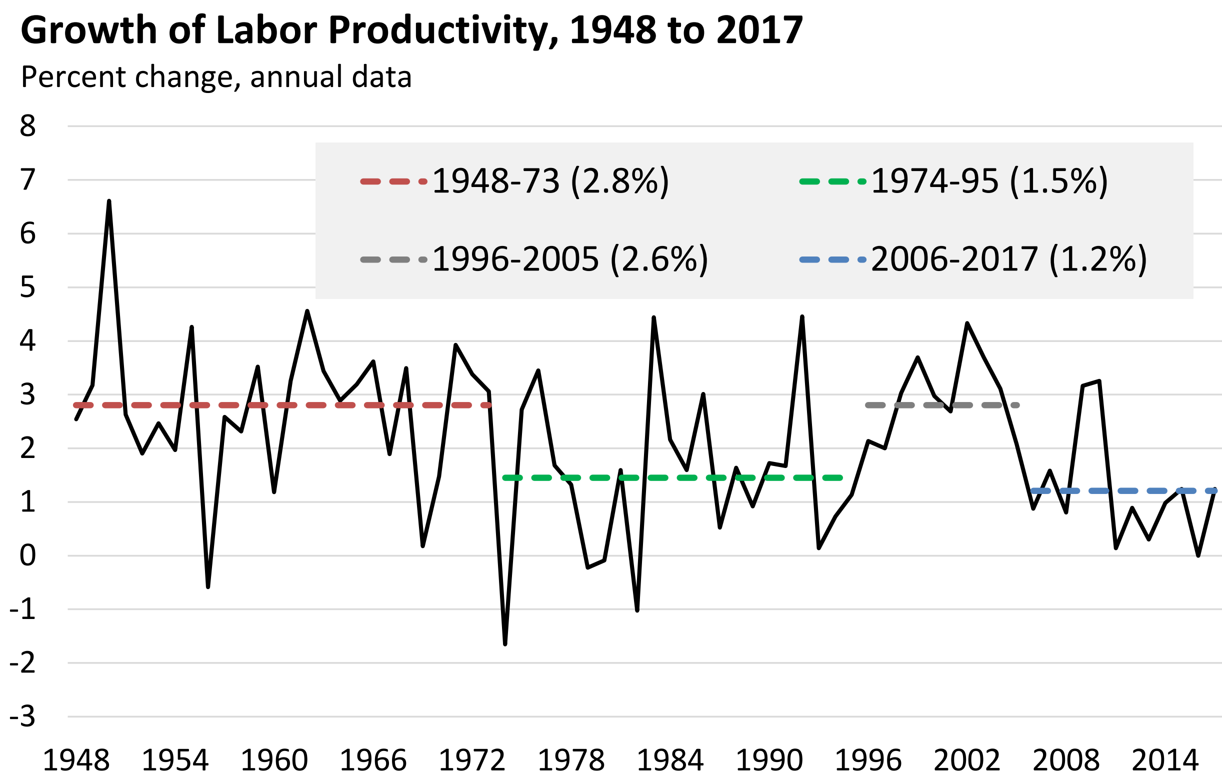
SOURCE: U.S. Bureau of Economic Analysis — Data through 2017:Q4

The Labor Force Participation Rate and the Employment-to-Population Ratio, 1984 to Present
Percent



Source: Bureau of Labor Statistics. *Data through February 2018.*

The Future Ain’t What it Used to Be?

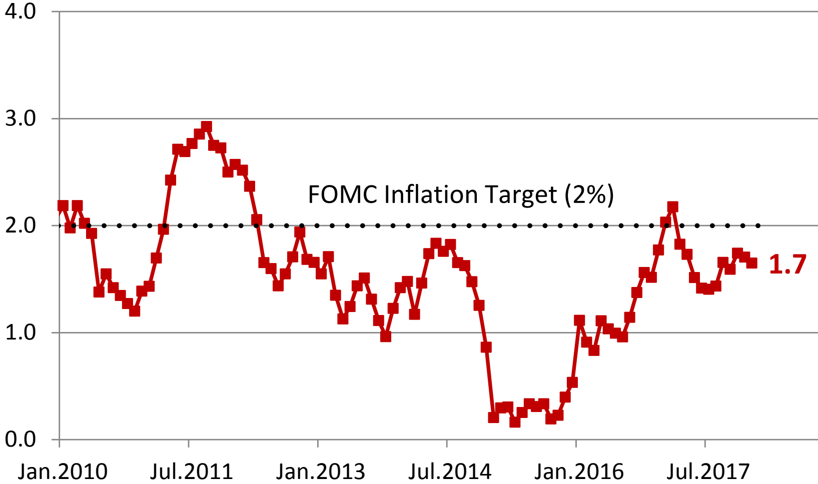


NOTE: Labor productivity is output per hour in the nonfarm business sector. Data for 2017 are for the first three quarters of 2017.

The Future Ain't What it Used to Be?

The Fed's Preferred Inflation Measure

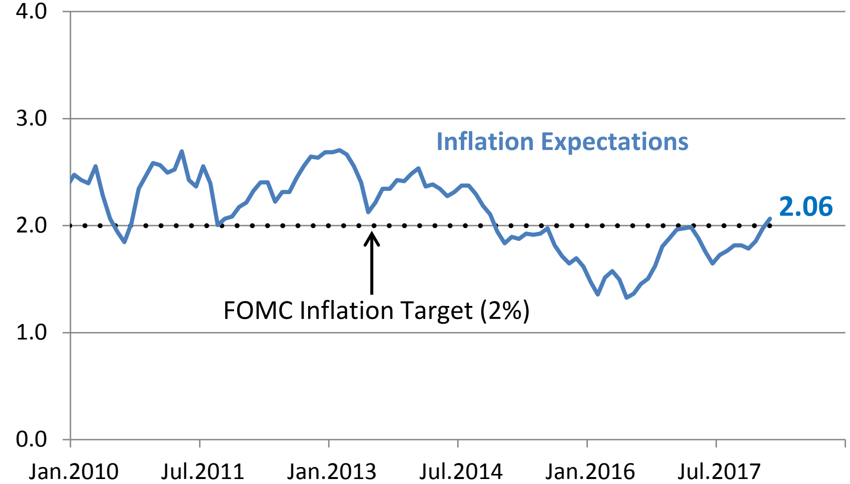
Percent change from a year earlier



NOTE: Inflation calculated from the personal consumption expenditures price index . Last observation is February 2018. Source is the Bureau of Economic Analysis.

Long-Term Inflation Expectations

(Inflation expectations based on TIPS)



NOTE: Inflation calculated from the personal consumption expenditures price index . Inflation expectations are 5-year, 5-year forward break-even inflation rates.

A New Normal for Inflation?

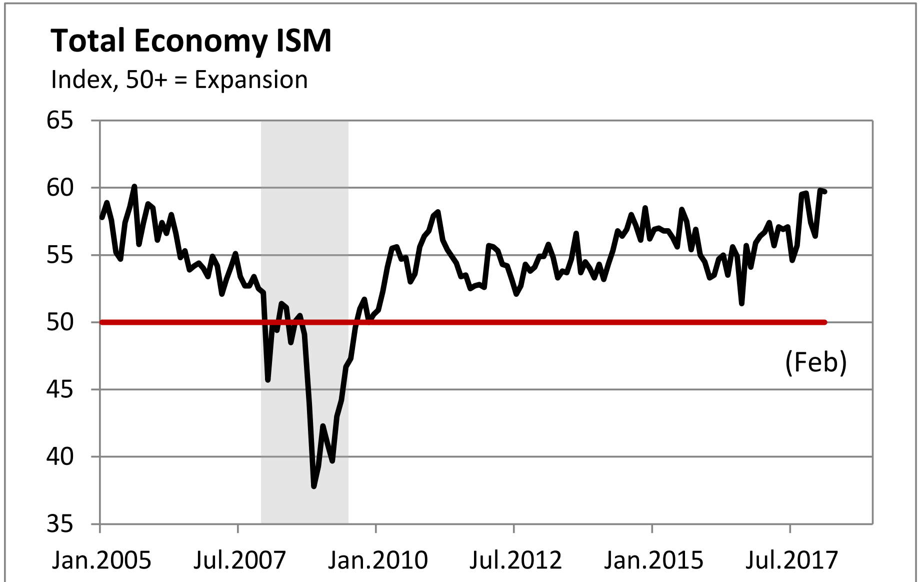
- Some economists are beginning to wonder if 2% inflation is attainable in light of fundamental changes in the economy.
- For example, the fracking revolution in the United States seems to have permanently lowered the price of crude oil (“shale band”).
- Others wonder whether the “Amazon effect” has exerted similar effects on retail prices.
- Regardless, most people have confidence that the Fed will keep inflation under control.

Current Economic Developments

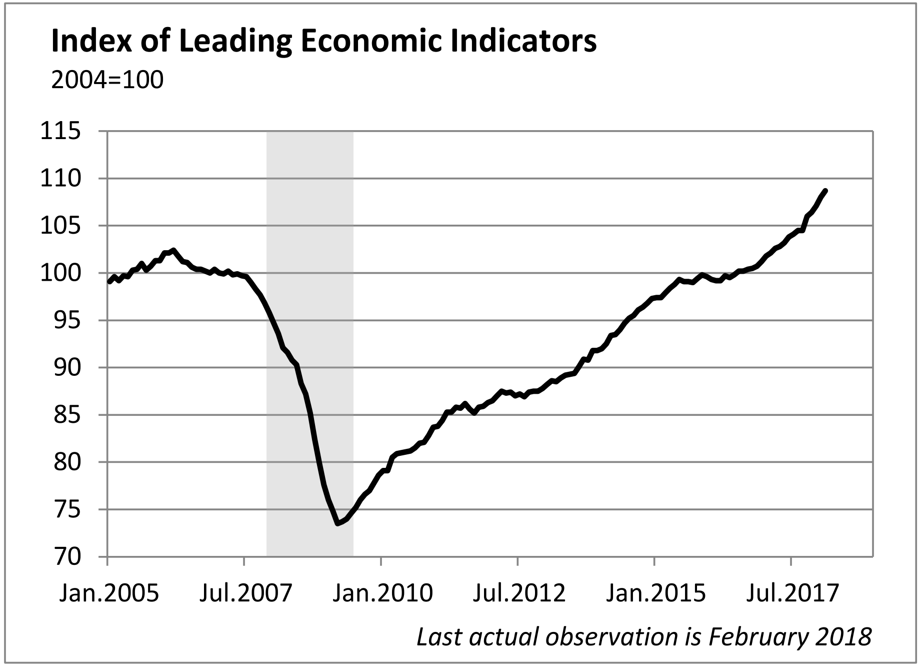
Current Economic Conditions

- Solid labor market conditions and low inflation.
- Consumer optimism supports spending on autos and other big-ticket items.
- Global growth looks pretty strong—even Europe is experiencing strong growth!
- Financial market volatility! Melt-up . . . Melt-down . . .
- Healthy forward momentum in the second half of 2017 bodes well for 2018 and 2019.
- Businesses are optimistic.

Two Key Barometers Looking Good



Source: Author's calculations based on data published by Institute for Supply Management and the Bureau of Economic Analysis.

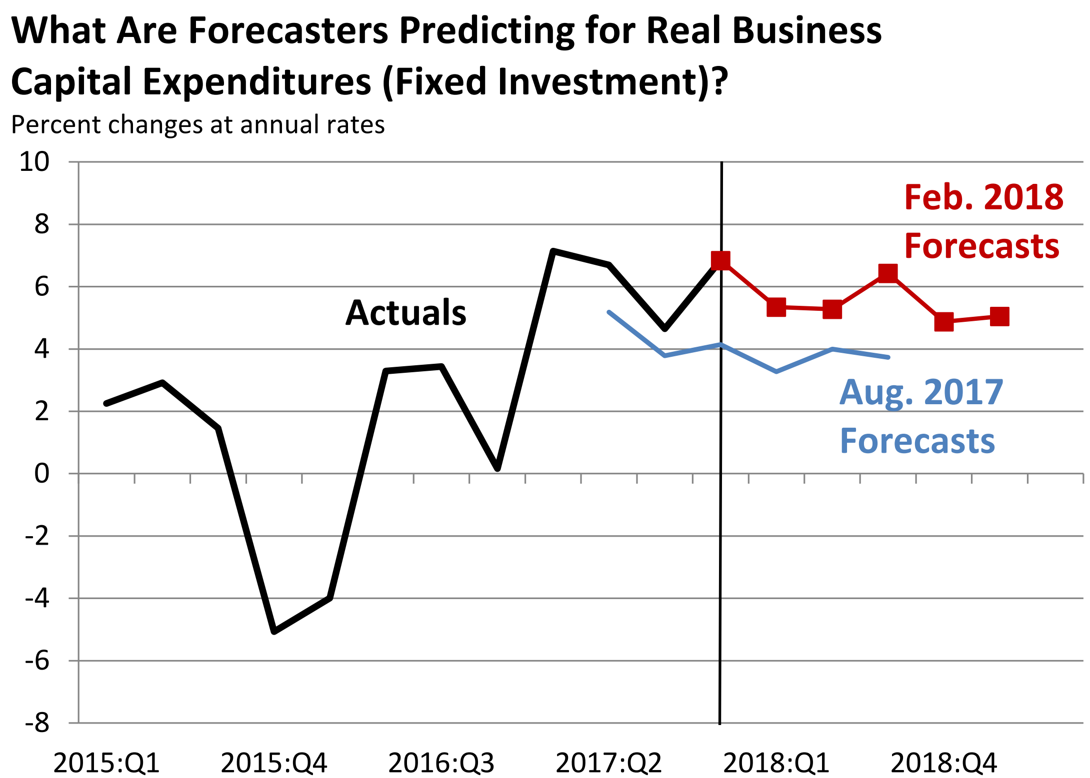


Current Economic Conditions

WHAT BUSINESSES ARE SAYING …

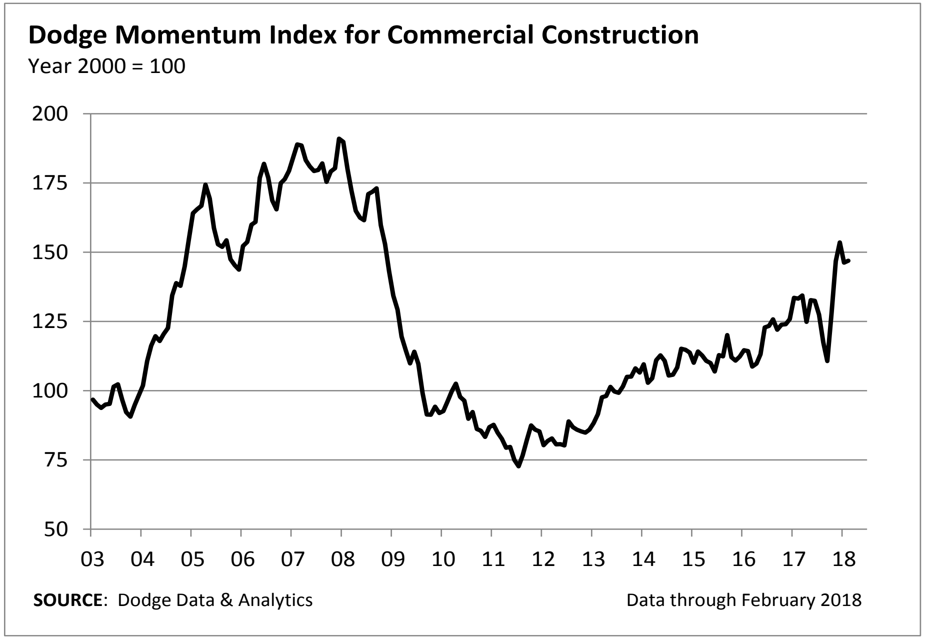
- “Sales nationally and internationally are strong in Q1. We are increasing our CapEx spend by 30% to 40% over [the] previous year.” (Chemical Products)
- “We have heard reports of additional business due to the recent reduction of tax rates.” (Machinery)
- “More than 40% of U.S. companies say they plan to boost wages and 38% will increase hiring in 2018 because of recent tax reform.” (Duke CFO Survey, March 7, 2018)
- “Business Roundtable CEO Economic Outlook Index Reaches Highest Level in Survey’s 15-Year History.” (BR Press Release, March 13, 2018)

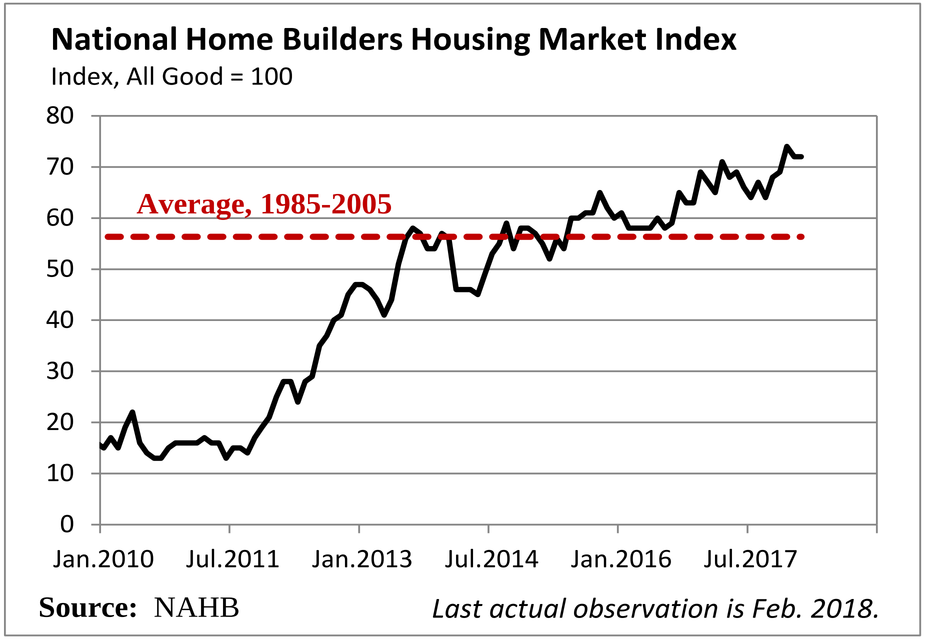
Forecasters: Expect More CapEx



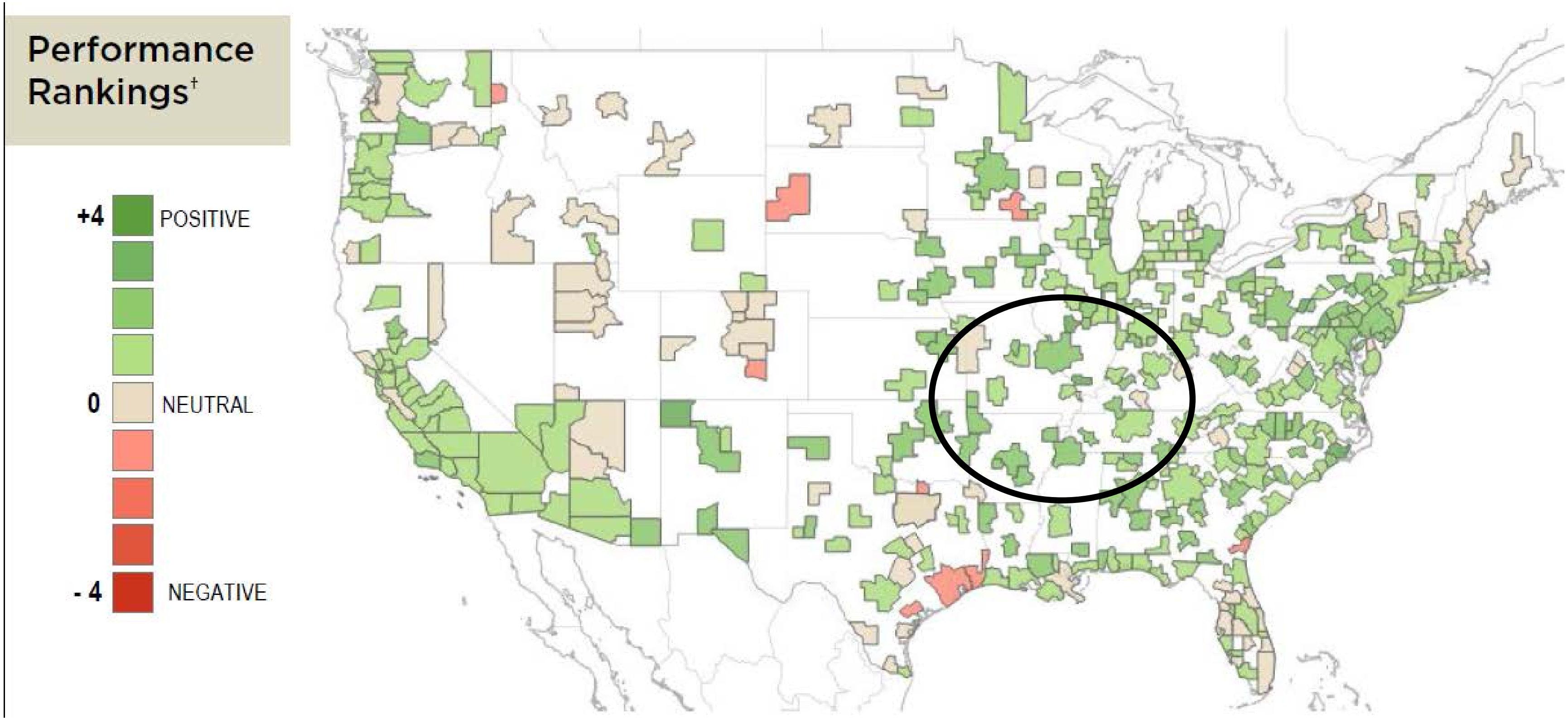
SOURCE: Survey of Professional Forecasters, Aug. 2017 and Feb. 2018.

Construction Outlook Appears to be Improving

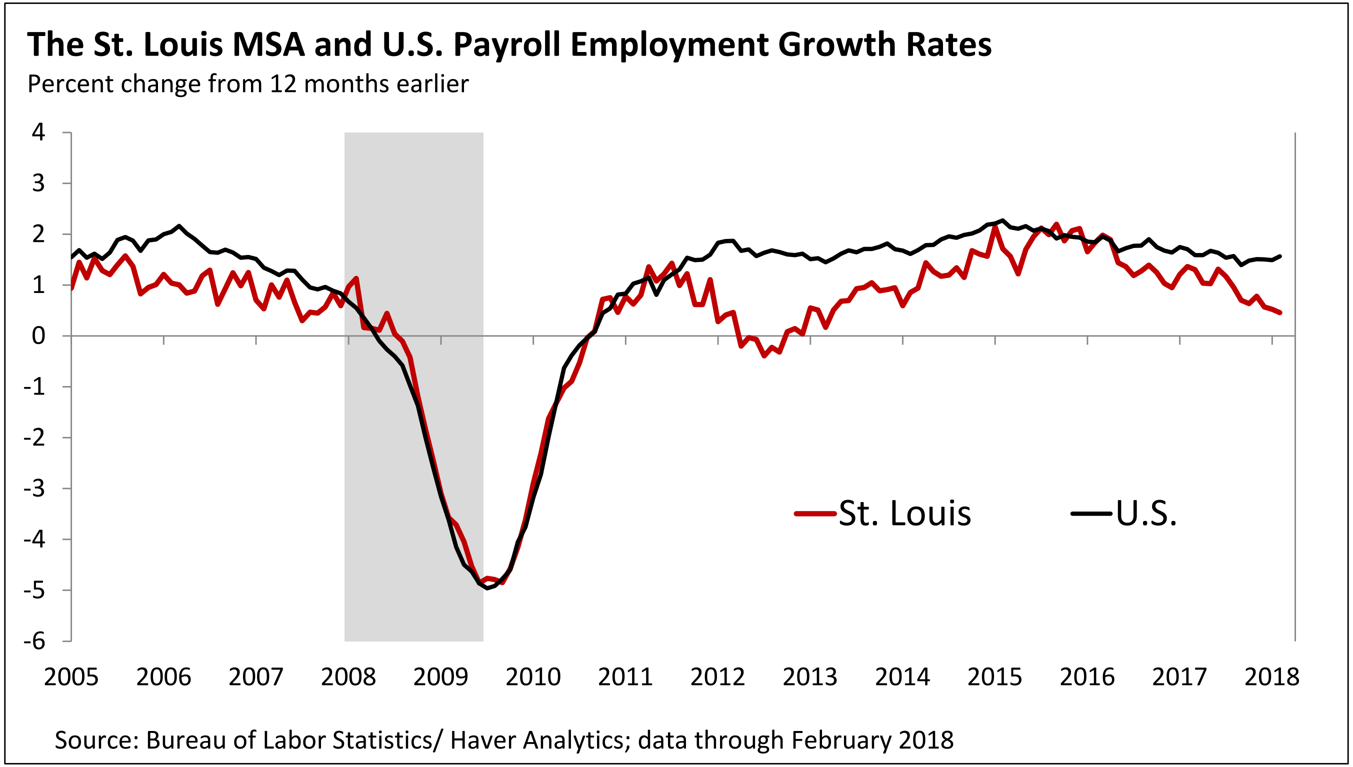




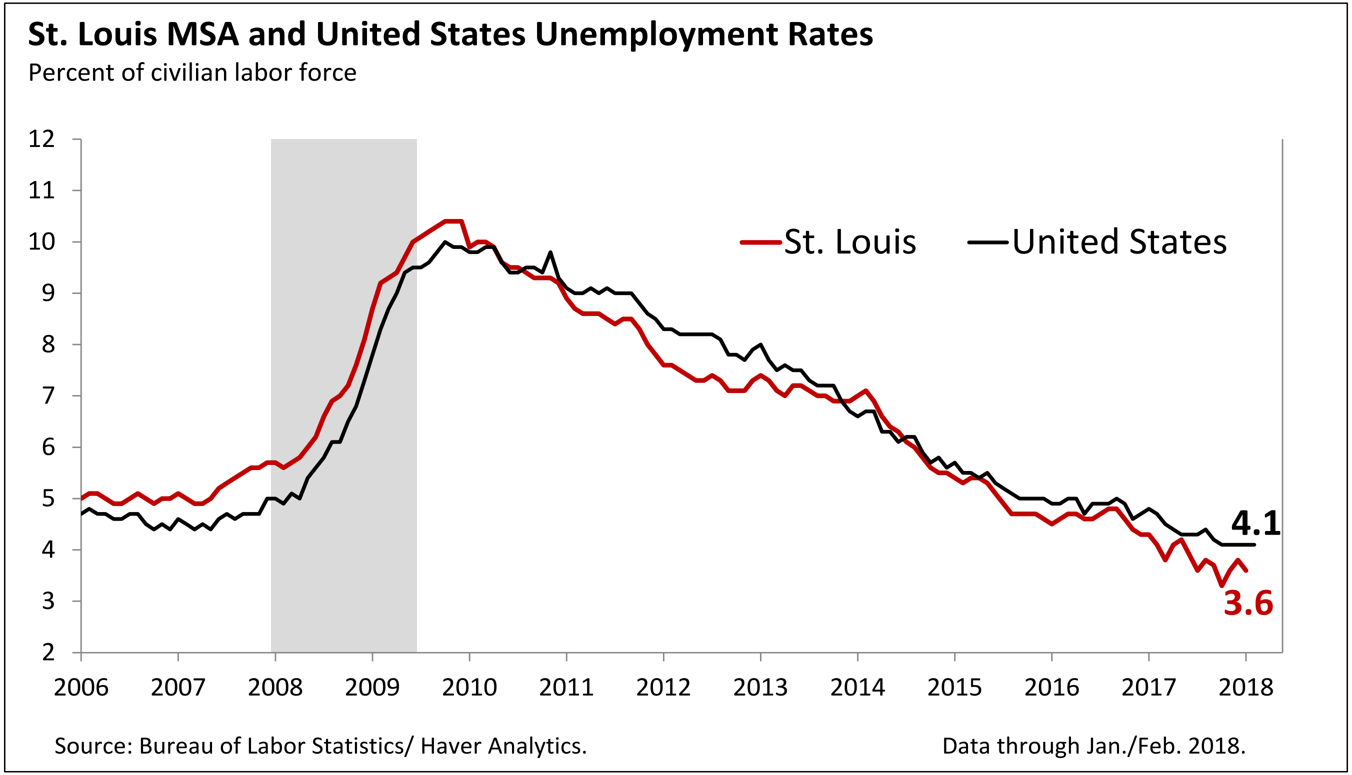
Housing Markets in the Midwest Appear in Good Condition



U.S. Job Growth has Outpaced St. Louis Job Growth of Late

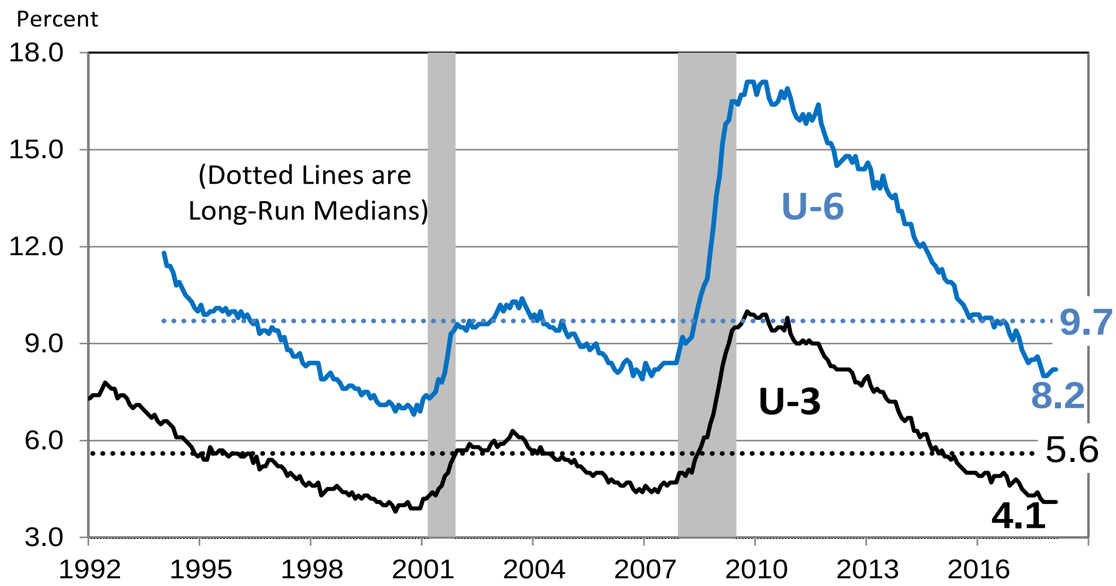


St. Louis' Unemployment Rate is Lower than the Nation's Rate



U.S. Unemployment Rates are Low, Regardless of How Measured

The U-3 (Official) and U-6 Unemployment Rates and ther Long-Run Median Unemployment Rates



Source: Bureau of Labor Statistics. Data through February 2018.

Where are Job Openings the Most and Least Plentiful by Industry?

Change in Job Openings Over the Past Year

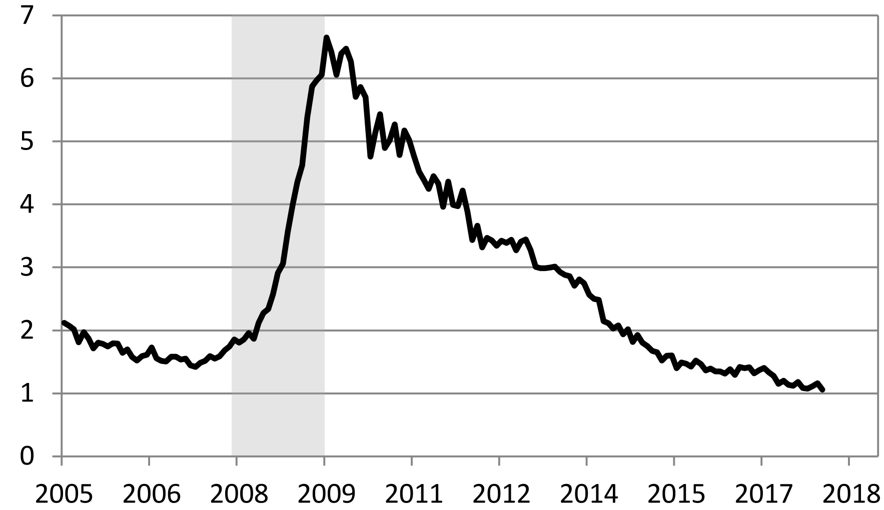
Percent change, Jan. 2017 to Jan. 2018

Construction	57.2%
Trade, Transportation & Utilities	33.4%
Leisure & Hospitality	20.8%
Government	18.4%
Manufacturing	17.0%
Professional Business Services	17.2%
Education & Health Care Services	2.6%

SOURCE: Bureau of Labor Statistics

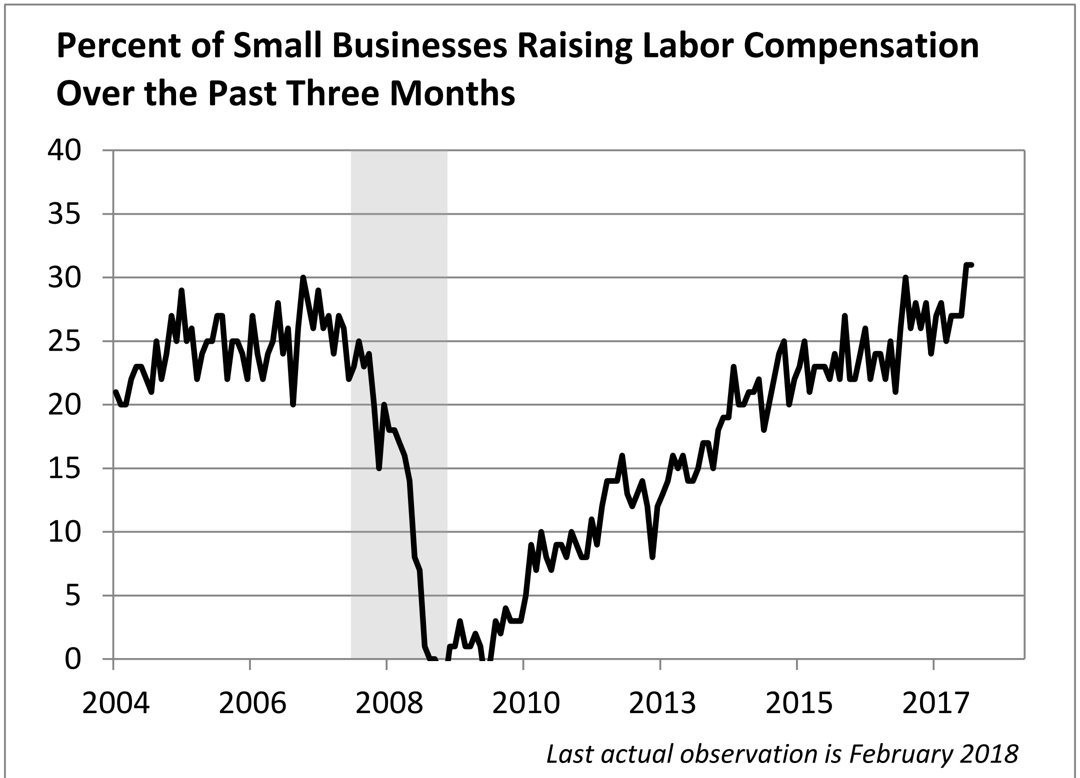
Number of Unemployed Persons for Each Job Opening

Ratio of unemployed to total job openings

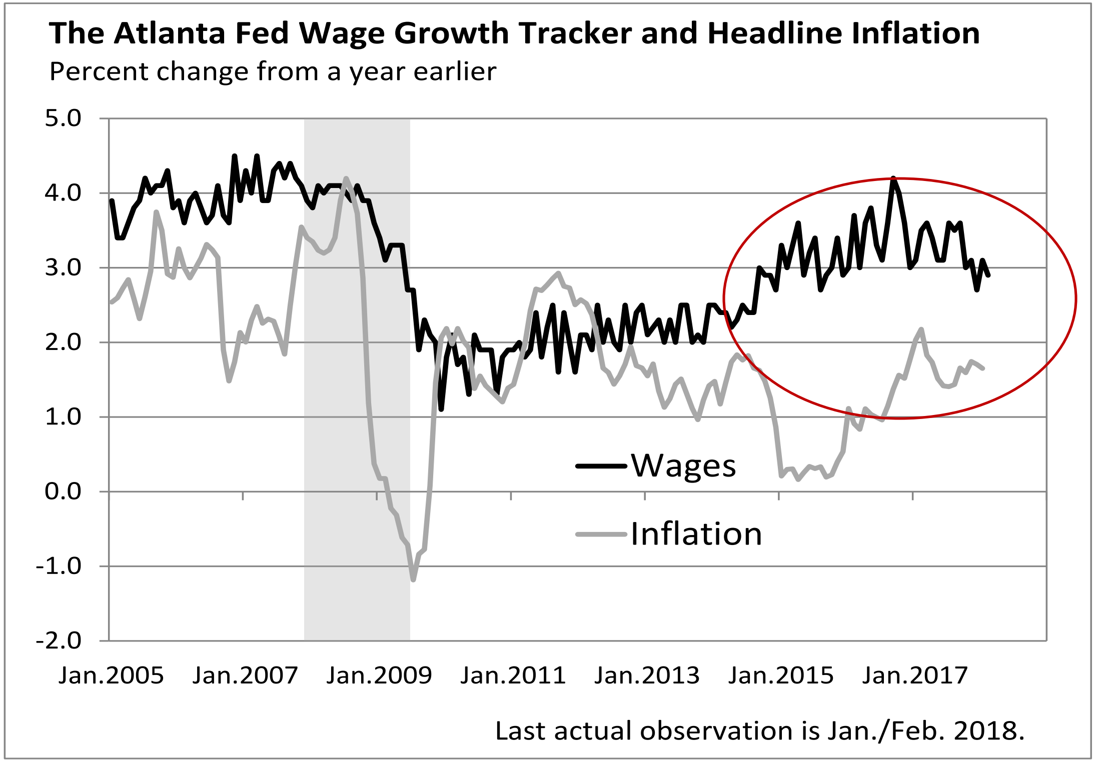


Last actual observation is January 2018

Wage Growth is Picking Up According to Small Businesses

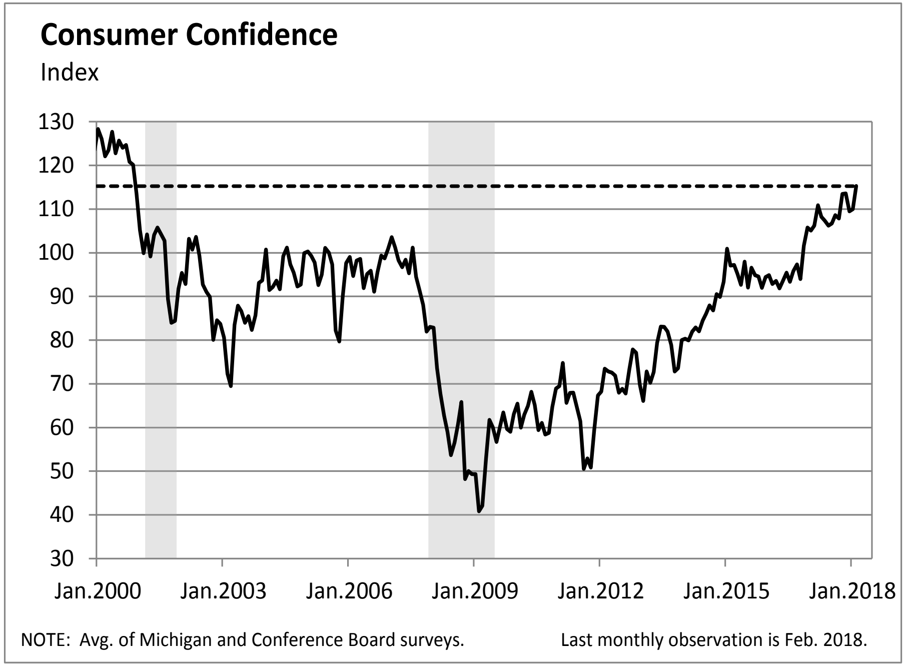


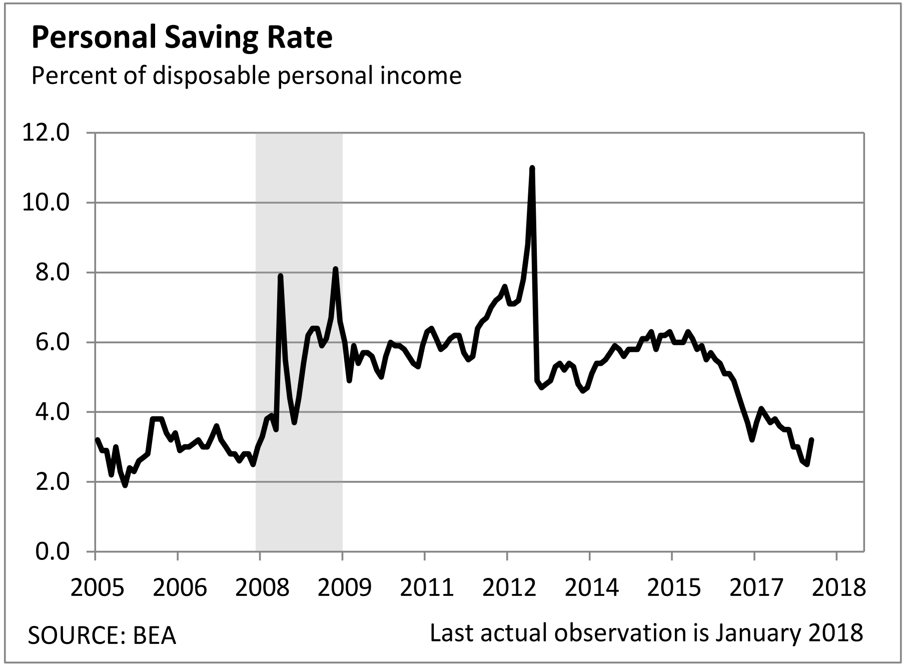
U.S. Wage Growth has Picked Up and Inflation Remains Below 2%.



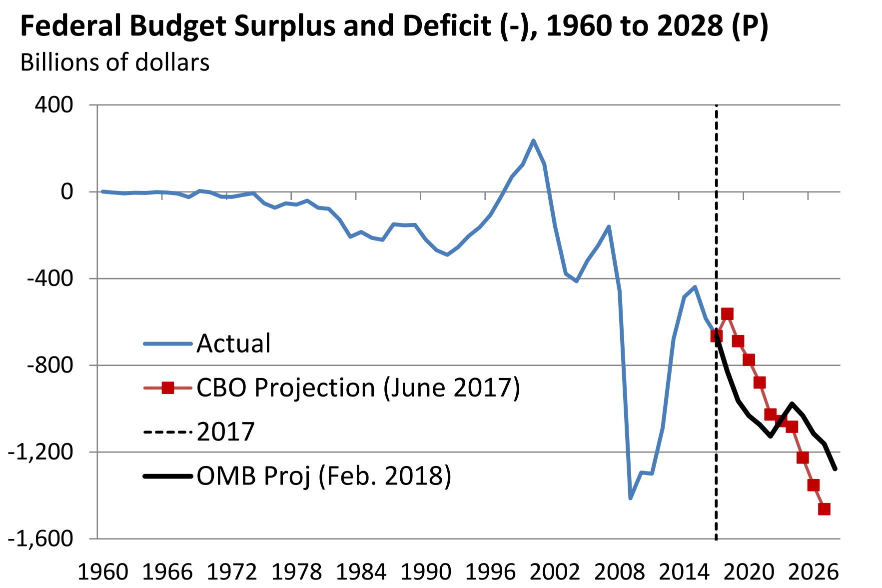
A widening gap is good because it signals improving purchasing power of households (inflation-adjusted wages).

Are Households Too Optimistic?

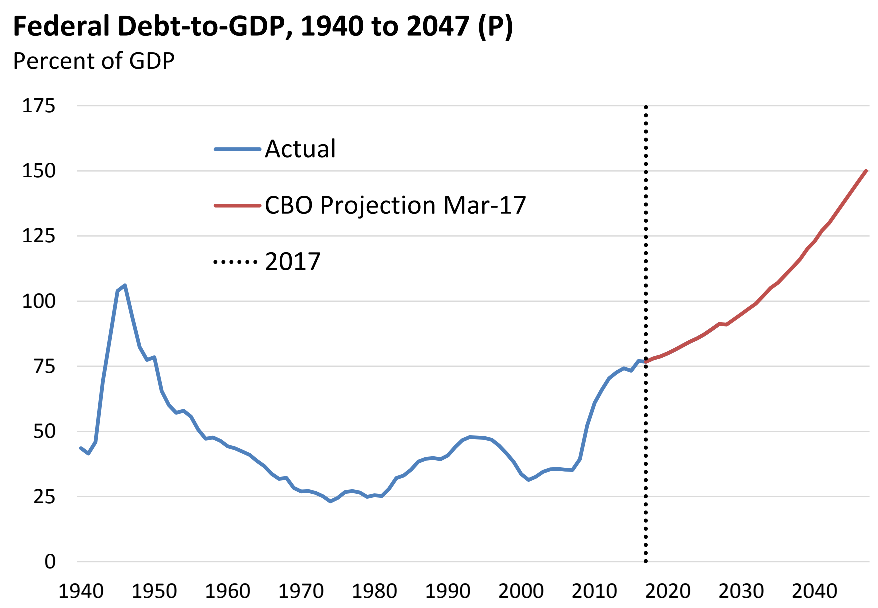




Are Households Too Optimistic? Yes, if you factor in future taxes.

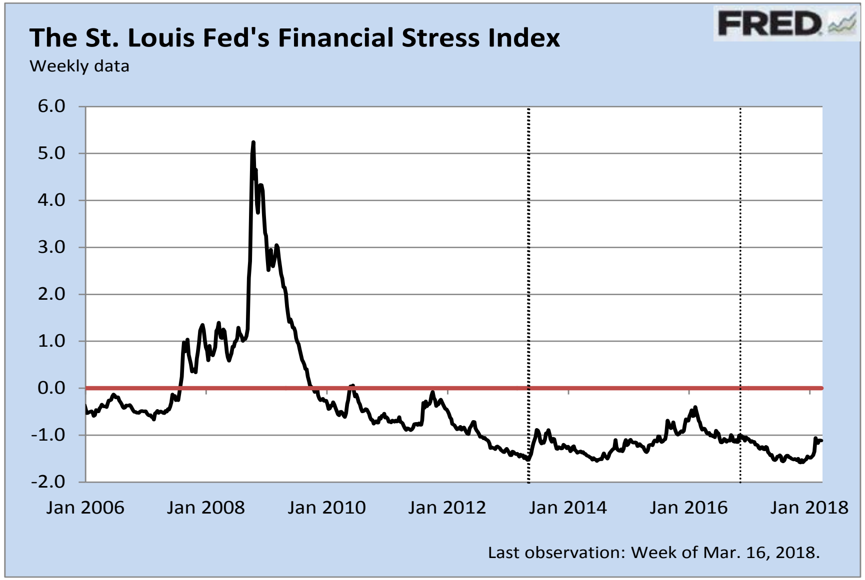


SOURCE: FRB St. Louis, Haver Analytics, CBO, OMB.

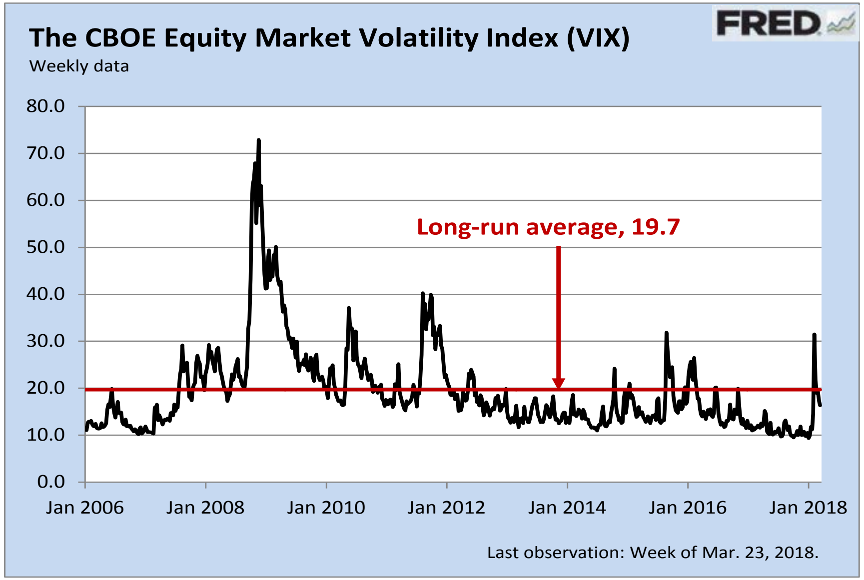


SOURCE: FRB St. Louis, Haver Analytics, CBO, OMB.

Financial Market Stress and Volatility Increases Modestly

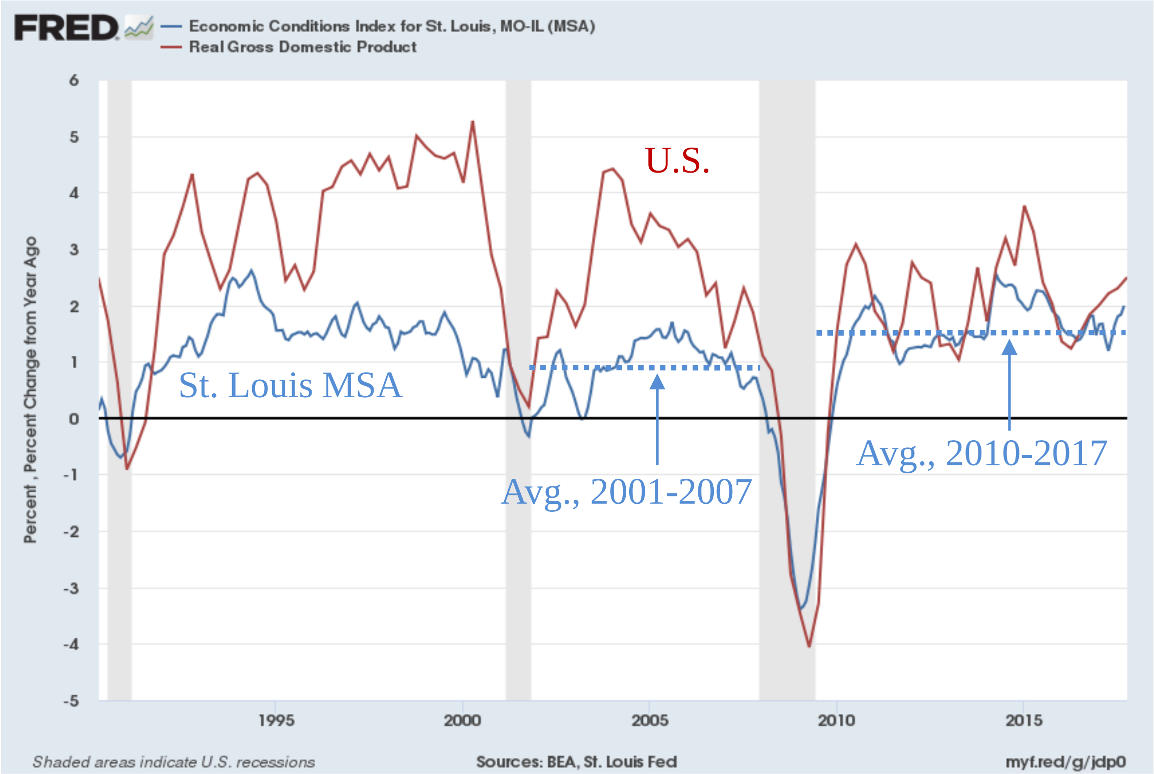


St. Louis Fed Financial Stress Index

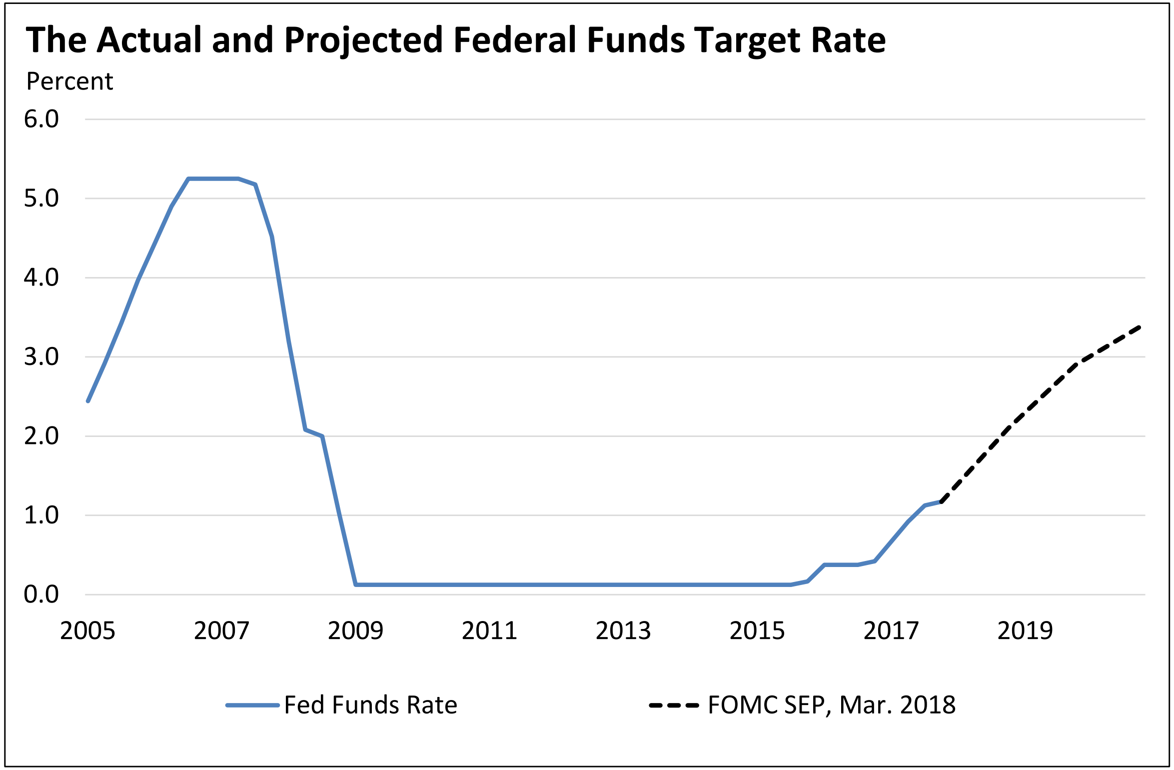


Equity Market Volatility Index (VIX)

St. Louis MSA Growth Tends to Trail U.S. Real GDP Growth



The FOMC: We're Bullish on the U.S. Economy!



"Information received since the Federal Open Market Committee met in January indicates that the <u>labor market has continued to strengthen and that economic activity has been rising at a moderate rate</u>. Job gains have been strong in recent months, and the unemployment rate has stayed low." [FOMC Statement, March 21, 2018]

Why You Should be Optimistic . . .

- Cuts in marginal tax rates, coupled with increases in household wealth, should keep consumer spending and housing construction growing at healthy rates.
- Tax law changes will encourage firms to boost capital spending, hiring, and repatriate foreign profits.
- All else equal, these developments will tend to raise productivity, real wages, and economic growth.
- Unless inflation ramps up, the FOMC will be patient in withdrawing monetary stimulus.

And Why You Might Worry.

- Some of the latest data suggest first-quarter real GDP growth could be weaker than initially expected.
- Fiscal stimulus could produce faster-than-expected real GDP growth (a good thing!). But this could raise inflation expectations.
- Larger-than-expected budget deficits could also cause a spike in inflation expectations and thus interest rates.
- International trade disruptions could roil markets, raise business uncertainty, and lead to lower growth.

Kliesen's Forecast

- Projected averages, 2018 to 2020:
  - Real GDP growth: 2.5% to 3.0%
  - Unemployment rate: 3.75% to 4.25%
  - Headline inflation: 2% (some upside risk)
- Punchline: Policy changes will boost economic growth. Inflation fears have crept into the market, so the Fed will need to remain vigilant.

QUESTIONS?