Current Economic Conditions

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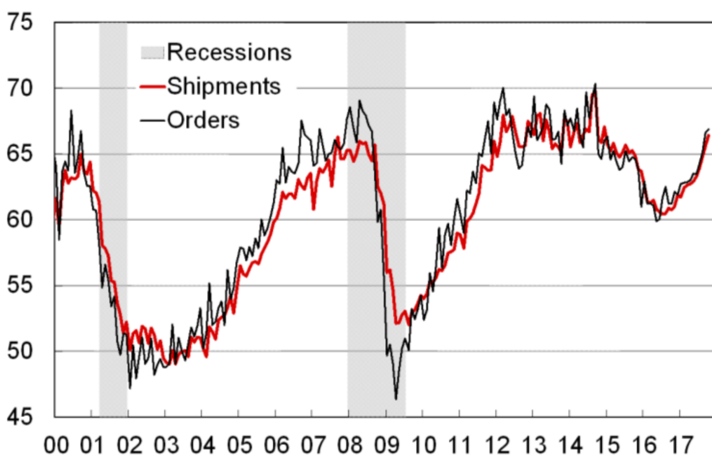
POISED FOR 3% GROWTH (AT LAST)

The annual growth rate of U.S. Real Gross Domestic Product hasn't exceeded 3% since 2005 and won't in 2017 either. Before this 12-year growth drought, the U.S. economy hadn't gone more than three years without a growth rate above 3% since 1933, during the Great Depression. But the drought is likely to end in 2018; a convergence of global and domestic factors is likely to push growth above 3%.

Since annualized quarterly growth has (slightly) exceeded 3% for two straight quarters, one could ask, "Aren't we already above 3%?" But some of that strong growth might reflect difficulties in seasonally adjusting the data, which result in an overstatement of growth in the second and third quarters of each year following an understatement in the first quarter. We won't really know that we've broken out to a higher growth trajectory until we post strong year-over-year growth. (Year-over-year growth is not affected by seasonal fluctuations.) I think that will happen in the first quarter of 2018. In the meantime, big increases in hours worked and strong retail sales in November (and an upward revision to October) make it likely that GDP growth will again be above 3% in the fourth quarter. Given the way that growth-rate math works, the pickup in **quarterly** growth we've seen this year will boost **annual** growth next year.



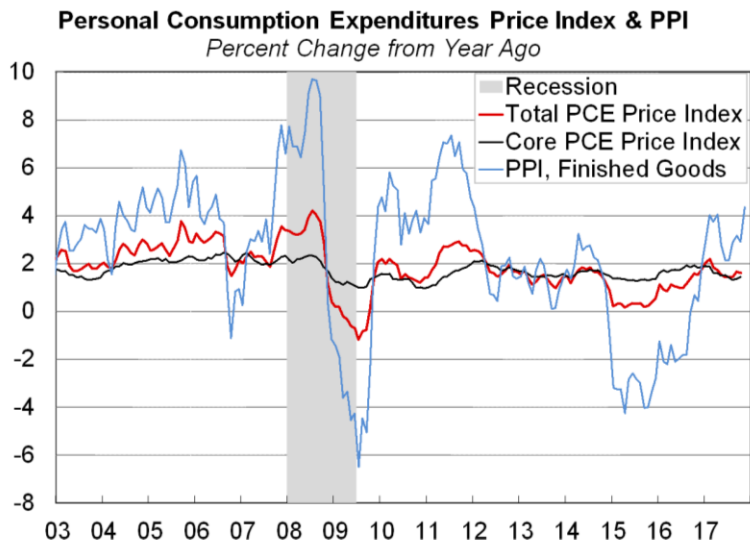
There are several reasons that growth has accelerated and is likely to remain strong (by the standards of the last 12 years) in 2018. Investment, particularly in business equipment, has picked up, as I discussed last month. Shipments of nondefense capital goods, a monthly proxy for the quarterly investment numbers, have surged, and orders point to further growth. I didn't expect investment to increase so much until the new tax law took effect, but surging optimism has driven some companies to invest this year. The National Federation of Independent Business's Small Business Optimism Index rose in November to a level that has only been exceeded twice, in November 2004 and in the third quarter of 1983.

The recent pickup in growth has occurred despite weakness in the housing sector. Investment in residential structures has declined for two straight quarters, but is unlikely to remain weak. After several years of underbuilding, there is much pent-up demand for houses. New home sales surged in October. With inventories of homes for sales at record lows, new construction is necessary to meet the demand. Housing starts rose again in November. Single-family building permits, the best (leading) indicator in the housing report, rose to an 11-year high. Homebuilder sentiment surged to an 18-year high in December.

U.S. motor vehicle production is scheduled to increase at an 18% annual rate in the first quarter of 2018. That could help break the pattern of weak first-quarter GDP growth. It could also help industrial production in U.S. manufacturing grow by 3% or more in 2018; it would be the first year of 3% growth since

2011. Production rose 0.2% in November after surging an upwardly-revised 1.4% in October as factories resumed full-time production after the disruptions caused by Hurricane Harvey.

U.S. manufacturing is starting to benefit from the acceleration of growth in the rest of the world. The pickup in growth has been most pronounced in Europe, Japan, and China, all of which are major oil importers. This reflects the lagged impact of the decline in oil prices in late 2014 and early 2015. Oil prices are up recently, but not enough to offset the benefits of the 2014-15 decline, and I don't think oil prices can stay this high for long. An acceleration in the Organization for Economic Cooperation and Development's broadest leading indicator (for all OECD members plus six non-member developing companies) suggests that the global economy carries considerable momentum into 2018. German real manufacturing orders accelerated to 6.8% year-over-year in October. Chinese imports were up 17.7% year-over-year in November. Strong growth abroad, combined with this year's decline in the value of the U.S. dollar, should boost U.S. net exports. Because the dollar affects exports and imports with a substantial lag, the decline in the dollar in 2017 will boost net exports in 2018 and 2019.



While the outlook for 2018 looks strong, there are always risks. Most U.S. business-cycle expansions have ended because the Federal Reserve has raised interest rates to choke off rising inflation. Key measures of consumer prices still show inflation under control, aside from the recent rise in energy prices, but producer prices show an increase in inflation pressures. The Producer Price Index for Finished Goods, which I prefer to the new headline PPI that includes services, has surged over the last four months and was up 4.3% year-over-year in November. So far, rising producer prices have not found their way into "core" (ex food and energy) consumer price inflation, which has remained amazingly stable. Either increased competition (e.g., from Amazon) is preventing retailers from passing higher energy and material costs on to customers, thereby squeezing margins, or higher energy and material costs are being offset by holding the line on labor costs.

In today's economy, a bigger risk to the expansion is the bursting of an asset bubble. While the U.S. Federal Reserve has begun to shrink its balance sheet, the European Central Bank and Bank of Japan are still increasing theirs. The longer they continue, the bigger the risk that asset bubbles will inflate and burst, and history tells us that the bursting of an asset bubble can do much more damage to the economy than the hike in interest rates needed to put the inflation genie back in the bottle. But bubbles are not created equal. The bursting of a stock or housing bubble would definitely hurt growth and could cause a recession, but if the price of bitcoin goes to zero or the price of Leonardo da Vinci's Salvator Mundi goes back to $10,000, that won't hurt the economy. And bubbles are much more dangerous if the assets involved are purchased with borrowed money. If larger down payments on houses were required and buying stocks on margin was eliminated, the bursting of housing and stock bubbles would do much less damage to the financial system and the economy. (Yet another reason to get rid of interest deductions!)

The U.S. economy enters 2018 growing at about a 3% rate. Tax reform could push growth even higher, mostly by boosting business investment in plant and equipment (although persistent seasonal adjustment problems could limit the increase in the first quarter). It is very unlikely that the Fed will raise interest rates quickly enough to slow growth early enough to significantly reduce the annual growth rate in 2018. Barring the (inherently unpredictable) bursting of an asset bubble or a hard landing in China, U.S. real GDP growth is likely to exceed 3% for the first time since 2005.

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