Current Economic Conditions

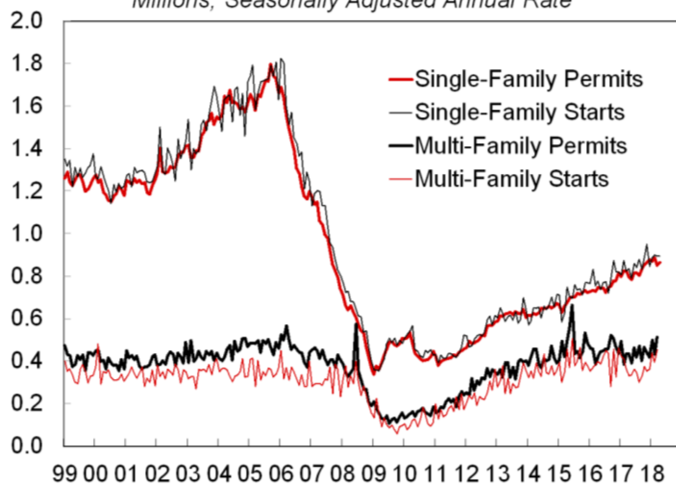
Robert C. Fry, Jr., Ph.D. May 29, 2018

SECOND QUARTER OFF TO GOOD START IN UNITED STATES

Economic reports for April (and early May) suggest that the U.S. economy got off to a good start in the second quarter, making it likely that this will be the strongest quarter for growth in real Gross Domestic Production since 2014. While payroll employment grew by a less-than-expected 164,000 – still much more than needed to absorb growth in the adult population – employment in March was revised up by 30,000 jobs, and the civilian unemployment rate fell to a new cyclical low of 3.9%. Aggregate hours worked in the private sector – the product of employment and the average workweek – rose to a record high. Total output in the economy is, in turn, the product of hours worked and productivity (i.e., output per hour).

Retail sales grew 0.3% in April and March's increase was revised up from 0.6% to a very strong 0.8%. Control-group sales, the part of retail sales used in calculating GDP, were up 0.4% in April after an upwardly revised 0.5% increase in March. Consumer spending accounts for about 70% of GDP, so this bodes well for second-quarter GDP growth.

Total housing starts fell in April due to a decline in multi-family (apartment and condominium) starts. Single-family housing starts, which generate more economic activity, rose in April and were up 7.2% year-over-year. Single-family housing permits, the most important number in the monthly housing report and a valuable leading indicator for the overall economy, also rose and were up 8.4% year-over-year. However, sales of both new and existing homes were down in April because of a lack of homes on the market. Early in the economic recovery, the paucity of existing homes on the market reflected the inability of homeowners to sell homes for less than they owed on their mortgages, but that problem has faded as home prices have surged to new highs. The lack of homes for sale reflects cutbacks in corporate relocations and a reluctance of dual-earner households to relocate, but surveys show that the biggest reason that homeowners don't put their homes on the market is that they can't find another home to buy, which implies that the underlying problem is insufficient homebuilding. Underbuilding, due to zoning and permitting restrictions and increased industry concentration in homebuilding and lot ownership, is one of the biggest reasons this economic expansion has been so slow. The silver lining is that we aren't likely to have a recession without a big downturn in housing starts, and it's hard to have a housing bust without first having a housing boom.

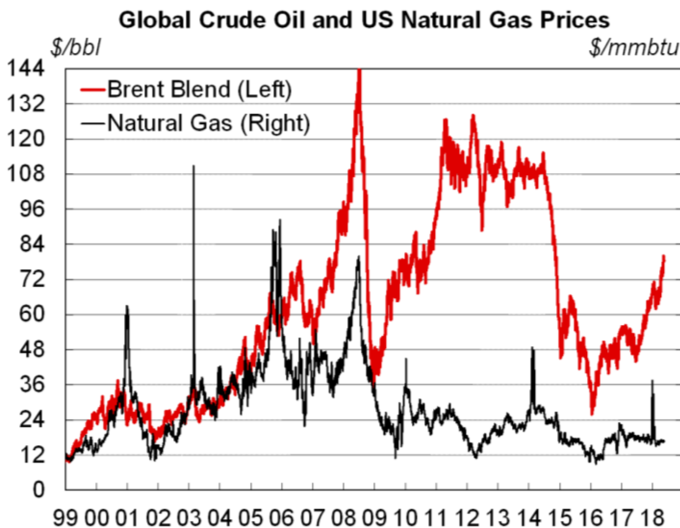


Industrial production in U.S. manufacturing rose 0.5% in April, albeit from a downwardly revised March reading. Total industrial production, which includes mining and utilities as well as manufacturing, rose 0.7% to a record high. Mining production has surged in recent quarters as oil and natural gas production have risen to record highs in response to rebounding oil prices. Survey data suggest that industrial production in manufacturing will be up again in May. Manufacturing indexes from the Federal

Reserve Banks of New York and Philadelphia are consistent with strong growth. IHS Markit's Flash (i.e., preliminary) U.S. Manufacturing Purchasing Managers' Index rose in May to its highest level since September 2014. The manufacturing production and new business components of the index rose strongly.

The Federal Reserve Bank of Atlanta's GDPNow estimate for second-quarter annualized GDP growth, based on monthly and weekly data released so far in the quarter, is currently at 4.0%. If growth is really that strong, this will be the best quarter for GDP growth since the third quarter of 2014. Competing "nowcasts" from the St. Louis and New York Federal Reserve banks are at 3.6% and 3.0% respectively. If GDP grows at a 3.5% annual rate, my current forecast, year-over-year growth will rise to 3%.

While second-quarter growth looks promising, there are developments that could slow growth later in the quarter or in subsequent quarters. The price of Brent Blend crude oil recently rose above $80 per barrel before falling in recent days. Gasoline prices have risen to nearly $3 per gallon, up from a cyclical low of $1.73 in February 2016. Each one-cent increase in gasoline prices costs American motorists about $1.35 billion per year. Fortunately, the negative impact of oil and gasoline prices on the U.S. economy is much smaller than in the past. Consumer spending on gasoline, as a percent of disposable personal income, is near record lows, and the negative impact of higher gasoline prices on consumers is largely offset by the positive impact of higher crude oil prices on drilling activity. Furthermore, natural gas prices, which are more important than oil prices for home heating and electricity generation, have remained low.



Some survey data show that capital spending has picked up since the enactment of tax reform, but the hard data on capital goods shipments, reported by the government, don't show a significant pickup yet. Without a significant increase in investment, any acceleration in GDP growth will be short-lived. Perhaps worse yet, without the increase in aggregate supply (potential GDP) resulting from increased investment and the productivity growth that results therefrom, inflation will accelerate in the medium run, as strong demand, stimulated by loose fiscal and monetary policy, pushes up against tight supply.

Most expansions slow and eventually end when central banks tighten monetary policy in response to higher-than-desired inflation. I would have preferred tighter monetary policy over the last few years, mostly because I think inflation should be lower than the Federal Reserve's 2% target, but the Fed seems satisfied with slowly rising inflation and gradual increases in short-term interest rates. Inflation, as measured by the year-over-year increase in the Personal Consumption Expenditures price index, has reached the Fed's 2% target and is likely to rise slightly above 2% in coming months, but could fall after August as big increases in late 2017 fall out of the calculation. If inflation surprises the Fed on the upside by not coming back down toward 2%, either because oil prices resume their rise, protectionist trade policies raise import prices, or demand simply grows faster than supply, the Fed could raise interest rates quickly enough to threaten the expansion, but that isn't likely to happen soon.

Pessimists believe that government debt – the result of an oversized tax cut, a severely oversized spending bill, and a political unwillingness to deal with entitlements – will ultimately cause an economic downturn. They're wrong. Debt doesn't **cause** economic downturns; it **magnifies** them. (Reflect on the meaning of the word "leverage".) The next economic downturn could be very bad, but it won't happen without a trigger, most likely an inverted yield curve or a triple-digit oil price. Until then, growth is likely to be stronger than the historical aberration we've mistakenly accepted as the "new normal."

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