Current Economic Conditions

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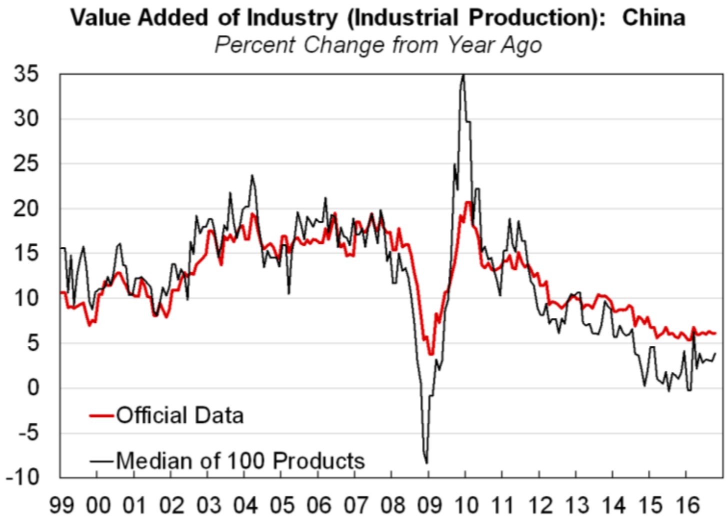
SIGNS THAT ECONOMIC GROWTH IS ACCELERATING . . . AND ONE WARNING SIGN

My special report discussed the possible impact of President-elect Trump's policies on economic growth in the United States. This regular issue discusses the economic environment he inherits. U.S. Real Gross Domestic Product grew at a 2.9% annual rate in the third quarter after growing at just a 1.0% rate over the prior three quarters. On the surface, it looks like economic growth accelerated significantly in the third quarter, but the rebound in growth was due mostly to a one-time surge in soybean exports and the end of a five-quarter slowdown in inventory accumulation. The increase in soybean exports will likely be reversed in the fourth quarter. Inventory rebuilding could add a little to growth over the next year, but is not a sustainable source of growth. If the acceleration in growth is to be sustained, other components of GDP must strengthen. That seems to be happening. Expect even stronger growth in the fourth quarter.

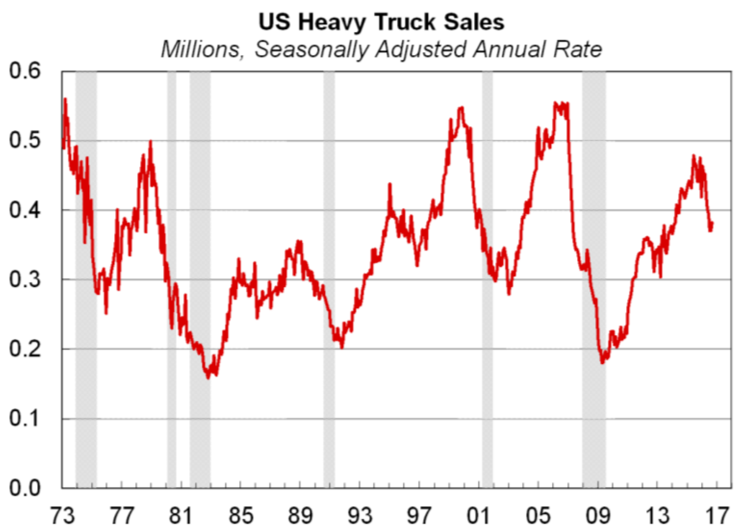
Until recently, there were few signs that the third quarter pickup in GDP growth was sustainable; most economic data were consistent with slow growth in the overall economy and essentially no growth in manufacturing. But recent data show growth picking up this fall. Light vehicle sales, which tend to lead vehicle production, rose in October to their highest seasonally adjusted rate since last fall's record three-month string. Total retail sales were up a very strong 0.8% month-to-month in October, after an upwardly-revised 1.0% increase in September. Even excluding auto dealers and gas stations, retail sales were up strongly. The improvement in retail sales reflects stronger growth in wages and salaries. Average hourly earnings (wages) rose 0.4% in October, and year-over-year growth rose to 2.8%, the highest since 2009. One would think that higher wages might translate into lower profit margins, but historical data show that profit margins generally increase during the early stages of a wage acceleration. U.S. housing starts rose a stunning 25.5% in October. They will probably fall back in November, but housing permits, which are less sensitive to weather, edged up to an 11-month high. A resumption in growth in residential construction after two quarters of decline is a vital component of the acceleration of GDP growth I expect over the next year. Finally, new claims for unemployment insurance declined last week to their lowest level since 1973!

There are positive signs outside the United States as well. Economic growth in Europe isn't particularly strong, but 0.4% quarter-to-quarter growth in European Union real GDP in the third quarter and 0.5% growth in United Kingdom GDP suggest that the UK's "Brexit" vote to leave the EU has not (yet) had a negative impact on growth. Growth in Europe isn't great by historical and global standards, but on a per capita basis and relative to its potential, it isn't as bad as generally perceived. Industrial production in manufacturing hasn't grown since the beginning of the year, but was still up 1.3% year-over-year in September. A recent surge in the IFO Business Climate Index for manufacturing, historically a good leading indicator for EU industrial production, suggests that growth is poised to accelerate over the next few months.



Real GDP in Japan grew at a 2.2% annual rate in the third quarter, much better than expected. Most of the growth was due to a big jump in exports. The pickup in Japanese exports likely reflects faster growth in China. Growth in China decelerated significantly from 2010 to 2015 – gradually in the official data, more precipitously in reality – but has firmed this year. Because China accounts for a significant share of global growth, an acceleration in Chinese growth – or at least the end of the multi-year deceleration – is likely to boost growth around the world. Faster growth in China likely explains the recent increase in the price of copper. The price of copper is such a good real-time indicator of economic activity that it is sometime referred to as "Dr. Copper." Technically, it might not be a leading indicator, but it points to turning points in economic growth a month or so before they show up in most economic data.

Before Election Day, most leading indicators for the United States pointed to continued slow growth, neither confirming the apparent acceleration nor signaling a recession. The Conference Board's Index of Leading Economic Indicators rose a tepid 0.1% in October. One leading indicator, however, was flashing a strong warning signal. Heavy truck sales have fallen sharply this year. In the past, such sharp declines have reliably signaled coming recessions. The current decline, however, might reflect a shift from truck transportation to rail transportation. Railcar loadings (excluding petroleum) have been rising lately. Pipelines are now carrying much of the crude oil that was shipped by rail a few years ago, freeing up rail capacity for other goods. Still, any further decline in heavy truck sales should be viewed as a cautionary signal.



Since the election of Donald Trump, U.S. stock prices, long-term interest rates, and the foreign exchange value of the dollar have all risen. Rising stock prices usually point to faster growth ahead. A stronger dollar isn't necessarily bad for the overall U.S. economy, but it is bad for exporters in the manufacturing and agriculture sectors. If interest rates are rising because of expectations for higher budget deficits and higher inflation, that's a bad thing, but if they're rising because of expectations of faster real growth, that's good. So far, the increase in long-term rates has increased the spread between long-term and short-term interest rates; a larger yield spread is a positive leading indicator. Recent data make it a near-certainty that the Federal Reserve will raise short-term interest rates in December, but they have a long way to go before they threaten the economic expansion. For a time, higher interest rates could even boost economic activity by inducing potential home buyers to get off the fence and into the housing market.

The apparent acceleration in economic activity does not guarantee an acceleration in manufacturing. Motor vehicles sales and production are unlikely to rise much further. The strengthening dollar will hurt exports. But a resumption of growth in housing starts should boost production of wood products, nonmetallic mineral products, and furniture; the recent upturn in oil and gas drilling should cause a small rebound in production of metals and machinery; and investments made to take advantage of abundant natural gas liquids from shale formations should boost production of chemicals and polymers.