U.S. Economy: Little Potential to Exceed Speed Limit

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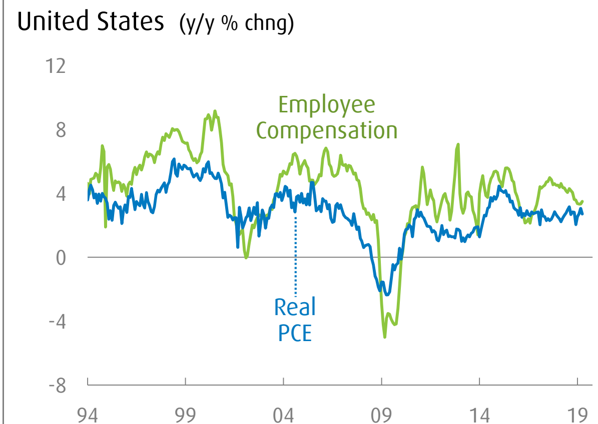
As it enters the record books for longevity, the U.S. expansion seems to be losing steam. Trade policy headwinds are mounting just as the tailwind from past policy stimulus has ebbed. The economy's big engines—consumer spending and fixed investment, accounting for 85% of GDP—sputtered at the turn of the year, weighed down by the stock market scare, government shutdown and wicked weather. Private final domestic demand grew only 1.3% annualized in the first quarter, half the prior quarter's pace and the weakest in 6½ years. Previously, we thought that, as the above-mentioned temporary factors ended, consumer and business spending would rebound and eventually lift growth modestly above potential (which the FOMC pegs around 1.9%). However, we now believe that just getting back to this long-run speed limit will be a challenge. Below we survey the key components of GDP, assessing which can propel it forward and which are more apt to hold it back.

Consumer Spending: Weighing in at two-thirds of the economy, consumers are well positioned to extend the expansion. Despite stalling in April, real consumer spending still rose 2.7% in the past year. Near-record high household wealth and low debt-service costs have shoppers in a good mood, with confidence near multi-decade highs. Consumer credit rose 5% y/y in Q1. But the main driver of spending, typically, is income. And here, sturdy job gains and rising wages are providing support (*Chart 1*). If companies continue to hire, households should keep spending at a solid rate for the rest of the year.

Chart 1
Compensating Factor

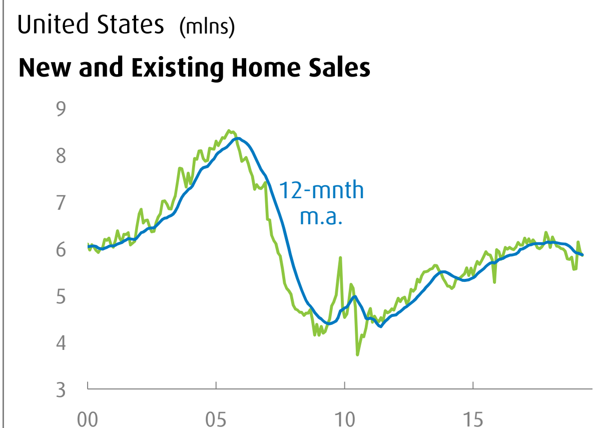


Sources: BMO Economics, Haver Analytics

Housing Market: Residential investment contracted 3.5% annualized in Q1, decreasing for the fifth straight quarter. The slide reflects several factors. Mortgage rates spent most of 2018 on the rise; 30-year tenors peaked at near 8-year highs in November, or 95 bps above where they began the year. Meanwhile, last year's tax changes reduced the tax-savings from mortgage interest deductibility and the attractiveness of ownership. Unfortunately, the stock market's autumn retreat, along with extreme winter and spring weather, kept a housing rebound at bay. However, borrowing costs have fallen almost one percentage point from their apex against a background of strong job creation, sturdy income growth, healthy household balance sheets, easing mortgage lending standards, and improving consumer confidence. This flags some rebound in housing activity.

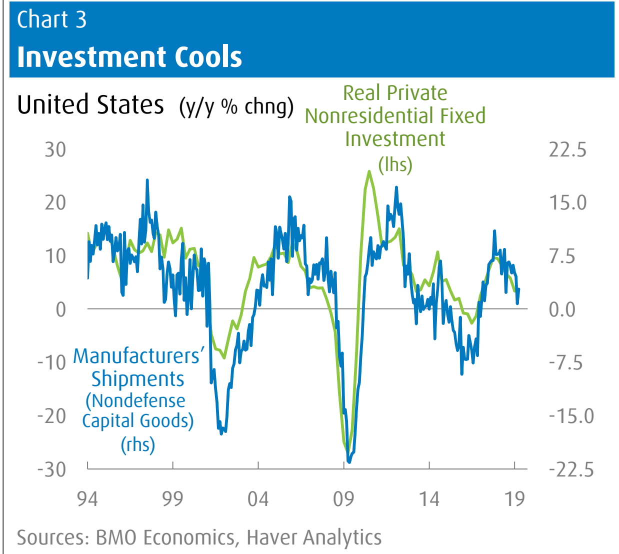
So far in Q2, however, housing indicators have been mixed. While starts hit a seven-month high in April and building permits are even loftier, existing, pending and new home sales all slipped in April (*Chart 2*), though the latter should find support from the homebuilders' sales activity index hitting eight-month highs in May. We expect positive readings for residential investment in Q2 and beyond. However, a sustained above-potential pace would likely require more millennials to jump off the fence.

Chart 2
Home Sales Cresting

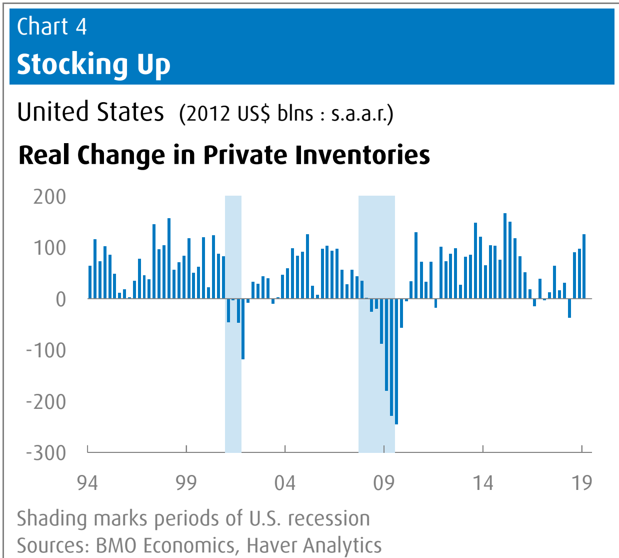


Sources: BMO Economics, Haver Analytics

Business Fixed Investment: As the trade war heats up, the risk grows that businesses will curb spending. After responding with gusto in response to tax reforms last year, business spending on structures and equipment has downshifted. Even demand for information processing gear has slowed from double-digit rates, despite the ongoing need to automate to expand capacity. A big downshift in capital goods orders in April suggests the retreat extended into Q2 (*Chart 3*). However, one area that breeds optimism is intellectual property products, namely software and R&D, which are still up a strong 8% y/y to Q1. Moreover, most surveys of business leaders suggest confidence remains above normal. Overall, fixed investment looks to grow at least near potential this year, though the trade war is a huge wild card.

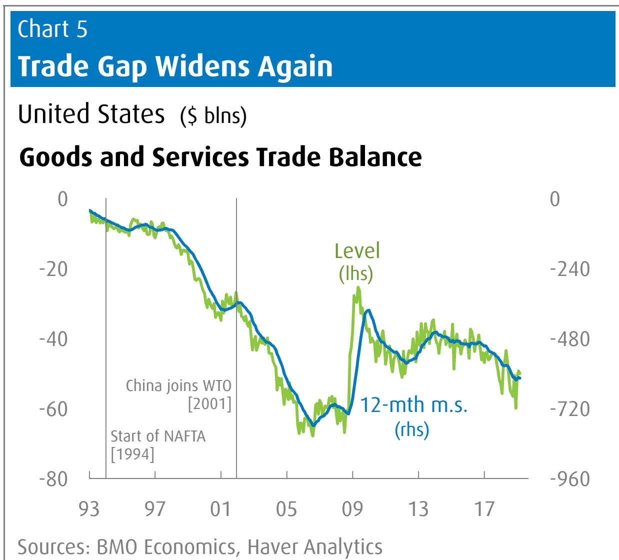


Business Inventories: A hefty recent build in inventories—the Q1 addition was more than double the past quarter-century norm—will undercut production and GDP in Q2 (*Chart 4*). The increase was partly unintentional as consumers retrenched in the face of temporary factors, but it also reflected a prior surge in imports ahead of feared new tariffs. Auto inventories are notably elevated. Historically, large inventory builds are often followed by weaker GDP growth the next quarter. However, the current drag should wane in Q3 if consumers bounce back. While inventories have piled up recently, this followed a period of modest gains that left the ratio to sales in line with the four-year norm. All in, inventories look to make little impression in the second half of the year.



Net Exports: Real imports dropped 2.5% annualized in Q1, the second largest decline since the recession. Imports were boosted previously by stockpiling ahead of feared tariff hikes. So, Q1 was payback and Q2 should see imports rebound, particularly as domestic demand improves during the period. Apart from this technicality, the trend for both exports and imports is weakening, as tit-for-tat tariffs and other trade barriers are mounting, while domestic and global growth trends are slowing (only partly due to the trade restrictions). For example, in 2017Q4, just before U.S. tariffs were deployed as a trade policy tool for the first time in many years, U.S. real exports and imports were expanding in the 4½%-to-5½% y/y range. But growth in trade volumes has since slowed to just 1½%-to-2½% y/y.

With real import levels about 35% above exports, import surges to get in front of tariffs on washing machines, solar panels, steel, aluminum, and $250 billion of Chinese goods have been whipsawing net exports. The underlying trend has deteriorated in the past year (*Chart 5*) and we expect this to continue, acting as a drag on GDP growth. Meanwhile, the U.S. dollar has appreciated 9.0% since early-2018's nadir (about when tariffs started), diminishing the impact of tariff-boosted import prices, while



augmenting the impact of retaliatory-tariff-boosted export prices, and impeding any net export gains.

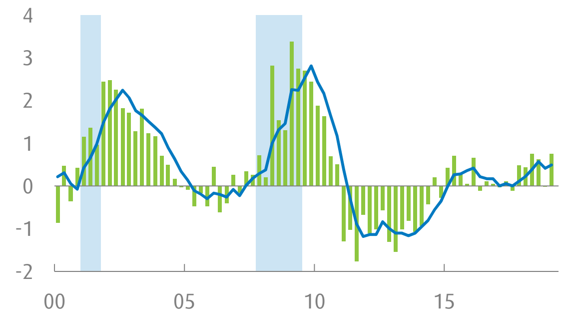
Government Spending: In Q1, the construction of highways and streets paved a large gain in state and local government investment outlays (an 18-year high of 21.2%), driving a 2.5% increase in total government spending. However, such outlays ramp up very quickly, and eventually steer growth rates into negative territory as construction is completed. At the federal level, last year's increase in defence spending continued (up 4.0% in Q1), but total federal outlays were flat as non-defence spending recorded a back-to-back decline. The latter will likely recover, but we judge that sub-potential-growing real federal government spending will emerge as the norm with trillion-dollar budget deficits looming (*Chart 6*). State and local governments are relatively less constrained, so total government spending could manage to keep pace with the economy.

Bottom Line: Of the key economic drivers, only consumers look to have enough fuel in the tank to propel the economy at an above-potential rate this year. The rest of the economy will likely prevent GDP from reaching its long-run speed limit, and we expect growth to average a modest 1.6% to the end of 2020. While this is still an OK performance in the late stages of a cycle when supply issues are also applying a brake, it comes with a big warning label: a further escalation in trade tensions would grind down this modest pace, pushing the jobless rate higher.

Chart 6
Fiscal Stimulus to Fade

United States (ppts)

Contribution of Fiscal Policy to Real GDP Growth[1]



[1] Hutchins Center Fiscal Impact Measure
Sources: BMO Economics, Brookings, Hutchins Center

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