

United States

GROWTH COMING DOWN TO EARTH

- As expected, the temporary boost from the Tax Cuts and Jobs Act (TCJA) and increased federal government spending has started to wane, with US economic growth slowing below potential in 2020.
- While the federal government shutdown and especially cold winter months are expected to crimp growth in Q1-2019, healthy economic fundamentals leave the economy on track for a strong 2019 as a whole.
- Our baseline forecast for a gradual US growth slowdown assumes a benign resolution to a multitude of trade and other risks, which have made for an unsettled atmosphere in financial markets and overseas economies.
- We assume no additional meaningful fiscal stimulus from the Trump administration.

SLOWING BUT SOLID GROWTH DESPITE SIGNIFICANT RISKS

US economic conditions continue to evolve roughly as we have expected. The tailwinds of the US fiscal stimulus are waning, as the hoped-for boost to business investment has proved to be short-lived, consumption shows signs of slowing and trade remains a drag on growth, despite the trade ambitions of the US administration. Our forecast continues to incorporate a gradual and orderly slowdown of GDP growth from 2.9% in 2018 to 2.4% in 2019 and 1.9% in 2020, consistent with expected growth dynamics following a fiscal boost (chart 1). Relative to our previous forecast (see March 7 [Forecast Tables](#)), growth in 2020 is revised up on account of lower short- and long-term borrowing rates, partly as a result of reduced expectation of monetary tightening over the next few years.

Despite the concern among analysts and market participants, we do not expect a recession in our baseline. Nevertheless, while the US economic fundamentals remain broadly healthy, the economy faces a long list of significant risks with a number of important issues waiting to be resolved that cloud the outlook, mainly centered on trade policy (e.g. China-US trade negotiations), and geopolitical risks, with Brexit being the most prominent one.

POLICY UNCERTAINTY UNSETTLES GLOBAL MARKETS

The fact that so many consequential issues are up in the air has made for an unsettled atmosphere in the business community and in financial markets, both in the US and globally in the last few quarters.

Partly as a result of erratic trade policy, economic activity outside of the US is slowing – industrial production in advanced economies other than the US declined in December in y/y terms and trade volumes disappointed (chart 2). Weakness in overseas economies, in addition to the impact of the US-China trade dispute, is expected to have constrained US export growth in Q4-2018, although more recently there are tentative signs of trade volumes improving.

CONTACTS

Brett House, VP & Deputy Chief Economist
 416.863.7463
 Scotiabank Economics
brett.house@scotiabank.com

Marc Desormeaux, Provincial Economist
 416.866.4733
 Scotiabank Economics
marc.desormeaux@scotiabank.com

Juan Manuel Herrera, Economist
 416.866.6781
 Scotiabank Economics
juanmanuel.herrera@scotiabank.com

René Lalonde, Research Director
 416.862.3174
 Scotiabank Economics
rene.lalonde@scotiabank.com

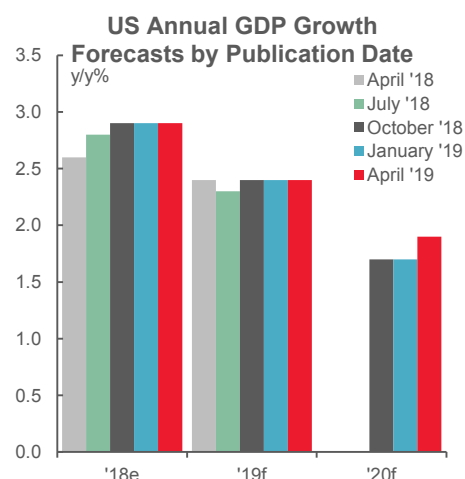
Nikita Perevalov, Senior Economist
 416.866.4205
 Scotiabank Economics
nikita.perevalov@scotiabank.com

Rebekah Young
Director, Fiscal & Provincial Economics
 416.862.3876
 Scotiabank Economics
rebekah.young@scotiabank.com

United States	2017	2018	2019f	2020f
Real GDP (annual % change)	2.2	2.9	2.4	1.9
CPI (y/y %, eop)	2.1	2.2	1.9	2.2
Central bank policy rate (% eop)	1.50	2.50	2.50	2.75
Canadian dollar (USDCAD, eop)	1.26	1.36	1.28	1.23

Source: Scotiabank Economics.

Chart 1



Source: Scotiabank Economics.

As another reflection of uncertainty, equity markets have suffered periodic sell-offs, with the S&P 500 currently still about 2% below the peak reached at the end of September 2018, although it has recovered smartly since reaching a trough at the end of 2018. Cushioning the blow from lower equity prices, partly driven by the flight to safety and partly due to a lower expected path for the Federal Funds rate, the Treasury bond yields have declined in tandem: 10-year rates have fallen from a recent peak of just above 3.20% in early October to as low as 2.38% at the end of March, bringing down borrowing rates for private borrowers (chart 3).

SHORT-TERM FACTORS CONSTRAIN GROWTH

In addition to financial market volatility, moderating foreign demand, and the significant risks weighing on the outlook, the US economy entered 2019 with growth in the short term likely constrained by a slew of temporary factors. This included an unusually cold winter and the effects of the December-January federal government shutdown that ended up being the longest in history (the Congressional Budget Office estimates that the shutdown subtracted 0.4pts from Q/Q SAAR real GDP growth in Q1-2019).

These temporary factors resulted in a string of weak data in January and February in the US, including distinct signs of a loss of momentum in household spending, with auto sales down by 4.8% m/m in January and retail spending down 0.2% m/m in February (chart 4), housing construction (housing starts fell to 1.16 million units in February) and hiring (total nonfarm payrolls +33K in February).

This weakness is expected to be transitory, and indicators in March point to improving conditions, including a rebound in car sales (+5.3% m/m), a sharp rise in existing home sales (+11.8% m/m) and a rebound in nonfarm payrolls (+196K).

GDP OUTLOOK

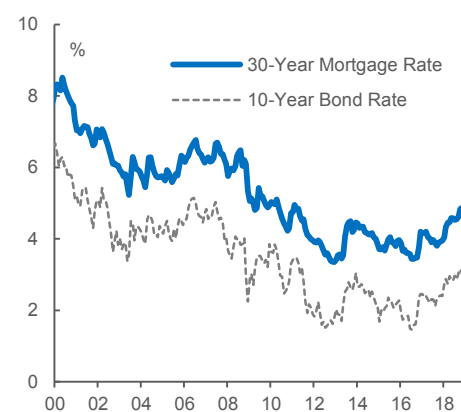
As a result of temporary factors we expect GDP growth in Q1-2019 to reach just 1.7%. With the US federal government re-opening at the end of January, the resumption of activity is expected to boost growth in Q2-2019 to 2.5%. After Q2-2019

Chart 2


Sources: Scotiabank Economics, CPB World Trade Monitor.

Chart 3

US Mortgage Rates Dip in Early 2019



Sources: Scotiabank Economics, Freddie Mac.

Table 1

Quarterly US Forecasts	2018		2019				2020			
	Q3	Q4	Q1e	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Economic										
Real GDP (q/q ann. % change)	3.4	2.2	1.7	2.5	2.1	2.1	1.7	1.7	1.7	1.7
Real GDP (y/y % change)	3.0	3.0	2.8	2.4	2.1	2.1	2.1	1.9	1.8	1.7
Consumer prices (y/y % change)	2.6	2.2	1.7	1.6	1.7	1.9	2.1	2.2	2.2	2.2
CPI ex. food & energy (y/y % change)	2.2	2.2	2.1	2.1	2.2	2.1	2.1	2.1	2.1	2.1
Core PCE deflator (y/y % change)	2.0	1.9	1.8	1.8	1.9	1.9	2.0	2.0	2.0	2.0
Financial										
Euro (EURUSD)	1.16	1.15	1.12	1.17	1.19	1.20	1.22	1.22	1.24	1.24
U.K. Pound (GBPUSD)	1.30	1.28	1.30	1.35	1.37	1.40	1.42	1.42	1.45	1.45
Japanese Yen (USDJPY)	114	110	111	110	108	108	107	107	105	105
Fed Funds Rate (upper bound, %)	2.25	2.50	2.50	2.50	2.50	2.50	2.75	2.75	2.75	2.75
3-month T-bill (%)	2.20	2.36	2.39	2.40	2.40	2.40	2.65	2.65	2.65	2.65
2-year Treasury (%)	2.82	2.49	2.26	2.45	2.50	2.60	2.80	2.80	2.80	2.80
5-year Treasury (%)	2.95	2.51	2.23	2.50	2.60	2.70	2.85	2.85	2.85	2.85
10-year Treasury (%)	3.06	2.68	2.41	2.65	2.75	2.85	2.95	2.95	2.95	2.95
30-year Treasury (%)	3.21	3.01	2.82	3.00	3.10	3.20	3.25	3.25	3.25	3.25

Sources: Scotiabank Economics, BEA, BLS, Bloomberg.

GDP growth gradually starts to slow and falls below that of potential output in 2020, as the temporary fiscal stimulus-driven boost to growth in business investment and consumption passes, 2017–18 interest rate increases slow growth in interest-sensitive sectors, and weaker foreign demand constrains exports.

Consumption and business investment explain most of the deceleration in growth over the next few years with their combined contribution to growth expected to decline from 2.2ppts in 2019 to 1.8ppts in 2020. Net exports are expected to continue to act as a drag on growth throughout the forecast.

HOUSEHOLDS AND BUSINESSES BACK TO SUSTAINABLE GROWTH

Consumer spending has recently begun to flag, after being a dominant source of US economic strength over 2018. Nevertheless, we continue to expect this pause by US consumers to be temporary. Consumption growth is expected to repeat 2018's 2.6% in 2019, before moderating to 2.1% in 2020.

US households are well-positioned to sustain this pace of consumption. Employment growth is near post-2008 highs, notwithstanding February's stumble; labour-market participation rates have increased from their 2015 post-crisis low; and unemployment at 3.8% remains near 40-year record lows. US households have 'dry powder' to support consumption growth and residential investment: the average ratio of household debt-service to disposable income is at 9.9%, its lowest level in 40 years of data (chart 5), and the average household saving rate is at 7.5%, well above the 4.6% pre-crisis average during 2000–07. A stabilizing housing market should provide new impetus to growth in consumer durables purchases. After four consecutive quarters of declines in 2018, residential investment is set to stabilize in Q1-2019, before resuming tepid Q/Q growth over 2019–20, helped by improved affordability and a recent decline in mortgage rates.

Growth in US business investment is expected to moderate during 2019–20 as the boost provided by the tax stimulus fades. Industrial capacity pressures, while being relatively acute now (chart 6), look set to diminish owing to strong capital outlays last year and slower domestic and global growth. The impact on business investment from the Tax Cuts and Jobs Act (TCJA)—which came into force in January 2018 and allows for a full tax write-off of expenses on equipment—likely ran its course in 2018, when it pushed investment growth to 7.0%. The hoped-for repatriation of overseas profits has fallen short of the US President's expectation of up to USD 4 tn and is unlikely to support investment growth going forward, with an important share of the USD 665 bn repatriated in 2018 having been spent on share buybacks (chart 7).

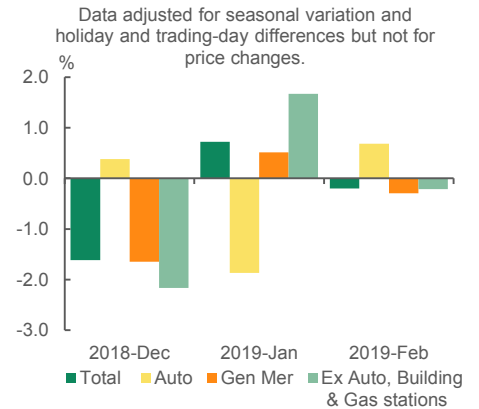
INTERNATIONAL TRADE: STUBBORN DEFICITS

Despite the likely resolution of its trade conflict with China, US exports are set to decelerate through the near future as global growth downshifts, particularly in China and the European Union. Furthermore, given the persistent strength of the USD against most major currencies, the US' trade deficit should continue to expand throughout the forecast horizon, mirroring the expansion of the US fiscal deficit and subtracting from GDP growth, as it has in 21 of the last 29 years since 1990.

We anticipate that the US and China will come to an agreement that would see the removal of recent two-way protectionist trade measures. Relative to the situation prior to 2018, an eventual agreement is likely to provide a small increase in energy and

Chart 4

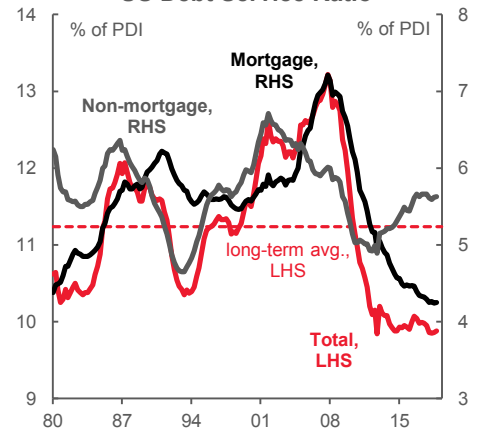
Percent Change in Retail and Food Services Sales from Previous Month



Sources: Scotiabank Economics, Census Bureau.

Chart 5

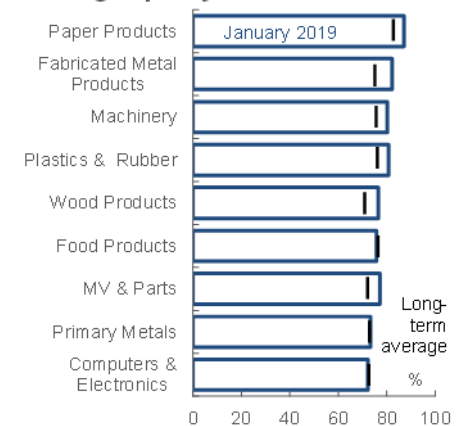
US Debt Service Ratio



Sources: Scotiabank Economics, US Federal Reserve.

Chart 6

Mfg Capacity Utilization Rates



Sources: Scotiabank Economics, BEA.

agricultural exports to China. The costs of the trade war have likely outweighed the potential benefits: nominal merchandise exports to China fell sharply in 2018 (-6.2%), in particular as a result of a fall in exports of soybeans. In contrast, imports rose 6.8% in 2018 (chart 8).

INFLATION PUSHES UP TO 2.0%, GIVING THE FED CONFIDENCE TO HIKE

Over the course of 2018, on the back of the fiscal stimulus, significant excess demand has built up in the economy, with the output gap expected to peak at 0.6% in the second half of 2019 before starting to decline rapidly and finally closing in 2021. This excess demand continues to provide support to core PCE inflation throughout the forecasting horizon (chart 9), bringing it closer to the target and countering disinflationary pressure coming from the weak growth in unit labour costs, the recent decline in oil prices and the relatively strong US dollar. As core PCE inflation rises from 1.8% to 2.0% in Q1-2020 and the economy continues to operate with sizable excess demand, the Federal Reserve should feel confident to raise its Federal Funds rate by 25bps in Q1-2020 to 2.75%, our estimate of the neutral rate in the US (see the [US & Canadian Monetary Policy and Capital Markets](#) report for more details).

Table 2

United States	2000-17	2017	2018	2019f	2020f
(annual % change, unless noted)					
Real GDP	2.0	2.2	2.9	2.4	1.9
Consumer spending	2.4	2.5	2.6	2.4	2.1
Residential investment	-0.3	3.3	-0.3	-1.2	1.2
Business investment	3.0	5.3	6.9	3.6	2.4
Government	1.0	-0.1	1.5	1.8	1.7
Exports	3.7	3.0	4.0	1.9	2.0
Imports	3.7	4.6	4.5	3.2	2.8
Nominal GDP	4.0	4.2	5.2	4.3	3.9
GDP Deflator	1.9	1.9	2.3	1.9	1.9
Consumer price index (CPI)	2.2	2.1	2.4	1.7	2.2
CPI ex. food & energy	2.0	1.8	2.1	2.1	2.1
Core PCE deflator	1.7	1.6	1.9	1.9	2.0
Pre-tax corporate profits	5.3	3.2	7.8	3.4	1.9
Employment	0.7	1.6	1.7	1.4	1.0
Unemployment rate (%)	6.1	4.4	3.9	3.9	4.0
Current account balance (USD bn)	-501	-449	-488	-542	-603
Merchandise trade balance (USD bn)	-680	-807	-891	-949	-1026
Federal budget balance (USD bn)	-540	-665	-779	-1,091	-1,101
percent of GDP	-3.7	-3.4	-3.8	-5.1	-5.0
Housing starts (mn)	1.26	1.20	1.25	1.25	1.26
Motor vehicle sales (mn)	15.6	17.1	17.2	16.8	16.7
Industrial production	0.7	2.3	4.0	2.8	1.8
WTI oil (USD/bbl)	62	51	65	59	61
Nymex natural gas (USD/mmbtu)	4.83	3.02	3.07	2.90	2.80

Sources: Scotiabank Economics, BEA, BLS, Bloomberg.

Chart 7

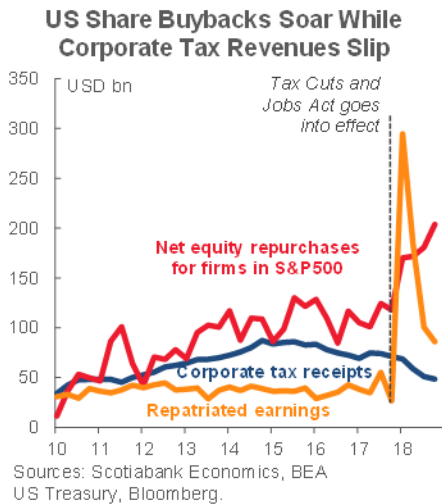
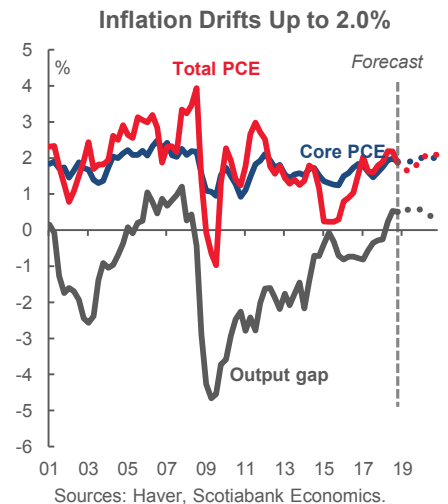


Chart 8



Chart 9



This report has been prepared by Scotiabank Economics as a resource for the clients of Scotiabank. Opinions, estimates and projections contained herein are our own as of the date hereof and are subject to change without notice. The information and opinions contained herein have been compiled or arrived at from sources believed reliable but no representation or warranty, express or implied, is made as to their accuracy or completeness. Neither Scotiabank nor any of its officers, directors, partners, employees or affiliates accepts any liability whatsoever for any direct or consequential loss arising from any use of this report or its contents.

These reports are provided to you for informational purposes only. This report is not, and is not constructed as, an offer to sell or solicitation of any offer to buy any financial instrument, nor shall this report be construed as an opinion as to whether you should enter into any swap or trading strategy involving a swap or any other transaction. The information contained in this report is not intended to be, and does not constitute, a recommendation of a swap or trading strategy involving a swap within the meaning of U.S. Commodity Futures Trading Commission Regulation 23.434 and Appendix A thereto. This material is not intended to be individually tailored to your needs or characteristics and should not be viewed as a “call to action” or suggestion that you enter into a swap or trading strategy involving a swap or any other transaction. Scotiabank may engage in transactions in a manner inconsistent with the views discussed this report and may have positions, or be in the process of acquiring or disposing of positions, referred to in this report.

Scotiabank, its affiliates and any of their respective officers, directors and employees may from time to time take positions in currencies, act as managers, co-managers or underwriters of a public offering or act as principals or agents, deal in, own or act as market makers or advisors, brokers or commercial and/or investment bankers in relation to securities or related derivatives. As a result of these actions, Scotiabank may receive remuneration. All Scotiabank products and services are subject to the terms of applicable agreements and local regulations. Officers, directors and employees of Scotiabank and its affiliates may serve as directors of corporations.

Any securities discussed in this report may not be suitable for all investors. Scotiabank recommends that investors independently evaluate any issuer and security discussed in this report, and consult with any advisors they deem necessary prior to making any investment.

This report and all information, opinions and conclusions contained in it are protected by copyright. This information may not be reproduced without the prior express written consent of Scotiabank.

™ Trademark of The Bank of Nova Scotia. Used under license, where applicable.

Scotiabank, together with “Global Banking and Markets”, is a marketing name for the global corporate and investment banking and capital markets businesses of The Bank of Nova Scotia and certain of its affiliates in the countries where they operate, including, Scotiabanc Inc.; Citadel Hill Advisors L.L.C.; The Bank of Nova Scotia Trust Company of New York; Scotiabank Europe plc; Scotiabank (Ireland) Limited; Scotiabank Inverlat S.A., Institución de Banca Múltiple, Scotia Inverlat Casa de Bolsa S.A. de C.V., Scotia Inverlat Derivados S.A. de C.V. – all members of the Scotiabank group and authorized users of the Scotiabank mark. The Bank of Nova Scotia is incorporated in Canada with limited liability and is authorised and regulated by the Office of the Superintendent of Financial Institutions Canada. The Bank of Nova Scotia is authorised by the UK Prudential Regulation Authority and is subject to regulation by the UK Financial Conduct Authority and limited regulation by the UK Prudential Regulation Authority. Details about the extent of The Bank of Nova Scotia's regulation by the UK Prudential Regulation Authority are available from us on request. Scotiabank Europe plc is authorised by the UK Prudential Regulation Authority and regulated by the UK Financial Conduct Authority and the UK Prudential Regulation Authority.

Scotiabank Inverlat, S.A., Scotia Inverlat Casa de Bolsa, S.A. de C.V., and Scotia Derivados, S.A. de C.V., are each authorized and regulated by the Mexican financial authorities.

Not all products and services are offered in all jurisdictions. Services described are available in jurisdictions where permitted by law.