Current Economic Conditions

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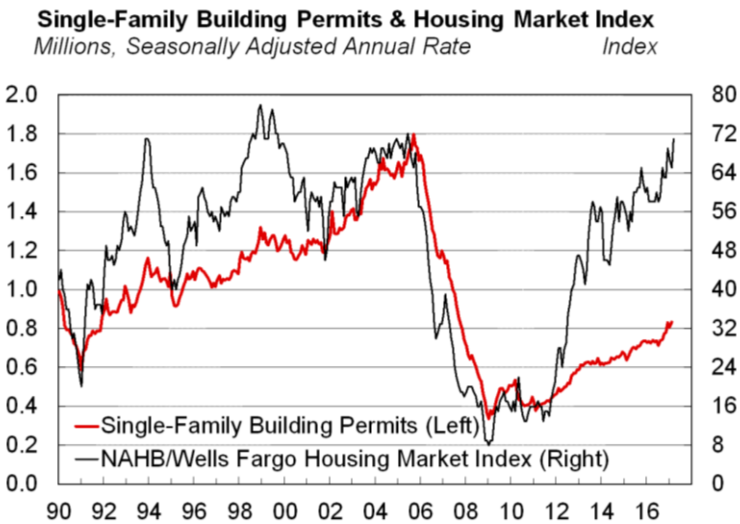
GROWTH IS ACCELERATING (BUT IT MIGHT NOT SHOW UP IN Q1 GDP)



Most economic data continue to show an acceleration in U.S. economic growth. U.S. payroll employment rose by 235,000 in February, on top of a 238,000 gain in January. (Employment only needs to rise by 100,000-125,000 per month to absorb growth in the adult population.) Retail sales rose just 0.1% in February, but that came on top of an upwardly revised 0.6% gain in January. The seasonally adjusted annual rate of light vehicle sales was lower in January and February than in December, but was essentially at the same level as last year's record annual selling rate and at the same level as my 2017 forecast. Building permits for single-family homes, the most important data point in the residential construction report, rose to a 10-year high in February, and the National Association of Homebuilders/Wells Fargo Housing Market Index surged in March to its highest level since 2005, indicating strong demand and further growth ahead.

The manufacturing sector is definitely taking part in the acceleration in growth. Employment in the manufacturing sector has risen by 57,000 over the last three months. The Institute of Supply Management's Manufacturing PMI® surged in February. Industrial production in U.S. manufacturing rose 0.5% (about 6% on an annualized basis) for a second straight month in February, and the ISM's forward-looking new orders index matched its highest level since 2004, suggesting more strong growth ahead.

Despite these strong reports, the Federal Reserve Bank of Atlanta's GDPNow™ projection of first-quarter growth in real Gross Domestic Product is just 0.9% at a seasonally adjusted annual rate. (Projections from the Federal Reserve Banks of St. Louis and New York are much stronger, at 2.5% and 2.8%, respectively, but most other projections are weak.) There are several reasons why the most well-known "nowcast" of current-quarter GDP growth seems weak relative to the data cited above. First, much of the expected weakness is due to an expected decline in net exports. This would be a rational response to the proposed Border Adjustment Tax in the House Republican tax reform proposal. Since a BAT would impose taxes on imports and rebate taxes on exports, it makes sense to accelerate imports (to beat the tax) and delay exports (to get a rebate) if you think there's a chance the BAT will be enacted. Of course, imports go into inventories until they're sold, and goods produced for export go into inventories until they're exported, so an increase in inventory investment should exactly offset the decline in net exports, leaving GDP unaffected. However, I have little confidence in forecasts of inventory investment and can easily believe that GDPNow™ is capturing the decline in net exports, but not the offsetting rise in inventories.

Second, growth in real GDP seems to have been understated in the first quarter for several years. Even though most of the components of GDP are "seasonally adjusted" to remove the impact of regular seasonal fluctuations, total GDP continues to exhibit "residual seasonality. GDPNow™ could be correctly anticipating a first-quarter GDP report that will be biased down by a faulty seasonal adjustment process. If that's the case, growth is likely to be stronger in the second and third quarters, catching up with the strength that other measures are showing in the first quarter.

The third possibility is that GDPNow™ is correct and that most of the apparent strength is in "soft" measures of economic activity, like surveys of confidence, sentiment, optimism, and expectations, rather than in hard data. Fortunately, these "soft" surveys tend to be leading indicators, so even if growth really is slow in the first quarter, it is likely to accelerate over the next couple of quarters. Most leading indexes have picked up in recent months. The Conference Board's Index of Leading Economic Indicators rose 0.6% for a second straight month in February. The Economic Cycle Research Institute's Weekly Leading Index has surged since mid-2016. The Organization for Economic Cooperation and Development's leading indicators have risen globally since mid-2016. My own leading index for industrial production in U.S. manufacturing has surged over the last six months and is pointing to above-trend growth for the first time since early 2015.

While most measures of growth show growth picking up, and leading indicators point to further growth, there is more than the usual amount of uncertainty. The stock market and surveys that show increased optimism about the U.S. economy seem to anticipate that President Trump achieves most of his goals regarding business tax cuts and deregulation, but avoids a trade war and realizes that immigration is necessary for economic growth (and funding expected Social Security and Medicare benefits). Significant deregulation seems likely. I believe this will boost growth, especially at small businesses, but the benefits are much harder for economists to quantify than the impact of a tax cut. In the case of tax cuts, the uncertainty is more political than economic. While a cut in corporate tax rates, changes in the taxation of foreign earnings (to encourage repatriation), and immediate expensing of investment are likely to be enacted, the rate cut might be smaller than markets anticipate. Opposition from consumers, retailers, and oil refiners could derail the Border Adjustment Tax, and without the revenue from the BAT, it's hard to cut the corporate tax rate to the 20% House Republicans propose, much less the 15% President Trump wants. A BAT would **level** the playing field for U.S. and foreign companies and benefit U.S. manufacturers, miners, and farmers, but American consumers, whose purchases of imports have been subsidized by foreign taxpayers, prefer a playing field that's **tilted** in their favor. Tax cuts could also be delayed by the debate over the repeal and replacement of the Affordable Care Act. If tax cuts are delayed until 2018, the recent surge in optimism will prove premature and growth will slow in the second half of 2017.

The nascent acceleration in growth in not just a U.S. phenomenon, indicating that it is not attributable solely to anticipated policy changes. (I suspect it reflects the long-awaited economic benefits from lower oil prices.) Growth in China has accelerated over the last year. This has started to boost growth in Japan and in South Korea. Industrial production in South Korean manufacturing, often a bellwether for global manufacturing, has increased sharply over the last three months after four years of stagnation. European economies continue to do better than most analysts appreciate (and better than European currency manipulators would have you believe). And the Brazilian economy, the worst-performing major economy in the world over the last several years, seems to have finally hit bottom.

U.S. economic growth has accelerated, at least for now, and you should heavily discount any first-quarter GDP estimate that says otherwise. The Federal Reserve apparently agrees. It raised its Federal Fund Rate target to 0.75-1% on March 15 and indicated that it expects to raise it to 3% by the end of 2019.