GENERALI INVESTMENTS

Focal Point

US: Steady growth, but hopes of fiscal boost cool

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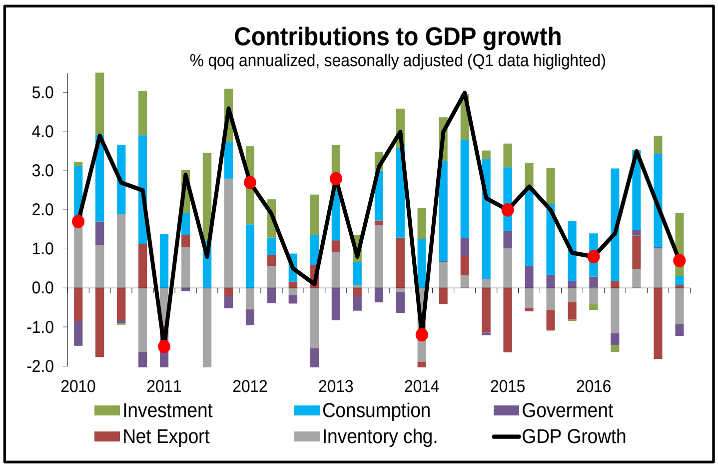
Author: Paolo Zanghieri

- Surprisingly soft Q1 data, with GDP up by just 0.7% saar, sparked concerns about the health of the US economy. This has triggered doubts on the outlook for the Fed's monetary policy normalization and weighed on US yields.
- Yet this recent weakness looks temporary, as one-off factors harming consumption and destocking played a key role.
- Going forward, a strong labor market, high net wealth and low borrowing costs will support households' purchases. Similarly, higher profitability and still favorable financing conditions will help the broad-based recovery in capex.
- Divisions within the Republican Party will lead to a scaled-down tax reform plan, to be approved no earlier than the end of the year amid extreme political polarization.
- In our baseline case, economic growth will slightly exceed 2% both this year and next. Mounting price pressures mean that the Fed will continue to proceed with monetary policy normalization, keeping upside pressures on US yields intact.

The surge in confidence indicators seen after Mr. Trump's victory in November 2016 and until mid-March has not been matched so far by equally strong activity data. This appears clearly in the subdued Q1 GDP figures. According to preliminary estimates, growth stood at just 0.7% qoq annualized. The disconnect between expectations and hard data is reflected in the evolution of macro surprises. The Citigroup Economic Surprise Index, which averaged 42.7 in Q1, eased to 22.6 in April before plunging to -25.8 in the first three weeks of May. Disappointing data, coupled with mounting doubts on the Trump Administration's ability to deliver a far-reaching tax reform, have sparked concerns about the health of the US economy. In turn, uncertainty has increased on how quickly the Fed will act to normalize monetary policy. As a consequence, and also due to softer inflation data and political turmoil, the yield on 10-year Treasuries has slipped from 2.6% in mid-March to 2.2%. In what follows we argue that the observed weakness in the data has a lot to do with seasonal and one-off factors affecting an otherwise steady growth path. While political gridlock and the risk of a constitutional crisis represent downward risks, we anticipate GDP to grow at rates above 2% both this year and in the next in our base scenario.

Mostly one-off factors dampened Q1 GDP data

The abrupt change in the seasonal pattern of data since the financial crisis has resulted in somehow artificially low Q1 GDP figures; in the 2010Q1-2017Q1 period GDP grew on average at 2.05% annualized per quarter, but the average for first quarter growth was just 1%. Data for 2017 seem no exception; in particular inventories (which tend to be revised in subsequent data releases) took out nearly one percentage point from growth, and consumption, barely growing at 0.1% annualized, appeared particularly weak in comparison with past data and households' economic conditions. Apart from statistical quirks, we see three mayor reasons for that, which does not have a strong structural nature. First of all, the rise in inflation, with the consumption deflator up by 2% yoy in Q1 against 1.4% in Q4 2016 mechanically dampened the real data. Secondly, unusually warm weather reduced demand for energy, taking out 0.1% from consumption growth. Finally and most prominently, auto purchases fell markedly (-4.3% qoq), an almost natural retrenchment after two quarters of over 4% qoq growth and given rising concerns over the quality of auto credit (more on that below).

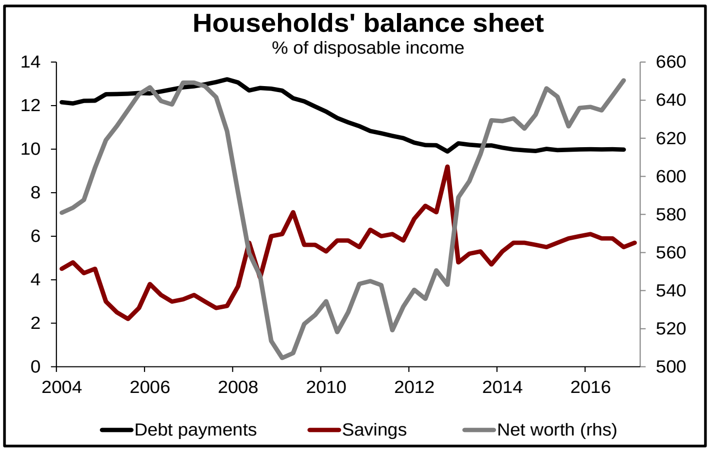


Solid balance sheets sustain consumption

Economic fundamentals driving consumption appear consistent with stronger and steady growth (above 2% yoy) in the next quarters. Employment improves, as witnessed by the 211k payroll growth posted in April. Median wages, which adjust for the demographic composition of employment and provide a better gauge of workers' purchasing power, continue to increase at over 3% yoy. Most other drivers of household purchases are expected to provide at least a neutral contribution.

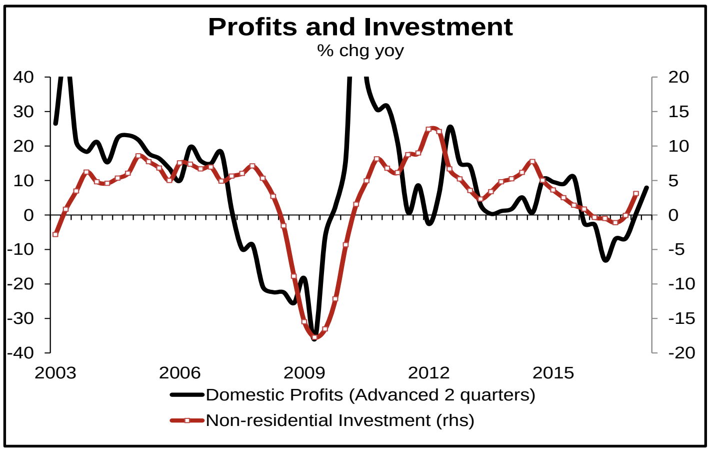
The saving rate remains above the pre-crisis average (5.7 in Q1, against a 3.9% average between 2002 and 2007). We tend to consider it a structural shift related to higher risk aversion, therefore we do not expect in the medium term an extent of dissaving capable to provide a boost to consumption. Additionally, consumer confidence is at a ten-year high. This reflects the improvement in the labor market and, to a significant extent, expectations on future fiscal policy. This of course makes confidence vulnerable to setbacks in case a disappointing outcome of the promised reforms on taxes and trade

Stronger equities and the ongoing increase in house prices have lifted the net worth to income ratio to just above the pre-crisis peak, even though the beneficial impact of wealth effect on consumption is likely to be somehow dampened by the a highly unequal wealth distribution. Low interest rates have kept borrowing costs in check and the large post-crisis deleveraging (household debt was 99% of GDP at the beginning of 2008, and 80% at the end of 2016), makes balance sheets more resilient to the smooth increase in interest rates we expect this year. Therefore we do not expect credit to constitute a headwind to consumption growth, with one notable exception, the vehicle market. Here, credit quality has deteriorated faster than in other consumer segments and delinquencies are heading back to the peak reached at the onset of the financial crisis. According to the New York Fed, in the first quarter of the year, 3.4% of all loans were overdue by more than 90 days while the share for auto loans was 3.8%. In Q4 2009 the overall of delinquencies was respectively 8% and 4.7%. The fast tightening in credit standards is largely responsible for the sharp downturn in Q1 car sales.

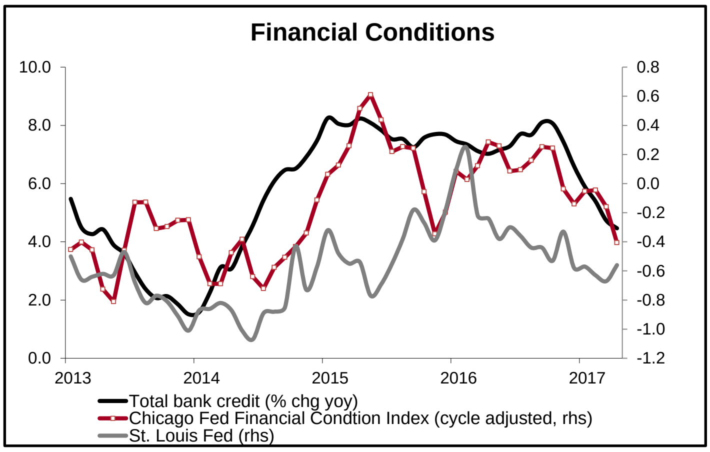


Pick-up in investment on rebounding profitability

The really important, and positive, piece of information in Q1 GDP data was the strong (9.3% qoq annualized) rebound in private nonresidential investment, as a strong showing by the non-oil industries was matched by a return to positive growth in capex by oil producers, lured by higher prices. The result mirrored the sharp increase in business sentiment around the turn of the year, and a key question is how resilient investment growth would be against diminished expectations on the outcome of the reforms on regulation and capital taxation. We think that the cyclical momentum and the availability of internal and external financing are strong enough to maintain capex growth. Firstly, domestic demand remains healthy and the growth acceleration shown in Q1 GDP data for the main trade partners bodes well for foreign one. Moreover, the trade-weighted dollar has slid back to mid-November levels, which will help export competitiveness. Internal financing will be sustained by the progression in profits, which have retuned in Q4 to positive (8%) yoy growth, after nearly two years of yoy contraction. Profitability remains, however, fragile as the ongoing and possibly accelerating wage increase contrasts sluggish productivity growth. We expect profit growth to moderate somewhat over the next quarters, but not to decline and this will help finance capex.



The ongoing slowdown in credit growth has reignited fears of a credit crunch. However, this looks more a return of demand to a "cruise speed" rather than supply constraints. The latest release of the Fed survey on Loan Officers (SLOOS) indeed shows that lending standards have, if anything, eased in Q1 for most of the loan types, and this trend is set to continue in Q2. More broadly, financial conditions have loosened, as the tightening in policy rate has been more than offset by higher equity prices, a weaker dollar and stable long term rates.



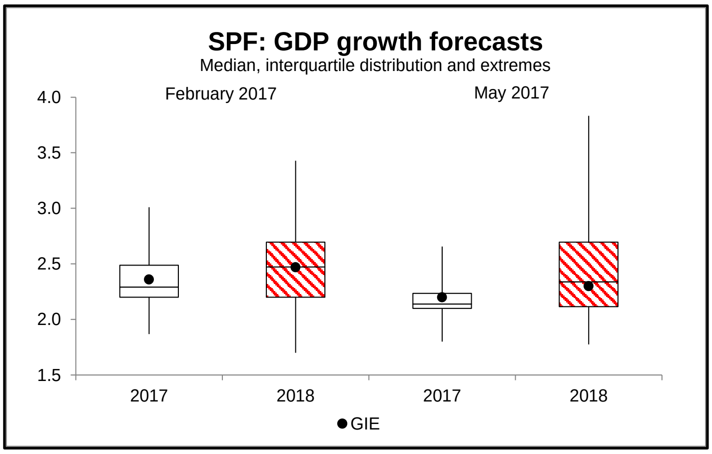
Political constraints limit fiscal boost

The political situation constitutes a key downside risk to this fairly benign outlook. The large tax cuts promised by Trump require far-reaching revenue-raising measures-like the border adjusted tax (BAT) or the end of favorable fiscal treatment of debt in order not to add to an already increasing debt. Any such moves would create losers; for example, BAT would harm heavy importers like retailers and the end of interest payment deduction would affect borrowers. Their strong lobbying efforts would be particularly successful given the highly polarized political environment, which prevents bipartisan agreements and also due to the division within the Republican majority. Internal splits have so far halted any significant legislative activity, first and foremost the healthcare reform. Gridlock is exacerbated by the lack of a clear economic policy strategy by the Administration and, above all, the risk of a full blown constitutional crisis, following the recent developments of the investigation on the alleged relationship between part of president Trump's staff and the Russian government. The cooling off posted by economic sentiment in April can be partly ascribed to disenchantment about tax and regulatory reforms, but clearly confidence will be sapped by any further spike in political uncertainty. Yet, given the challenging political environment, Republican lawmakers need tangible achievements before the November 2018 mid-term election, and therefore we continue to factor in a fiscal stimulus in our baseline scenario. It could take the form of a 10 pp reduction in the statutory corporate income tax rate and deductions for low and middle-income households, resulting in a roughly 0.5% boost to GDP, starting from Q1 2018. Timewise, the Administration and the Congress majority will have to agree on the plan by the end of July at the latest, for it to be passed into law by November and be enacted at the beginning of next year.

Two years of above potential growth

A smaller and delayed fiscal stimulus is the key motivation for the downward revision of our growth forecast; we now project GDP to growth by 2.2% this year and 2.3% in 2018 (from respectively 2.4% and 2.5%). Diminished expectations are evident also in the Survey of Professional Forecasters (SPF), a quarterly poll among economists collected by the Philadelphia Fed as background information for the FOMC. Between February and May the median growth forecast for 2017 fell from 2.3% to 2.1%. More important, the uncertainty around it has shrunk, which can be interpreted as a signal that most forecasts for 2017 just consider the dynamics of the business cycle (on which there is less disagreement) without the (uncertain) impact of the fiscal boost, as it is now expected to display their effects in 2018.

While slower than previously expected, growth will remain well above the 1.8% yoy estimated potential rate and will continue to be largely driven by consumption. The growth picture remains consistent with a steady buildup of demand pressures on prices and wages. Therefore it does not alter materially our outlook for the Fed, with two further hikes this year and a further gradual tightening in 2018.



Imprint

Head of Research (*ad interim*): Santo Borsellino (santo.borsellino@generali-invest.com)
Deputy Head of Research: Dr. Thomas Hempell, CFA (thomas.hempell@generali-invest.com)

Team:
Luca Colussa, CFA (luca.colussa@generali-invest.com)
Radomír Jáč (radomir.jac@generali.com)
Jakub Krátký (jakub.kratky@generali.com)
Michele Morganti (michele.morganti@generali-invest.com)
Vladimir Oleinikov, CFA (vladimir.oleinikov@generali-invest.com)
Dr. Martin Pohl (martin.pohl@generali.com)
Dr. Thorsten Runde (thorsten.runde@generali-invest.com)
Frank Ruppel (frank.ruppel@generali-invest.com)
Dr. Christoph Siepmann (christoph.siepmann@generali-invest.com)
Dr. Florian Späte, CIIA (florian.spaete@generali-invest.com)
Dr. Martin Wolburg, CIIA (martin.wolburg@generali-invest.com)
Paolo Zanghieri (paolo.zanghieri@generali.com)

Issued by:
Generali Investments Europe Research Department
Cologne, Germany · Trieste, Italy
Tunisstraße 19-23, D-50667 Cologne

Sources for charts and tables: Thomson Reuters Datastream, Bloomberg, own calculations

In Italy:
Generali Investments Europe
S.p.A Società di gestione del risparmio

Corso Italia, 6
20122 Milano MI, Italy

In France:
Generali Investments Europe
S.p.A Società di gestione del risparmio

2, Rue Pillet-Will
75009 Paris Cedex 09, France

In Germany:
Generali Investments Europe
S.p.A. Società di gestione del risparmio

Tunisstraße 19-23
50667 Cologne, Germany

www.generali-invest.com