US Economic Growth: Will a "New Norm" Trump the Political Agenda?

Scott J. Brown, Ph.D., *Chief Economist, Equity Research*, outlines his expectations for economic growth.

Economic growth is an important factor in financial market performance and investors typically focus on near-term prospects while long-term trends are often overlooked.

In recent years, economists have increasingly come to accept the view that slower labour force growth will limit the trend in inflation-adjusted US gross domestic product (GDP). Financial markets may have yet to fully embrace this "new normal."

TIGHTENING US JOB MARKET CONDITIONS

Monthly changes in nonfarm payrolls are subject to statistical uncertainty and difficulties in seasonal adjustment. This noise can be reduced, but not eliminated, by looking at a period of months. The payroll figures have shown a clear downtrend over the last few years, which likely reflects the tightening in job market conditions. Firms are simply running out of people to hire. The recent pace of job growth is still beyond a long-term sustainable rate, which is okay since there is some slack remaining in the job market. However, that slack is being reduced, leaving us closer to full employment. The unemployment rate fell to 4.3% in May, a 16-year low. The percentage of people involuntarily working part time has fallen. The unemployment rates for teenagers and young adults are trending lower.

Tight job market conditions are normally associated with faster wage growth. In recent months, average hourly earnings were trending at around 2.5% year-over-year, better than the 2.0% pace of a few years ago, but far short of the wage growth (3.5% or more) we would expect to see at such a low unemployment rate. Moderate wage growth likely reflects labour's limited bargaining power. Union membership is a fraction of what it was in previous decades, and a higher concentration of large firms makes the job market less competitive.

Wage growth has been muted in 2017 on an inflation-adjusted basis. Gasoline prices are higher than last year. With more money going into gas tanks, households have less money to spend on other things. Rents have been rising faster than overall inflation. Healthcare costs are accounting for an increased share of household budgets. Consumer spending was weak in the first quarter of 2017. That's not necessarily a problem – a soft Q1 17 following a strong Q4 16 is not surprising – but recent data suggests that the Q2 17 rebound is disappointing.

TRUMPONOMICS AND TAX REFORM

It's no secret that U.S. politics have become more polarised. What's unusual is that this division has become more clearly reflected in economic expectations. The University of Michigan's May Survey of Consumers showed sharp differences by political affiliation, "with Republicans holding more favourable views on jobs and policies than Democrats." According to the report, "The impact of this divide led most Republicans to expect a robust expansion and most Democrats to anticipate a recession." That division may also be reflected in consumer spending. Retailers note some decrease in spending due to the crackdown on undocumented workers.

Business fixed investment rose sharply in the first quarter, largely reflecting the rise in business confidence. However, more than a third of that increase was in oil and natural gas drilling. Energy exploration contracted sharply from the end of 2014 to the middle of 2016. Oil and gas well drilling, which is capital intensive, rebounded some in the first quarter. However, beyond the energy sector, capital goods orders and shipments appear to have slowed to a more moderate pace into the second quarter.

Since the November election, financial market participants have been encouraged by the "Trump agenda" of reduced regulation, large-scale infrastructure spending and broad tax reform. However, even with one-party control of the White House and both chambers of Congress, this agenda is facing a significant uphill battle on Capitol Hill. Under broad tax reform, individual and corporate tax rates would be lowered, with lost revenue recovered partly through the elimination of most tax deductions. These deductions (also called "tax expenditures") amount to $1.5 trillion per year. However, nobody wants to give up their deductions and lobbyists will vigorously defend them. Congress may still lower tax rates later this year or in early 2018, but on a much smaller

scale than had been hoped for earlier.

A $1 trillion deficit-financed infrastructure spending package is a nonstarter. Members of the House are not going to vote to boost the deficit. Private-sector funding of infrastructure has been proposed, but privatisation doesn't provide a boost to the overall economy and should be limited beyond airports and air-traffic control. By contrast, a rollback in regulations is easily achievable. Congress doesn't even need to change legislation. The executive branch can simply ignore the regulatory laws on the books. However, it's unclear how much restraint regulation has imposed on the overall economy.

Even if the Trump agenda were enacted in full, the economy would remain subject to labour market constraints. Indeed, consensus forecasts for GDP growth were raised only marginally following the election and have softened a bit more recently.

SLOWER GROWTH TRENDS

Slower-trending U.S. economic growth creates a number of intermediate-term concerns, and countries around the world face similar challenges. One issue is how to improve the standard of living. Another is how to fund the retirements and healthcare of aging populations. Entitlement spending (Social Security and Medicare) accounts for an increasing portion of federal government spending. Eliminating all nondefense discretionary spending, an extremely unlikely prospect, would still leave us with a budget deficit.

Efforts to boost growth beyond the 1.5 - 2.0% sustainable trend should be directed to two areas: adding to labour force growth and boosting productivity growth. The Labour Department projects that potential labour force growth will average about 0.5% per year over the next ten years, with immigration accounting for about 40% of that. Slower population growth could be offset by increased immigration. Instead, both legal and illegal immigration have slowed this year. Productivity-enhancing capital expenditures rose in the first quarter, but it remains to be seen whether such a strong pace will continue. Longer term, advances in technology, principally robotics and artificial intelligence, should help offset slower labour force growth. However, it's difficult to say by how much.

For the most part, we are only talking about a slower trend rate of economic growth, not a recession. However, for any given pace of GDP growth, some sectors will grow faster than others. As trend growth slows, some sectors will be in contraction. *Historically, the strength of the U.S. economy has been its ability to evolve and adapt to changing circumstances.* One hundred and fifty years ago, most of the economy was in agriculture. Sixty years ago, one out of every three jobs was in manufacturing. The future will look different to us in ways we cannot see now. However, it seems clear that the U.S. will need a more adaptive, better-educated workforce.

KEY TAKEAWAYS:

- In recent years, economists have increasingly come to accept the view that slower US labour force growth will limit the trend in inflation-adjusted gross domestic product (GDP). Financial markets may have yet to fully embrace this "new normal."
- Since the November election, financial market participants have been encouraged by the "Trump agenda." However, this agenda is facing a significant uphill battle on Capitol Hill.
- Historically, the strength of the U.S. economy has been its ability to evolve and adapt to changing circumstances. The future will look different to us in ways we cannot see now. However, it seems clear that the U.S. will need a more adaptive, better-educated workforce.

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