US Economic Outlook: Policy Uncertainty and Demographic Constraints

Scott J. Brown, Ph.D., *Chief Economist, Equity Research*, outlines his expectations for the US economy in the coming year.

Prior to the election, there was a growing consensus that demographic changes would be a major factor restraining economic growth in the U.S. and around the world. The expectation of the "new normal" is based on the idea that populations are ageing and labour force growth will be significantly slower than in previous decades.

Barring a substantial increase in immigration or a sharp pickup in the pace of productivity growth, real Gross Domestic Product (GDP) can be expected to trend at a 1.5 - 2.0% annual rate, rather than the 3.0 - 3.5% pace seen in previous decades. Post-election, those constraints will still be binding. Hence, fiscal stimulus (increased government spending and large-scale tax cuts) may not provide much of a lift. Moreover, policy uncertainties, particularly in regard to foreign trade, add more uncertainty and risk to the economic outlook.

REAL GROSS DOMESTIC PRODUCT
IS EXPECTED TO TREND AT A
1.5-2.0%
ANNUAL RATE

U.S. ECONOMY

Recent data suggest that the economy is in good shape. Real GDP growth appears likely to finish 2016 at about 2% (4Q16-over-4Q15). Consumer spending growth has been relatively strong, fuelled by robust job growth and moderate wage gains. Low gasoline prices have helped, but the beneficial impact will fade over time as oil prices stabilise and move somewhat higher. Business fixed investment has been sluggish, reflecting the contraction in energy exploration, a sluggish global economy, and general uncertainty in the economic outlook. Residential home building has continued to improve.

JOB MARKET

Job growth remained strong in 2016, but was somewhat slower than in the last couple of years. That may reflect business caution ahead of the presidential election, but job growth will normally slow as the job market tightens. A tighter job market would normally lead to faster wage growth. Average hourly earnings have picked up, but the underlying trend appears to be moderate, suggesting that there is still some slack in the job market. Long-term unemployment and measures of underemployment are still above levels considered to be "normal," but they have been improving.

FEDERAL RESERVE

Federal Reserve (Fed) policymakers have remained focused on the job market and the outlook for inflation. As 2016 began, most Fed officials expected to raise short-term interest rates four times over the course of the year, but improvement in the labour market was slower than expected and inflation remained muted. Most Fed officials believe that the economy is getting close to full employment. Following the December 14 increase in the federal funds target rate, most officials expect two to four rate increases in 2017, with a median of three. However, that depends on the job market and the inflation outlook. If the job market tightens more rapidly than anticipated and wage growth picks up more sharply, additional monetary tightening could come sooner. Conversely, if growth is sub-par and inflation remains low, officials would be inclined to move more slowly.

DEMOGRAPHIC TRENDS IN THE U.S. AND ABROAD

Demographic issues, particularly slowing population growth, are expected to play a major role in the outlook for economic growth in the U.S. and the rest of the world.

Between 1960 and 2000, labour force growth in the U.S. averaged 1.8% per year as the baby-boom generation came into the job market and women entered the workforce in greater percentages. The Bureau of Labour Statistics now expects trend labour force growth to be about 0.5% per year.

Output (GDP) is the amount of input (labour) times the output per worker (productivity). Hence, GDP growth is labour force growth plus productivity growth. As the remaining slack in the job market is taken up, growth should exceed the longer-term trend, but the demographics will eventually become binding.

Productivity growth has been unusually soft in recent years. That may reflect softness in capital spending during the recession and early recovery. If so, productivity growth should improve as capital spending picks up. Longer term, advances in robotics and artificial intelligence could boost productivity significantly in the years ahead, offsetting the impact of slower labour force growth. However, it's difficult to predict how changes in technology will affect the economy.

Note that slower population growth and weak productivity growth are not issues unique to the U.S. Population growth is slowing worldwide. Productivity has also slowed outside the U.S., along with business fixed investment. In turn, global trade has slowed in the last couple of years – and that's absent of any significant increase in protectionist measures.

BETWEEN
1960 & 2000
GROWTH IN THE U.S. LABOUR FORCE AVERAGED
1.8% PER YEAR

EXPECTED LABOUR FORCE GROWTH TREND
0.5% PER YEAR

OUTPUT PER WORKER (PRODUCTIVITY)
X INPUT (LABOR)
OUTPUT (GDP)

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PRESIDENTIAL ELECTION

Following the election, investors have been encouraged by expectations of a roll-back in regulations and a major fiscal stimulus package. Donald Trump's surprise victory has significantly changed the Washington outlook. Republicans control the House and the Senate, and while there are likely to be differences between the incoming administration and the establishment Republicans on a number of issues, it should be easier to get things done.

INFRASTRUCTURE SPENDING

Trump called for more infrastructure spending during the campaign. However, it's unclear how it will be funded. Additional federal spending may be hard to get through the House. The House no longer allows earmarks (specific allocations in spending bills), which means that you don't get the kind of "horse-trading" needed to reach a broad agreement.

TAX REFORM

Tax cuts, on the other hand, should be relatively easy to achieve, although substantially less than what Trump had proposed during the campaign. Presumably, lower taxes on households and businesses would be achieved through tax "reform." However, even with lower tax rates, few will want to get rid of the deductions they enjoy, which makes true tax reform difficult, if not impossible.

FISCAL STIMULUS

Fiscal stimulus can be effective in countering an economic downturn, but is unlikely to provide much of a boost if the economy is close to full employment. Most economists have raised their GDP forecasts for 2017, but only modestly – reflecting the restraining impact of labor market constraints. Hence, while there is some possible upside for growth as the remaining labor market slack is reduced, that should be limited, and fiscal stimulus is more likely to result in higher inflation or an asset price bubble.

INTEREST RATES

Tax cuts do not pay for themselves, and the bond market is currently anticipating an increase in government borrowing in 2017 and beyond. However, the rise in U.S. bond yields is expected to be kept in check somewhat by lower long-term interest rates abroad. In turn, higher U.S. bond yields put some upward pressure on long-term interest rates outside the U.S., complicating monetary policy effectiveness in Europe and elsewhere.

PROTECTIONISM: A GLOBAL RISK

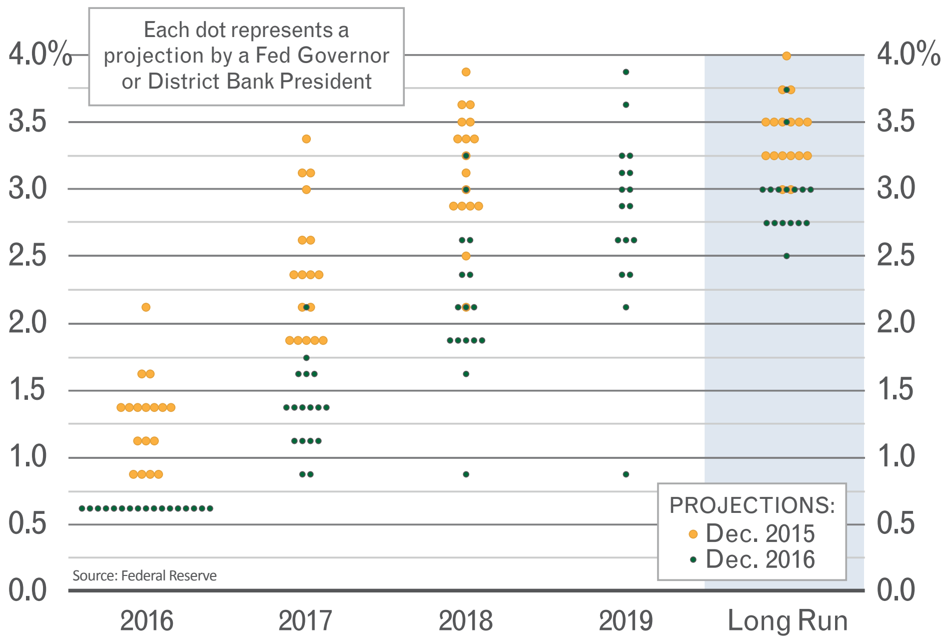
The bigger risk to the economy is the possibility of global trade disruptions. Entering trade agreements requires congressional approval, but the president can, by himself, pull out of existing agreements, such as NAFTA. Economists will tell you that neither side wins in a trade war. If the Treasury Department were to officially declare China as a currency manipulator – even though the country is trying to prevent its currency from weakening, rather than pushing it lower – that designation would automatically set off tariff increases, which would likely be met by countermeasures against U.S. exports. U.S. manufacturing uses parts and materials from around the world. Disruptions to the supply chain would have adverse effects on the overall economy. There's a strong belief that cooler heads will prevail, but a rise of protectionism remains a key risk to the global economic outlook.

OVERALL

New presidential administrations typically face a number of unforeseen challenges. Optimism about the economy may be short lived. However, there is significant positive economic momentum heading into the new year. Households and businesses are generally in good shape.

TARGET FEDERAL FUNDS RATE AT YEAR-END

At the Federal Open Market Committee meetings in March, June, September and December, senior Fed officials submit forecasts of the appropriate year-end federal funds target rate (the overnight lending rate that banks charge each other for borrowing excess reserves). Each dot in the dot plot represents a forecast of an individual Fed official. Note that there is uncertainty surrounding each dot and that not every official gets to vote on monetary policy. The dots are expectations, not a plan of action. Monetary policy decisions will remain data dependent, with a focus on the job market and the inflation outlook.



KEY TAKEAWAYS:

- Barring a substantial increase in immigration or a sharp pickup in the pace of productivity growth, real Gross Domestic Product can be expected to trend at a 1.5 - 2.0% annual rate, rather than the 3.0 - 3.5% pace seen in previous decades.
- Demographic issues, particularly slower population growth and weak productivity growth, are expected to play a major role in the outlook for global economic growth. These constraints will be binding post-election, limiting the impact of fiscal stimulus.
- There is significant positive economic momentum heading into the new year. Households and businesses are generally in good shape, and recent data suggest that the economy is healthy.
- Key risks to the global economic outlook are the possibility of global trade disruptions under the Trump administration and a resultant rise of protectionism.

All expressions of opinion reflect the judgment of the Research Department of Raymond James & Associates, Inc. and are subject to change. There is no assurance any of the trends mentioned will continue or any forecasts will occur. Real Gross Domestic Product (real GDP) is a macroeconomic measure of the value of economic output adjusted for price changes (i.e., inflation or deflation).

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