RSQE FORECASTS

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For Release: 9/16/2016

The U.S. Economic Outlook for 2016–2018
Executive Summary: September 2016

Modest Rebound Ahead

The economy grew at an annual rate of just 1.0 percent in the first two quarters of 2016. One major drag on growth was a correction in inventory investment, which reduced growth in the first half of 2016 by 0.8 percentage points. We believe that after five consecutive quarters, the inventory adjustment is finally over. Personal consumption expenditures continue to drive growth, contributing more than two percentage points in the first half of 2016. We consider consumption and other factors supporting economic growth to be durable, and expect growth to rebound in the second half of the year.

The Bane of the Global Swing Oil Producer

Investment in new oil and gas exploration continued to plummet in the second quarter, subtracting 0.3 points directly from real GDP growth, versus an average drag of 0.4 points since the first quarter of 2015. The overall impact was possibly even larger due to oil-related declines in equipment investment. Lately, however, there have been some encouraging higher frequency data, and we foresee a modest recovery in this sector from here. The recent hit to domestic output came at a time when global growth was already slowing, increasing the sensitivity of the domestic economy to global shocks. The increased sensitivity comes with the role of the global marginal oil producer.

Resilient Labor Markets

Despite modest output growth, labor market progress continued without a major hiccup in 2016. Nonfarm payrolls added a solid 182,000 jobs per month through August. The headline unemployment rate in August was 4.9 percent, equal to its value in January despite the labor force participation rate ticking up a tenth of a percentage point. In what we see as hopeful signs for the future, initial weekly claims for unemployment insurance have averaged 266,000 so far in 2016, the lowest level on record as a fraction of payroll employment, while the job openings rate has averaged 3.8 percent, the highest level since this series began in 2000.

Mixed Messages

Business indicators paint a mixed picture of the current state of the economy. The ISM nonmanufacturing index slipped in August to its lowest level since February 2010, although it continues to indicate expansion. The Fed's Industrial Production Index, however, has rebounded 0.7 index points since May, following a long decline, from late 2014 to early 2016, that coincided with the collapse in oil exploration.

The recovery in the housing market continues to proceed erratically. Single-family housing starts fell at a 16 percent annualized rate in the second quarter after a solid first-quarter performance. After three quarters of declines, multi-family housing starts grew sharply in the second quarter, but were still 10 percent lower than a year earlier.

Light vehicle sales have declined from a pace of 17.8 million units at an annual rate in the fourth quarter of 2015 to a 17.2-million-unit pace so far in 2016. We now believe the sales pace in the second half of 2015 was unsustainable, and do not see light vehicle sales providing substantial contributions to GDP growth in our forecast period.

A Feud at the Fed?

In the last few weeks, there have been opposing signals in public statements from some prominent voting members of the Committee. Federal Reserve Chair Janet Yellen stated that "the case for an increase in the federal funds rate has strengthened in recent months," while two established policy doves appeared to push in opposite directions from each other with regard to the timing of the next rate hike. We think that September is off the table, but the public disagreement likely means that internal FOMC pressure to raise rates is building, which makes a rate hike in December very likely.

Subsequently, we project the Fed will raise the target federal funds rate range by 25 basis points roughly every six months through 2018, a path we deem most consistent with our economic outlook.

Divided Government Awaits

We expect divided government to continue over our forecast. This likely means no major fiscal reforms in the near future and keeps the next President and Congress prolonging the status quo of suspending the debt ceiling and sequestration budget caps.

Federal current expenditures on a NIPA basis are projected to accelerate steadily from 3.3 percent growth in fiscal 2016 to 4.6 percent in fiscal 2018, driven mostly by the rise in transfer payments. The share of defense expenditures in overall federal consumption is falling during our forecast, from 60.4 percent in 2016 to 59.7 percent in 2018. Federal expenditures remain nearly flat as a share of GDP. As personal income growth picks up, federal receipts as a share of GDP inch up from 19 percent in fiscal 2016 to 19.3 percent in fiscal 2018.

With revenue growth slightly outpacing expenditure growth as a share of GDP, the federal deficit remains steady at 3.4 percent of GDP in fiscal 2016 and 2017, then ticks down to 3.3 percent in fiscal 2018.

The 2016-2018 Outlook

Looking ahead, we deem the inventory adjustment to be largely over and expect GDP growth to return to a 2.2–2.3 percent pace after a brief rebound to 3.0 percent growth in the current quarter. Due to weakness early in the year, annual growth in 2016 is projected to average only 1.5 percent, rising to 2.4 percent in 2017, and then edging down to 2.2 percent in 2018. Moderate consumption growth, respectable growth in fixed investment, and a contribution from government purchases help maintain modest GDP growth.

Net exports and inventory investment provide mild boosts to economic growth in the second half of 2016, but by 2018 their combined contribution turns negative.

Employment and Inflation

The unemployment rate is projected to continue decreasing slowly, averaging 4.9 percent for 2016, then declining to 4.8 percent for 2017 and 4.6 percent for 2018. As labor markets tighten, we project employment growth to slow from 2.5 million jobs in 2016 to just 1.9 million in 2018.

Core CPI inflation is poised to remain within a few tenths of 2 percent throughout the forecast window. Increasing oil prices help headline inflation to return to a moderate 1.7 percent reading for 2017 and to 2.0 percent in 2018.

	Actual	**RSQE Forecast**		
	2015	2016	2017	2018
GDP (billions of current $)	18036.6	18541.1	19309.1	20117.3
Real GDP (billions of chained 2009 $)	16397.2	16642.6	17040.5	17412.1
% change: year-over-year	2.6	1.5	2.4	2.2
% change: 4th-qtr-to-4th-qtr	1.9	1.8	2.4	2.1
Nonfarm payroll employment (millions)	141.8	144.3	146.4	148.3
Civilian unemployment rate (%)	5.3	4.9	4.8	4.6
Capacity utilization, total industry (%)	76.7	75.5	76.3	77.6
Inflation (private nonfarm GDP deflator, % change)	1.1	1.3	1.7	2.0
Inflation (CPI-U, % change)	0.1	1.1	1.7	2.0
Inflation (core CPI, % change)	1.8	2.2	1.9	2.1
Light vehicle sales (millions)	17.4	17.2	17.1	17.0
Private housing starts (thousands)	1108.2	1186.2	1260.0	1314.0
3-month Treasury bill rate (%)	0.1	0.3	0.8	1.3
10-year Treasury note rate (%)	2.1	1.7	2.2	2.6
Conventional mortgage rate (%)	3.9	3.6	3.9	4.3
Real disposable income (billions of chained 2009 $)	12343.2	12672.2	12999.0	13332.2
% change	3.5	2.7	2.6	2.6
Corporate profits after tax (billions of current $)	1583.8	1595.9	1645.1	1699.2
Value of U.S. $ (FRB broad index), % appreciation	12.6	3.6	–0.5	0.5
Current account balance (NIPA basis, billions of current $)	–477.4	–483.0	–496.3	–533.8
Federal surplus (FY, NIPA basis, billions of current $)	–569.7	–656.6	–657.9	–647.7