STIFEL | Economic Commentary

Economic Insight

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Near-term Acceleration, Longer-Term Moderation

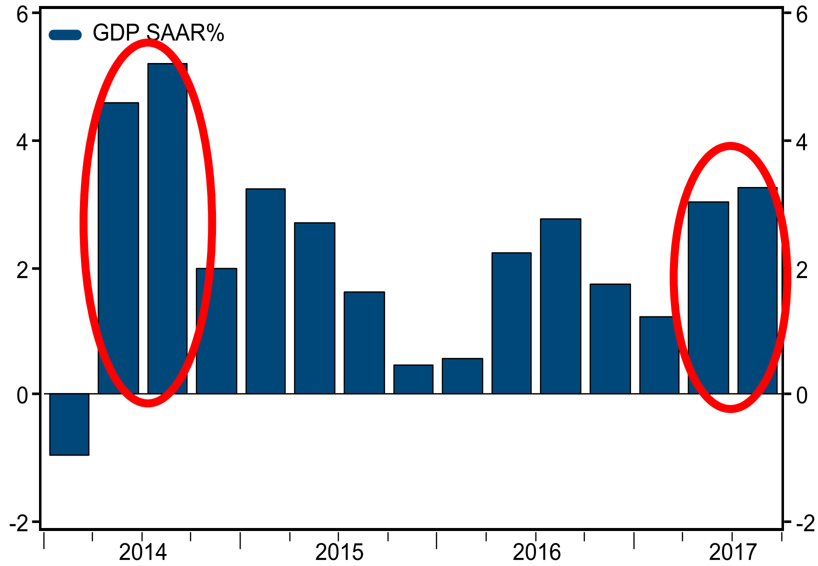
Economic Data Calendar			Prior	High	Low	Median	*Stifel*
				Economist Estimates			
Monday	*11-Dec*	JOLTS Job Openings - *Oct*	6093	--	--	--	**6090**
Tuesday	*12-Dec*	NFIB Small Business Optimism - *Nov*	103.8	104.5	104.0	104.0	**104.0**
		PPI MoM - *Nov*	0.4%	0.7%	0.2%	0.4%	**0.3%**
		Core PPI MoM - *Nov*	0.4%	0.3%	0.0%	0.2%	**0.2%**
		PPI YoY - *Nov*	2.8%	3.2%	2.8%	3.0%	**2.8%**
		Core PPI YoY - *Nov*	2.4%	2.4%	2.1%	2.4%	**2.4%**
Wednesday	*13-Dec*	CPI MoM - *Nov*	0.1%	0.5%	0.3%	0.4%	**0.3%**
		Core CPI MoM - *Nov*	0.2%	0.3%	0.2%	0.2%	**0.2%**
		CPI YoY - *Nov*	2.0%	2.3%	2.1%	2.2%	**2.1%**
		Core CPI YoY - *Nov*	1.8%	1.8%	1.7%	1.8%	**1.8%**
		FOMC Rate Decision (Upper Bound)	1.25%	1.50%	1.25%	1.50%	**1.50%**
		FOMC Rate Decision (Lower Bound)	1.00%	1.25%	1.00%	1.25%	**1.25%**
Thursday	*14-Dec*	Initial Jobless Claims - *Dec 9*	236k	240k	225k	239k	**240k**
		Import Price Index MoM - *Nov*	0.2%	0.8%	0.0%	0.8%	**0.5%**
		Retail Sales Advance MoM - *Nov*	0.2%	0.9%	0.1%	0.3%	**0.2%**
		Retail Sales Ex Auto MoM - *Nov*	0.1%	1.0%	0.3%	0.7%	**0.3%**
		Business Inventories - *Oct*	0.0%	0.2%	-0.2%	-0.1%	**-0.1%**
Friday	*15-Dec*	Empire Manufacturing - *Dec*	19.4	25.0	11.0	18.0	**17.0**
		Industrial Production MoM - *Nov*	0.9%	0.5%	0.0%	0.3%	**0.2%**
		Capacity Utilization - *Nov*	77.0%	77.4%	76.9%	77.2%	**77.0%**

Source: Bloomberg, Stifel

The U.S. economy grew at a faster pace than previously reported in the third-quarter, rising over 3%. Following a similarly sized increase April to June, the recent improvement in domestic activity coupled with the prospect of future tax reform has increased expectations for a continued accelerated pace of growth. But while near-term improvements may be enough to buoy the equity market, as well as offer justification for the Fed to raise rates again come December 13th, six months of above-trend GDP are hardly indicative of a new and improved economy after years of lackluster activity. Underlying support to third-quarter production appears to be overselling the economy's strength, indicating isolated gains as opposed to broad-based strength. Furthermore, while the prospect of a reduced tax burden appears a welcome change in fiscal policy, some economists caution the added benefit to growth will be minimal at best. In other words, economic conditions may appear rosier than they actually are.

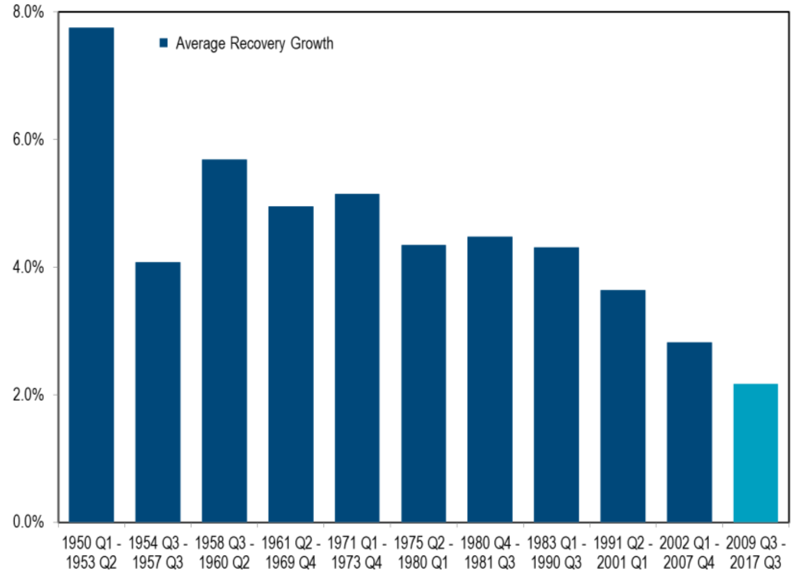
Temporary Deviation from Trend

Topline GDP was revised up from 3.0% to 3.3% in the second-round third-quarter report, the fastest pace in nearly three years. A notable achievement on a nominal level, following a similarly sized 3.1% rise in Q2, this marks the first back-to-back quarters of above 3% growth since 2014.



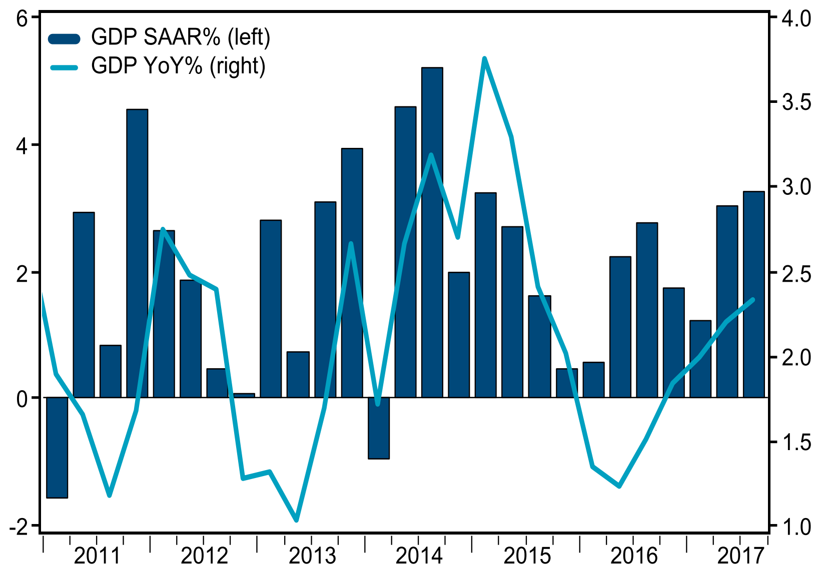
Source: Bureau of Economic Analysis /Haver Analytics

Focusing on the last six months alone, the latest pop in GDP would suggest a gangbuster economy. Isolated recent improvement, however, has done little to solidify a sustained, improved deviation from the well-established and more moderate pace of growth in the aftermath of the financial crisis. After accounting for accelerated activity April to September, domestic growth continues to track a 2.3% pace year-over-year, only minimally above the average 2.2% pace established since 2009, the weakest recovery pace in post-war history.



Source: NBER/ Haver Analytics

Furthermore, taking into account subdued GDP at the start of the year, 2017 growth still remains far from impressive. With a minimal increase of just 1.2% January through March, 2017 GDP is trending 2.5%. While slightly improved from an average pace of 2.2% in the first half, 2.5% growth is significantly weaker than third-quarter's 3.3% alone would imply.

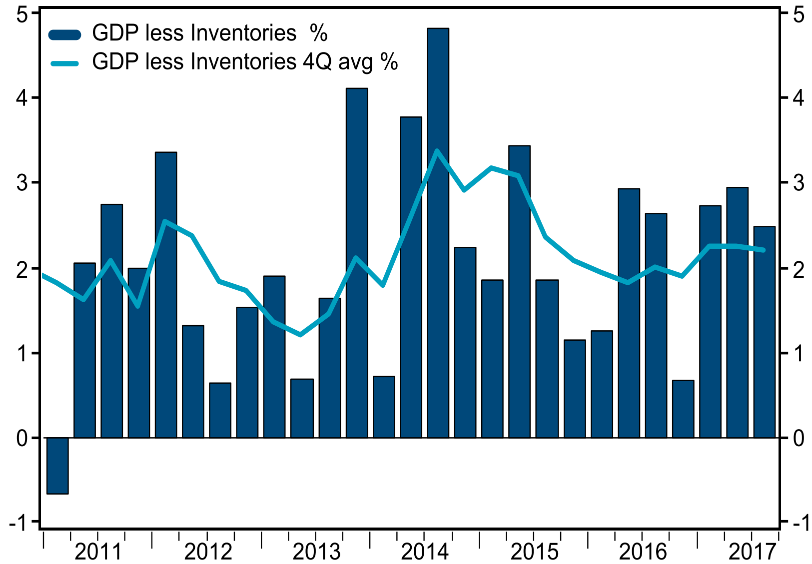


Source: Bureau of Economic Analysis /Haver Analytics

Devil is in the Details

While a welcome step in the right direction, the past six months of above-trend growth have yet to indicate a sustained deviation from more restrained activity. After all, two data points hardly make a trend. The latest Q3 GDP report likely exaggerates the health of the U.S. economy as the majority of support stems from isolated improvements in business investment in equipment and technology, and a rebuilding of inventories.

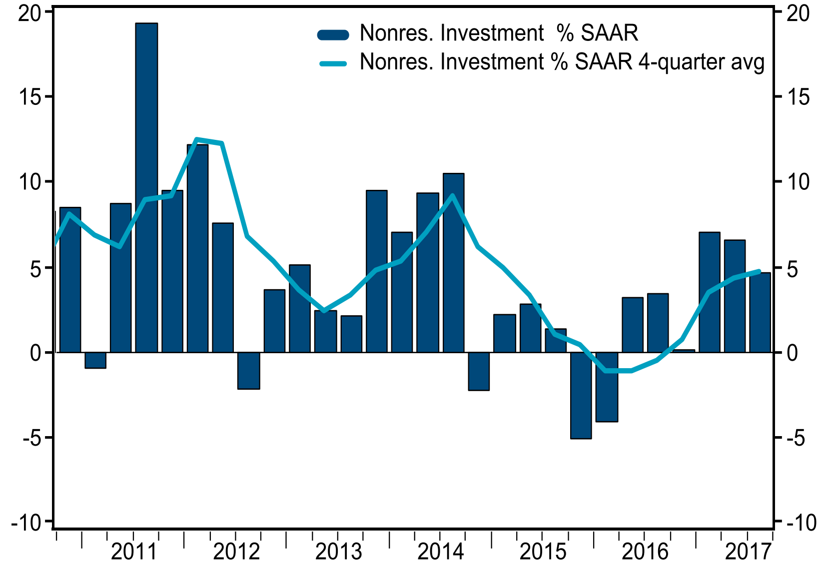
In the second-round Q3 GDP report, gross private investment was revised up from 6.0% to 7.3% following a 3.9% rise April to June, thanks to a significant stockpiling of goods. Inventories jumped \$39.0 billion at the end of September, eight times the stock reported the quarter prior and providing a significant boost to the headline report. Inventories alone contributed nearly a full percentage point to topline growth. Excluding inventories, third-quarter GDP rose just 2.5% in Q3 following a 2.9% increase June to August.



Source: Haver Analytics

Going forward, following such a significant buildup of goods, producers are expected to curtail additional stockpiling near-term. In other words, while a sizable driver of growth in the third-quarter, inventories could result in a net drag as early as the fourth-quarter. Recall, GDP is calculated on a quarter to quarter basis; even if inventory growth remains positive in the fourth-quarter, if it is less positive than that of Q3, it will result in a negative contribution to topline GDP. According to *Bloomberg*, economists have already pared back Q4 estimates by as much as five-tenths of a percentage point to as low as 2.3%.

Aside from inventories, growth in the third-quarter largely reflected a pickup in a few pockets of corporate investment. Superficially positive, this too could prove short-lived with support stemming from pent-up demand for technology as opposed to a more general upswing in corporate dollars flooding into the market. Nonresidential investment rose 4.7% in Q3, revised up from 3.9%, following a 6.7% increase Aril to June. The still-solid gain in Q3 investment steadied on equipment expenditures, up 10.4%, the fastest pace in two years and a 5.8% increase in intellectual property, a five-quarter high. Structural investment, on the other hand, was revised down from a 5.2% decline to a larger loss of 6.8% in the second-round Q3 GDP report, the largest drop in seven quarters. Going forward, while corporations appear to be increasing consumption of machinery, software and technology after months of minimal expenditures, the loosening of corporate purse strings does not apparently translate into a need for extra warehouse or office space, let alone additional employees.



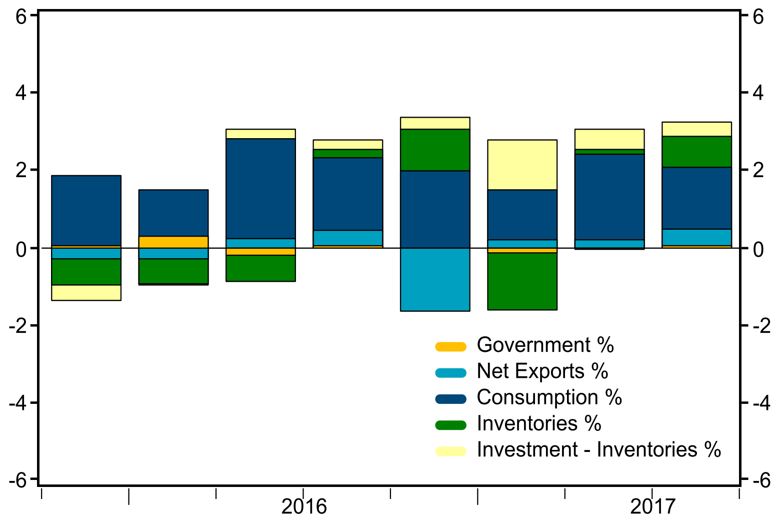
Source: Bureau of Economic Analysis /Haver Analytics

Further Information

In other details, personal consumption was revised down one-tenth to 2.3% in the second-round Q3 GDP report following a 3.3% rise the quarter prior. The slower pace of spending July to September reflects a weaker pace of goods consumption at 4.1% after a 5.4% rise in Q2. Service consumption in Q3, meanwhile, was unchanged at 1.5% in the second-round report, down from a 2.3% increase in the second-quarter. Hurricanes Harvey and Irma can in part be blamed for month-to-month volatility in spending throughout the third-quarter. However, given the timing of the storms, striking Texas and Florida late August and early September, consumers were already replacing damaged items by mid-September, particularly autos, and rebuilding damaged structures. The end of the month surge in activity more than compensated for the initial dip. Thus, while partially to blame for uneven monthly sales, the net reduction in consumer spending in Q3 continues to reflect a long-standing trend of minimal wage growth.

On the trade side, both export and import activity was revised down in the second-round Q3 report. Export growth, while still positive, rose just 2.2% following a 3.5% gain the quarter prior. Imports, furthermore, were revised from a 0.8% decline to a larger loss of 1.1% in the second-round Q3 GDP report, still contributing, however, a minimal two-tenths of a percentage point to topline GDP. Hesitant to purchase domestic goods, U.S. consumers also curtailed purchases of imported goods throughout the third-quarter as well.

Finally, government consumption was revised up from a 0.1% decline to a 0.4% increase in the second-round Q3 report, contributing 0.07% to headline growth and a four-quarter high. Although a welcome addition to an uneven growth report, a further expansion of government expenditures is hardly suggestive of additional private sector stability or momentum.



Source: Bureau of Economic Analysis /Haver Analytics

Tax Optimism

The U.S. *"recovery"* is now in its eighth year of expansion. And while, to be fair, at present there are few clear indications of a significant loss of momentum, there remains equally evasive support for further gains beyond today's stagnant 2% trend pace of activity. Job creation remains stable and business investment has improved over the course of the new year, however, despite what a one-off better-than-expected GDP report may suggest, in many respects the U.S. economy appears to be supported simply by unbridled optimism, particularly in terms of improved fiscal policy. In other words, the recent pickup in activity may not reflect enhanced economic conditions but rather a vote of confidence in the Trump administration that it will make good on its campaign promise to deliver a more business friendly, pro-growth environment, including meaningful tax relief.

Going forward, there is little doubt that improvements in fiscal policy resulting in a reduced tax burden could help sustain a more positive trend rate of growth. However, at this point, with the timeline for passage indefinitely extended and the specifics of a tax cut bill increasingly uncertain, there remains a sizable and arguably unrealistic expectation for the resulting legislation to reflate the household balance sheet as well as provide an incentive to businesses to grow, develop and hire.

Recently the U.S. Senate took an additional step forward, narrowly passing one version of the tax bill over the weekend in the wee hours of the morning; in a 1:49am ET Saturday morning vote, the measure passed 51 to 49 entirely across party lines (not a single Democrat voted in favor of the bill). But it's not over yet. From here, Republicans must overcome another hurdle of merging the Senate and House versions to create a joint bill that will then be presented to the President. The administration would like to see a deal completed by Christmas but time is rapidly running out.

Aside from Down, Nowhere to Go but Up

Even amid heightened uncertainty of what the final bill will look like, or if there is a final bill, the equity market nonetheless remains invigorated by recent progress and the prospect of tax cuts stimulating the economy.

Following the December 2nd Senate vote, equities began the week with a more than 200 point open, although Monday's close posted a more muted gain of 50 points. Analysts, however, appear less enthusiastic about tax reform. But, it's not a question of if; like many market participants driving the stock market rally, the majority of economists anticipate tax reform – both on the individual and corporate side – to be passed by the end of 2018. Rather it's a question of how much?

According to the National Association of Business Economics' (NABE) 2017 outlook survey, the majority of economists anticipate only a minimal impact from fiscal policy changes. Assuming tax reform is enacted near-term and assuming it is passed in a somewhat version *"lite"* of what was promised along the 2016 campaign trail, economists estimate the impact on real GDP from the resulting legislation to be a minimal increase of around 0.2% over the coming year. While two-tenths of a percentage point is a positive influence, recall that inventory building in the third-quarter alone added nearly a full percentage point to headline growth. In other words, while positive, the expected gains from the President's *"historic"* tax cuts is expected to fall well short of the intended boost to headline growth.

The President and many supporters of tax reform have sought to boost growth to a sustained 3% annual pace as a result of significantly reduced tax rates. In fact, earlier this week, the President suggested tax cuts could bring about 6% GDP. *"No reason why we don't go to 4, 5, even 6%,"* the President boasted. By contrast, however, after accounting for anticipated tax reform, the NABE panel's expectations for near-term GDP were only slightly revised; according to the outlook survey, the median forecast for growth near-term in 2017 is 2.2%, unchanged from the September survey and 2.5% for 2018, a mere tenth of a percentage point higher than the previous forecast of 2.4%. While falling well short of the administration's hopes of more robust growth, panelists do anticipate continued positive activity in the U.S., noting a recession in 2018 is unlikely. Furthermore, those noting downside risks to the economy through 2018 fell from 48% to 33%.

Conclusion

Since April, the U.S. economy has been growing at a noticeably accelerated 3% clip. While impressive relative to a more moderate 2.2% trend of the past eight years, the more recent uptick offers little evidence of sustained improvement; much of the recent growth stems from pent-up demand after repeated quarters of weakness and stockpiling of goods after grossly depleting inventories. In other words, the very reliance on isolated components to boost third-quarter growth calls into question the durability of the recent gains in topline activity, suggesting the *"improvement"* could prove short-lived.

Additionally, at this point, heightened expectations for continued gains in economic activity appear to be less rooted in the data and more the result of anticipated changes in Washington aimed to jumpstart domestic investment and boost consumer spending, a tall order for legislative policy, particularly in the near-term. While the administration hopes for 4%, 5% or 6% growth, economists suggest a continuation of moderate GDP through 2018 with only a small boost from tax reform.

-Lindsey Piegza, Ph.D., Chief Economist

Glossary

GDP – Gross Domestic Product
NABE – National Association for Business Economics
SAAR – Seasonally Adjusted Average Rate
YoY – Year over Year

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