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Flash Note

US growth update – On the rise

2017-18 growth forecast raised on stronger momentum

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We are raising our US GDP forecast for 2017 (+0.1 percentage point to 2.3%) and 2018 (+0.3 point to 2.0%) on the back of stronger momentum in Q4 2017.

Accelerating global growth is a tailwind for the US economy – as seen in the recent sharp pick up in exports, particularly to emerging markets. Reconstruction efforts in the southern US should also help support GDP in Q4.

But the 'big picture' factors in our 2017-18 scenario remain unchanged: still no 'escape velocity' in sight, with the prospect that corporate investment underwhelms and that fiscal boost is limited.

We now forecast a total of two Fed rate hikes in 2018, up from one previously. Core inflation should remain in check. Incoming Fed Chair Powell should remain true to the Yellen line, but uncertainty remains elevated due to Trump's ability to reshape the Board of Governors.

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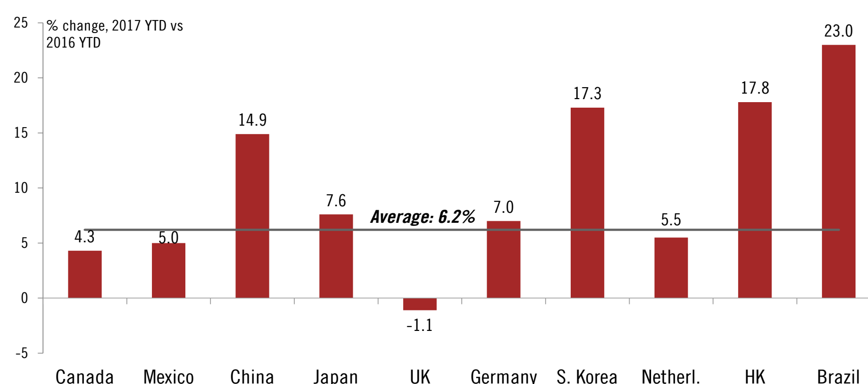
Global growth is picking up and it seems to providing a stronger impetus to the US economy than we expected, both directly via stronger exports and indirectly via higher oil prices, which are supporting the domestic energy ecosystem – a backbone of the US economy. Total nominal exports were up 6.2% in the first nine months of 2017, driven by a 14.9% rise in exports to China, 17.3% to South Korea, 17.8% to Hong Kong and 23.0% to Brazil (*See Chart 1*). Helped by a sharp pick up in crude oil exports (in particular to Asia), US oil production has climbed. On top of favourable global tailwinds, reconstruction efforts after recent major hurricanes, particularly in Florida, should provide an additional impetus to Q4 GDP growth.

We are therefore raising our 2017 and 2018 US growth forecasts by 0.1 percentage point and 0.3 percentage points to 2.3% and 2.0%, respectively. Nonetheless, the 'big picture' drivers of our scenario – still-tepid corporate investment, the probability of limited fiscal boost, an ageing business cycle – remain in place, limiting our enthusiasm.

Incoming Fed Chair Jerome Powell is widely expected to continue Janet Yellen's gradual (and well telegraphed) monetary tightening. Still, better economic momentum leads us to add an additional rate hike to our scenario for 2018. We see the Fed hiking in December and again in March, as per our central scenario up to now, but we now foresee a last rate hike in June 2018, with the interest rate on excess reserves (IOER) then stabilising at 2.0% (up from 1.25% today). We are keeping our 2018 core PCE inflation forecast at 1.8%. Persistently sub-2% core inflation should mean Fed tightening will remain modest in 2018-19, in our view.

Chart 1: US nominal export growth to top 10 export partners, 2017 year-to-date, %



(YTD: January-September 2017) Source: Pictet WM – AA&MR, Census Bureau.

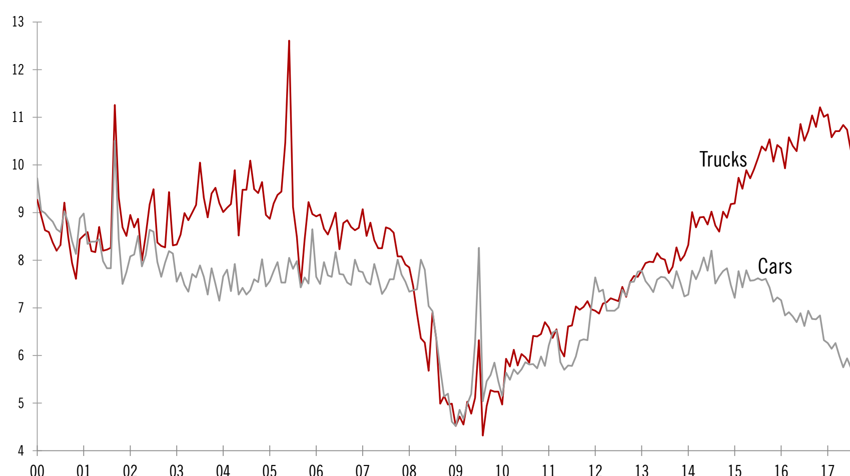
Stronger than expected growth momentum in Q4

Recent growth data has been more robust than we expected and momentum still appears firm in the near term. Part of this improvement is linked to the reconstruction efforts in the southern US after the recent violent hurricanes, which hit Texas and Florida particularly hard. This rebuilding is particularly evident in the recent uptick in industrial inventories, as well as in the sharp pick up in new car sales in September-October. Car sales were 18.5mn in September (at a seasonally-adjusted annualised (SAAR) rate) and 18.0mn in October, above the one-year average of 17.2mn.

Another tailwind is the pickup in global growth, which is particularly boosting the machinery sector in the US. And a further indirect boost is via increasing oil prices, which are supporting the energy sector. Producing around 9.6 million barrels per day (up from around 5 million barrels per day ten years ago), the oil industry is now a backbone of the US economy. While the number of oil rigs has moderated lately, the recent uptick in oil prices (WTI rose above USD 57/barrel recently, the highest level since July 2015) suggests that oil rig numbers could start creeping back up again. Oil rigs feed into GDP via investment in structures.

Our preliminary quarterly GDP forecast calls for 3.2% q-o-q SAAR growth in Q4-2017 (2.6% y-o-y), a touch below the current Nowcast by the Atlanta Fed (3.3%).

Chart 2: US car sales (mn SAAR): cars versus trucks



Source: Pictet WM – AA&MR, Thomson Reuters.

Question marks hang over investment and consumption

Looking ahead into 2018, the reconstruction tailwinds could start fading; car sales in particular could resume the downtrend evident since 2015. The question is whether broader consumption and investment will pick up. Our cautious view on this score explains why we believe US growth could slow slightly next year.

Regarding consumption, we worry about the recent downtrend in credit card lending, which suggests credit card companies and banks may be becoming more prudent about extending credit as the US consumer appears increasingly stretched. Indeed, the savings rate (as a percentage of disposable income) fell to 3.1% in September, the lowest since December 2007.

Meanwhile, income growth has stalled. Real disposable personal income was up only 1.2% y-o-y in September. Growth has averaged only 0.9% in the past 12 months. And wage data in the October employment report was not encouraging, with the growth in (nominal) average hourly earnings moderating to 2.4% y-o-y from 2.8% in September.

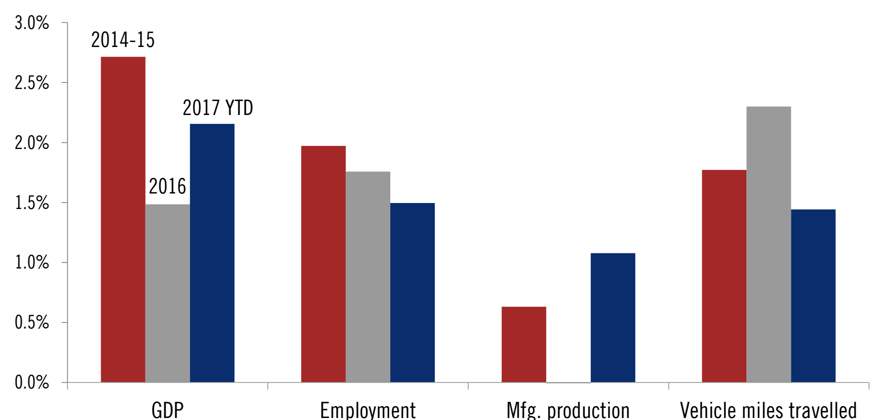
These mixed 'hard facts' about consumption contrast with near-euphoric consumer sentiment surveys. However, recent data has shown that the chasm between surveys and hard data seems to be more enduring than we initially expected, and we would tend to put less weight on surveys as a result.

Divergence is also to be seen between hard and soft data for corporate investment. While business surveys are universally positive, recent 'hard data' has been more mixed. Manufacturing production was up only 1.0% y-o-y in September, despite an ISM manufacturing survey averaging a robust 59.4 in the past three months (the highest three-month average since April 2011).

We remain prudent regarding the outlook for US capex. We are acutely aware of the softness in commercial and industrial (C&I) lending lately. C&I lending has flatlined in recent months, and was up only 1.3% y-o-y in October. Worse, the Q3 Federal Reserve senior loan officer survey showed that demand for credit remained feeble. Demand rather than supply could be behind the recent downturn in lending, which in turn places a question mark over corporate investment next year.

As we detail below, corporate tax cuts could help the investment picture, although they are unlikely to be a major game changer, in our view. We note that outside the energy sector, US corporates have remained prudent in their investment spending this year despite exceptionally favourable funding conditions.

Chart 3: Growth in GDP in 2017 YTD versus alternative economic indicators



Source: Pictet WM – AA&MR, Thomson Reuters.

What about tax reform? If enacted, could be diluted

Tax reform could be a boost to growth, but it is unlikely to have a huge effect on our growth outlook. If the reforms currently being discussed in Congress are enacted, we think the corporate tax cuts, in particular, will be spread out over time (we believe a couple of percent will be cut from the statutory rate over several years). In other words, we doubt that the House of Representatives' plan for an immediate cut in the federal corporate tax rate from 35% to 20% will see the light of day. Part of the problem is the maths, as the budget resolution voted by Congress calls for a USD1.5 trillion deficit expansion over 10 years. An immediate cut to 20% would cost precisely that amount – and that's just for one item on a big list of proposed tax changes.

An alternative plan in Senate calls for delaying the corporate tax cut until 2019 so as to smooth the impact on the budget deficit. We think this opens the door for a gradual (rather than one-off) drop in the corporate tax rate as tax committees continue to discuss proposals.

Tax changes of any sort are far from certain. The most problematic aspect will be getting the current proposals through Senate, where the Republicans hold only a slim majority (52-48) and where Democrats are almost uniformly opposed to the plans, which many of them see as a just a "gift to the rich".

Meanwhile, there is some tension inside the Republican camp itself. Some are worried about increasing the deficit at a time of elevated federal debt. Others are opposed to several measures on the individual income side, such as the end of state and local tax (SALT) deductions and restrictions on property-tax deductions, which could lead to higher taxes in the high-tax states (which happen to be mostly in the Democratic bastions of the Northeast and California).

That said, tax reform could also act as a catharsis for the Republican camp, as legislative successes have so far been meagre under President Trump. The politicians will soon be gearing up (and raising funds) for mid-term elections in November 2018. The Democrats have clinched some victories at the local level lately, including the gubernatorial races in Virginia and New Jersey.

Some Republicans could therefore put their opposition to tax changes on ice for the sake of conserving the Republican Party's chances in the midterm elections. However, the tax cuts the politicians eventually agree on could remain symbolic rather than substantial, in our view, just enough to ensure they do not turn up empty handed before their voters.

Our updated US macro forecasts (previous forecasts in brackets)

	2015	2016	2017F	2018F
GDP growth	2.9	1.5	2.3 (2.2)	2.0 (1.7)
CPI inflation	0.1	1.3	2.1 (1.9)	2.0 (1.9)
Core PCE inflation	1.3	1.8	1.5 (1.6)	1.8
Fed IOER, end-period	0.50	0.75	1.50	2.00 (1.75)

Source: Pictet WM – AA&MR, Thomson Reuters.

Fed scenario: We now see two rate hikes in 2018

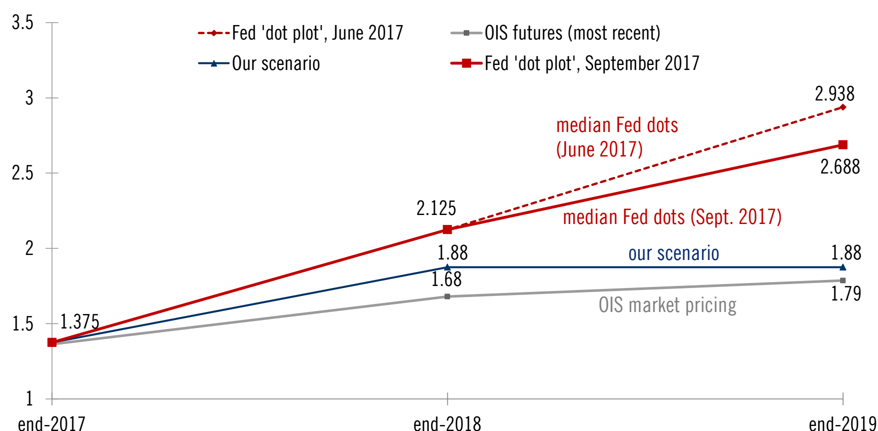
From a monetary-policy perspective, we now expect two quarter-point rate hikes in 2018, instead of just one, as we previously forecast. Indeed, if economic momentum is stronger than we initially expected at the start of 2018, the Federal Reserve Open-Market Committee (FOMC) could feel more comfortable about prolonging the current rate-hiking cycle, even though core inflation is likely to persist below 2%. Our Fed call is therefore for a 25bp hike in December, followed by further 25bp rises in March and June, after which we expect a long pause.

We think the key level to watch for the interest rate on excess reserves (IOER) is 2%, which should be reached by June 2018. We think that beyond that level, the Fed will consider that it is really entering tightening mode, and we think it is unlikely to venture there. Why? Because there may not be enough evidence, in the Fed's view, of any overheating of the US economy by then.

Core inflation should remain below 2%, in our view (slower rent growth should further dampen inflation next year). Meanwhile, GDP growth is unlikely to accelerate to the point (say, 3 or 4% growth) where overheating threatens. Similarly, despite a very tight labour market, we expect wage growth to rise to a y-o-y rate of no more than 3.0-3.5%. There are structural factors at play that are dampening wage growth, including globalisation and technology/robotisation.

A risk to this view of mild Fed policy normalisation would be the delivery of bold one-off tax cuts, which could lead the Fed to become more hawkish and respond more aggressively to fiscal easing.

Chart 4: Fed rate forecasts (dot plot) versus OIS market pricing and our scenario



Market pricing as of 9 November. Source: Pictet WM – AA&MR, Federal Reserve.

There remains much uncertainty about the direction of future monetary policy due to the ongoing changing of the guard at the Fed and the departure of several (dovish) heavyweights. For now, we think that incoming Chair Jerome Powell will closely mirror Janet Yellen's philosophy, and will aim to keep the Fed on the slow track to rate normalisation. Powell seems to be influenced by the very academic (and dovish) Fed staff, and this should ensure a degree of continuity. Meanwhile, New York Fed president Bill

Dudley has announced he will leave next summer. His replacement could have a crucial influence on future monetary policy since the New York Fed president tends to have a large influence on Fed policy decisions compared to the other regional Fed presidents (the NY Fed has permanent voting rights on the FOMC). This could be the key event to watch next year.

President Trump does not seem to be in a hurry to fill currently vacant seats on the Fed Board. One reason may be because he is mostly interested in the Fed's role in banking regulation. Banking deregulation has been a clear focus of his administration, and he has tasked Randal Quarles, the incoming Fed Vice Chair for banking supervision, to carry out that mission. The monetary-policy aspects of the Fed's mission seem therefore to have taken a backseat, and that may also explain Powell's appointment. Powell has been a low-key Fed governor in recent years, and is very consensus oriented. The slowness in filling the Fed Board vacancies also suggests that the Fed will stay in gradual tightening mode. Our view is that several seats could remain unfilled for some time, mirroring the situation in the Trump administration itself where many positions remain vacant (for instance, at the Treasury and the Commerce department).

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