DALLASFED Economic Update
National

U.S. Economic Growth Picking Up in the Second Half

November 8, 2016

Recent data releases point to a modest pickup in output growth nationally in the second half of the year. The pace of expansion accelerated in the third quarter, although the manufacturing sector remained sluggish. Employment grew at a moderate rate over the same period, slightly exceeding the pace consistent with working-age population growth. The unemployment rate has remained just below or at 5.0 percent since late last year. Wage inflation has been ticking up, exceeding price inflation, while disinflationary pressures from energy prices continue to dissipate.

Output Growth Strong; Consumption Slows

The first estimate of third-quarter gross domestic product (GDP) growth was 2.9 percent annualized, following 1.4 percent growth in the second quarter *(Chart 1)*. A more detailed breakdown shows that higher-than-expected increases in inventories and net exports led to the strong GDP growth.

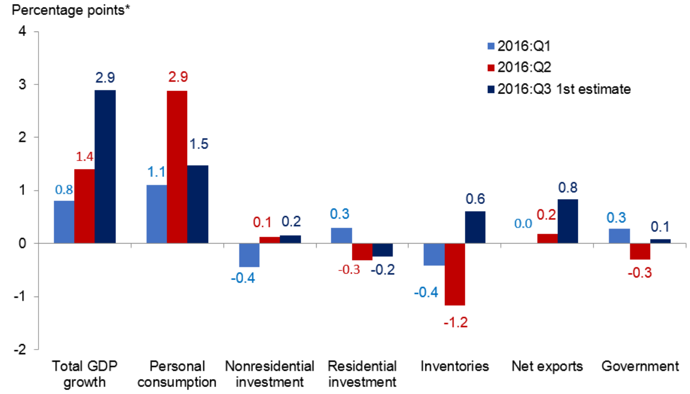
A surge in inventories contributed 0.6 percentage points, a sizable improvement from –1.2 percentage points in the second quarter. Net exports added 0.8 percentage points, up from a 0.2 percentage-point contribution in the second quarter. Exports were boosted by a spike in soybean exports, which is most likely a one-time event.

Inventories and net exports are the most volatile components of GDP, and changes in them do not necessarily signal strength in coming quarters. Although still rising, personal consumption added only 1.5 percentage points to output growth, considerably less than the 2.9 percentage-point contribution posted in the second quarter.

The positive outlook for GDP growth is supported by the Institute for Supply Management (ISM) non-manufacturing index, which has been strongly correlated with real GDP growth in the past *(Chart 2)*. The index dropped to 54.8 in October from 57.1 in September but was still well above August's reading of 51.4, which had raised fears of a weakening economy. The average value from July to October of 54.7 gives credibility to expectations that GDP growth will be in excess of 2 percent in the second half of the year.

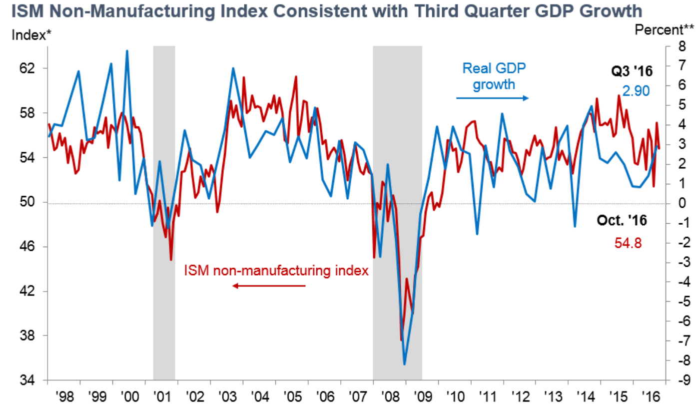
However, the manufacturing sector is barely growing—with industrial production increasing 0.2 percent in September after dropping 0.6 percent in August—and the manufacturing ISM index is just slightly above 50 *(Chart 3)*. This contrast between growth in the goods and services sectors is also evident in payroll data.

Chart 1
Real GDP Growth Strong in the Third Quarter



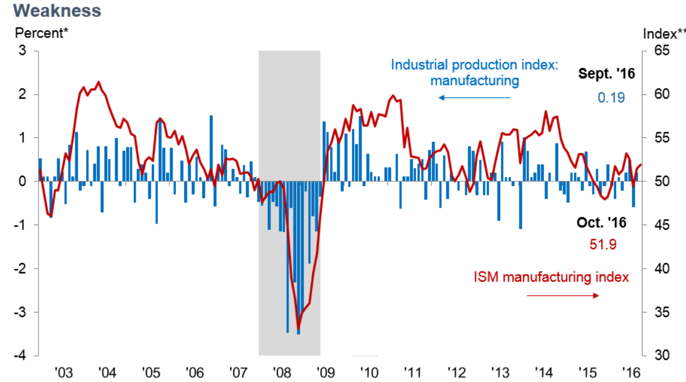
*Contribution to total gross domestic product (GDP) growth.
SOURCE: Bureau of Economic Analysis.

Chart 2
ISM Non-Manufacturing Index Consistent with Third Quarter GDP Growth



*Values above 50 indicate expansion.
**Quarterly percent change, annualized rate; seasonally adjusted.
NOTE: Shaded areas indicate recession.
SOURCES: Bureau of Economic Analysis; Institute for Supply Management (ISM).

Chart 3
Industrial Production, ISM Manufacturing Indexes Suggest Continued Weakness



*Monthly percent change.
**Values above 50 indicate expansion.
NOTE: Shaded area indicates recession.
SOURCES: Federal Reserve Board; Institute for Supply Management.

Employment Growth Running Above Trend

Consistent with continued economic expansion in the third quarter, total nonfarm employment grew by a solid 161,000 jobs in October. Private sector nonfarm payrolls gained 142,000 jobs, while the government sector added 19,000. The pace of employment gains is still a notch above trend employment growth and implies a continued reduction in labor market slack. To illustrate and better explain the sources of job growth, Chart 4 plots the average number of jobs added per month for the major industries in the third quarter, in the first half of the year and in 2015. Most added as many jobs per month in the third quarter as they did in the first half of 2016. There are some differences; for example, the business services and utilities industries added more jobs, and retail trade added fewer.

The dichotomy in the goods and services sectors, first seen in 2015, has continued into 2016. While most service-providing industries are doing nearly as well or better in 2016, the goods-producing industries are still showing considerable weakness. Slow or negative job growth in mining, construction, and durable and nondurable goods manufacturing is partially a result of continued weakness in the energy sector driven by still-low energy prices.

Price and Wage Inflation Steadily Move Upward

Headline inflation has picked up, mainly reflecting stabilization in energy prices. The year-over-year headline personal consumption expenditures (PCE) inflation rate was 1.3 percent in September, up from 1.0 percent in August. However, core PCE inflation, which excludes food and energy prices, remained flat at 1.7 percent in September *(Chart 5)*. A similar pattern was seen in the Dallas Fed's Trimmed Mean PCE—a good predictor of future headline inflation. The various indicators of core inflation have been slowly rising over the past year and a half, with some divergence between the CPI (consumer price index) and PCE inflation measures.

After several years of stagnation earlier in the recovery, wage inflation has picked up over the past two years *(Chart 6)*. This trend has continued in the second half of 2016 across various measures of wage growth, indicating a further strengthening in the labor market. Wage growth has outpaced price inflation and, therefore, reduced firms' profits. Still, wage growth has not reached rates seen prior to the Great Recession, and it is converging to a long-run rate that may have been lowered by a downshift in productivity growth.

—Emil Mihaylov

About the Author

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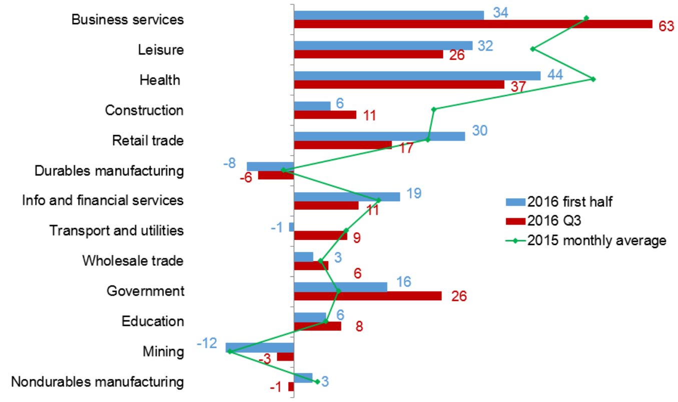
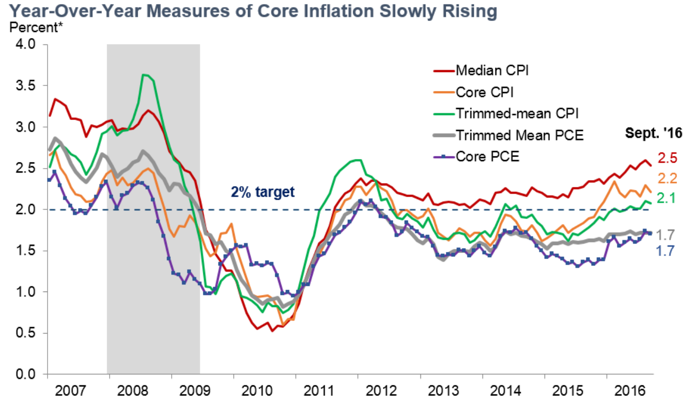
Chart 4
Manufacturing Remains a Drag on Job Growth
(Average number of jobs added per month, in thousands*)



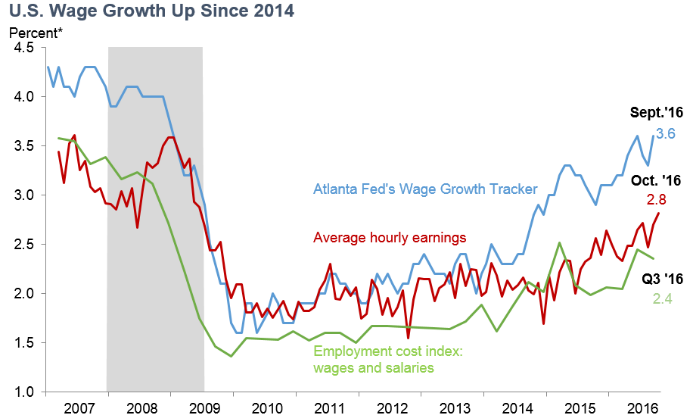
*Seasonally adjusted.
SOURCE: Bureau of Labor Statistics.

Chart 5
Year-Over-Year Measures of Core Inflation Slowly Rising



*12-month percent change.
NOTES: Shaded area indicates recession. The dashed line shows the Federal Reserve's 2 percent inflation target.
SOURCES: Bureau of Labor Statistics; Bureau of Economic Analysis; Federal Reserve Bank of Cleveland; Federal Reserve Bank of Dallas.

Chart 6
U.S. Wage Growth Up Since 2014



*Year-over-year change.
NOTES: The Atlanta Fed's Wage Growth Tracker is a three-month moving average. Shaded area indicates recession.
SOURCES: Bureau of Labor Statistics; Federal Reserve Bank of Atlanta.