DALLASFED Economic Update
U.S.

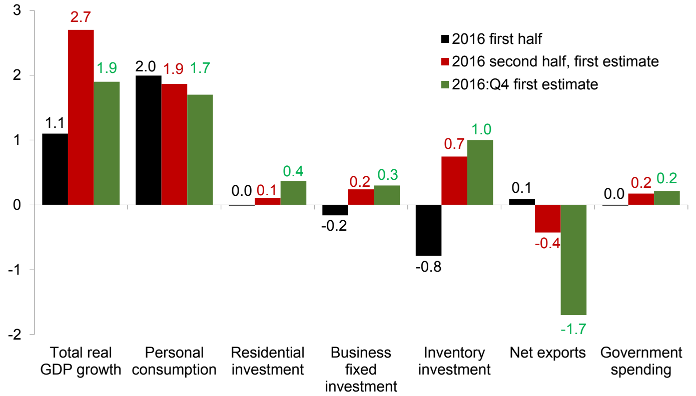
New Year Brings Economic Promises and Challenges

February 8, 2017

U.S. economic growth slowed in fourth quarter 2016 following a strong third quarter. While coming in below expectations, real gross domestic product (GDP) growth in the fourth quarter was on par with the average for 2016. Consumer spending moderated but still contributed significantly to output growth and is set to be one of the major drivers going forward.

Employment gains remain robust as the economy continues to make progress toward full employment. However, tepid wage growth signals limited inflation pressure in the near term from the labor market. Various inflation measures point to a steady increase toward the Federal Reserve's 2 percent target. Tightening labor markets and firming input costs and producer-paid prices are expected to put upward pressure on inflation measures from the supply side over the next few quarters.

Chart 1
Weak Net Exports Put a Drag on Output Growth



*Contribution to total real gross domestic product (GDP) growth, quarter-over-quarter; annualized and seasonally adjusted.
SOURCE: Bureau of Economic Analysis.

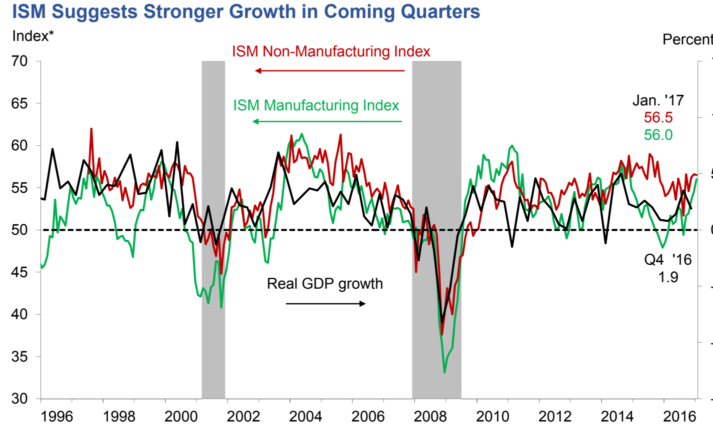
Fourth-Quarter Growth Slows; Prospects Improve

The first estimate of fourth-quarter GDP growth showed the U.S. economy growing at a below-forecast 1.9 percent—slower than the 3.5 percent increase in the third quarter *(Chart 1)*. Growth averaged 2.7 percent in the second half of the year versus a meager 1.1 percent in the first. Output grew 1.9 percent year-over-year in the fourth quarter.

The main driver of growth in the fourth quarter was consumer spending, which contributed 1.7 percentage points, followed by inventories at 1 percentage point and fixed investment (residential and business) at 0.7. On the downside, following a strong third quarter, net exports contracted and stripped 1.7 percentage points off GDP growth. This plunge in net exports has been paralleled by the recent appreciation of the U.S. dollar. An appreciating dollar coupled with, as of now, ambiguous trade policy suggests that net exports could continue to constitute a downside risk to growth.

Nevertheless, the latest releases of the Institute for Supply Management (ISM) indexes suggest stronger output growth in coming quarters *(Chart 2)*. The ISM Manufacturing Index has been on the rise in recent months and in January came in at 56.0, its highest value since November 2015. The index saw its fifth consecutive increase in orders and production, signaling a rebound in U.S. manufacturing activity.

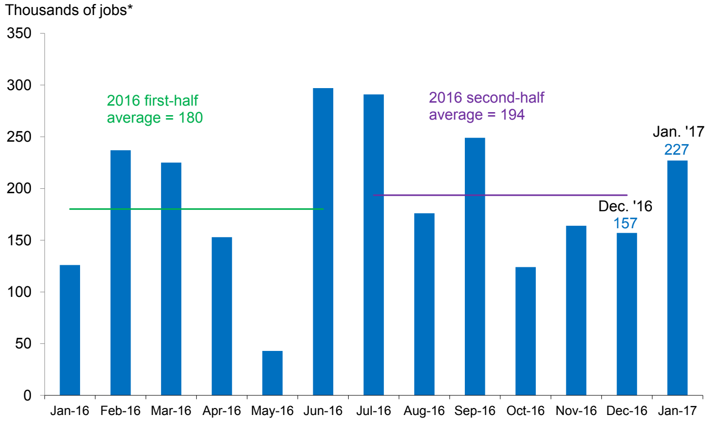
Chart 2
ISM Suggests Stronger Growth in Coming Quarters



*Values above 50 indicate expansion.
**Percent change, quarter-over-quarter; annualized, seasonally adjusted.
NOTE: Shaded areas indicate recession.
SOURCES: Institute for Supply Management (ISM); Bureau of Economic Analysis; National Bureau of Economic Research.

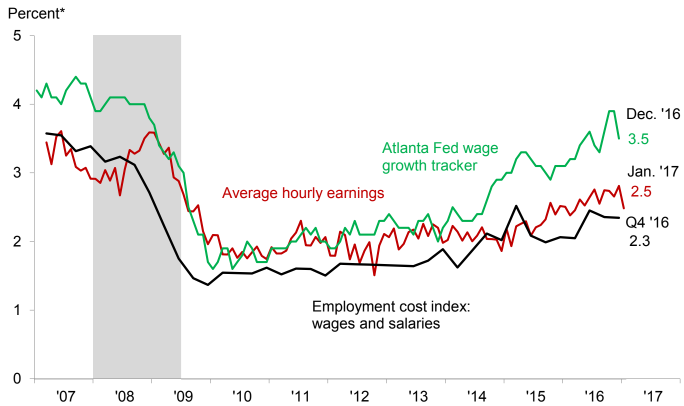
Additionally, the ISM Non-Manufacturing Index was stable in January, coming in at 56.5 after a 56.6 reading the previous month and remaining above the expansionary threshold of 50. Service industries in January continued the upward trend set in December. Non-manufacturing activity—based on the business activity and new orders components—eased in January after December saw the highest increase since October 2015. In addition, the prices-paid indexes from both the ISM manufacturing and non-manufacturing surveys have shown increases in recent months, pointing to inflationary pressures from the supply chain.

Chart 3
Labor Market Continues Adding Jobs at a Brisk Pace



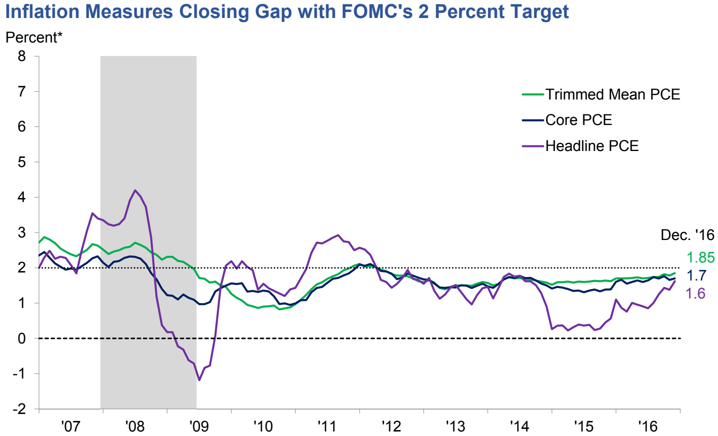
*Monthly change in payroll employment.
SOURCE: Bureau of Labor Statistics.

Chart 4
Wage Growth Moderates



*Year-over-year percent 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; National Bureau of Economic Research.

Chart 5
Inflation Measures Closing Gap with FOMC's 2 Percent Target



*12-month percent change in personal consumption expenditures (PCE) measures.
NOTE: The shaded area indicates recession.
SOURCES: Federal Reserve Bank of Dallas; Bureau of Economic Analysis; National Bureau of Economic Research.

Job Growth Robust, but Wage Growth Weakens

The U.S. has been adding jobs at a brisk pace. Unemployment has steadily fallen as labor market slack diminishes and the nation approaches full employment. As shown in Chart 3, payrolls increased by 227,000 in January 2017, well above the average monthly increase for 2016. Although the unemployment rate ticked up from 4.7 percent in December to 4.8 percent in January, the increase was partly due to people joining the labor force and looking for jobs as the participation rate increased from 62.7 percent to 62.9 percent.

Wage growth decelerated in January. Year-over-year average hourly earnings grew 2.5 percent, 0.3 percentage points slower than the December rate *(Chart 4)*. Hourly earnings were up a modest 0.1 percent in January from the previous month, and December numbers were revised down from 0.4 percent to 0.2 percent. The 0.1 percent rise was surprising because the implementation of higher minimum wages in 19 states was expected to lift wage growth.

Price Inflation Measures Steadily Rise

On the inflation front, December data showed that personal consumption expenditures (PCE) inflation measures were firming up and closing the gap with the Federal Open Market Committee's 2 percent target *(Chart 5)*. The 12-month headline, or all-items, PCE inflation rate rose to 1.6 percent in December from 1.4 percent in November, driven in part by an increase in the price index for gasoline and other motor fuel. The equivalent rate for PCE excluding food and energy (core PCE) was 1.7 percent, with the 12-month change in prices at 2.4 percent for core services and –0.4 percent for core goods. Food prices fell again in December, marking an eighth straight monthly decline.

The Dallas Fed's 12-month Trimmed Mean PCE inflation rate continued to rise and, at 1.85 percent, achieved its highest increase since July 2012. Historically, gaps between the headline and trimmed-mean rates tend to be closed by the headline rate converging toward the trimmed-mean rate. The gap, which had been a full percentage point at the end of 2015, has now narrowed to 0.2 percentage points. Measures of inflation should continue approaching the 2 percent target.

—Emil Mihaylov

About the Author

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