Economic Update
UNITED STATES
Federal Reserve Bank of Dallas

U.S. Economic Outlook Improves in First Quarter

March 23, 2018

The U.S. economic outlook has slightly improved since January, owing to strong gross domestic product (GDP) and employment growth. Forecast GDP growth has ticked higher as recent changes to federal tax law have provided fiscal stimulus. Inflation expectations have remained firmly anchored, with inflation gradually rising in recent months.

Real GDP Continues Expansion at Year-End 2017

The second release of real (inflation-adjusted) GDP growth in fourth quarter 2017 stood at 2.5 percent, down from the initial release of 2.6 percent. Improving personal consumption expenditures (PCE) and residential/nonresidential investment contributed the most to overall GDP growth, while private inventories and net exports were restraining influences (*Chart 1*).

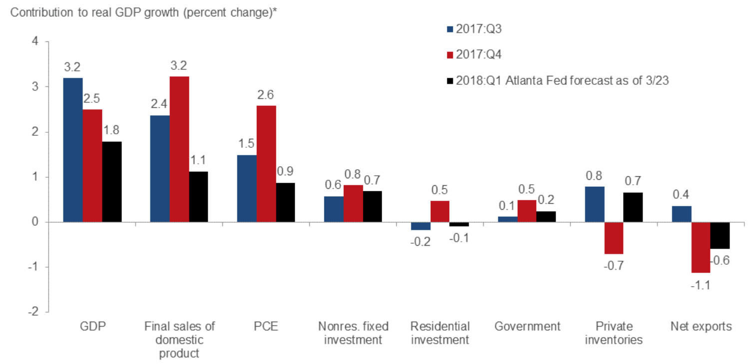
Of concern for first-quarter growth are relatively weak releases of real PCE and real retail sales. Real PCE declined 1.7 percent on an annualized basis during January, a sharp contrast from a 3 percent gain in December, while real retail sales growth slumped to 0.1 percent in February, below consensus estimates. This weakness explains why the Atlanta Fed's GDP Nowcast for first-quarter growth is low. However, both PCE and retail sales are likely to improve in February and March as some consumers begin receiving tax refunds.

Survey-based indicators for investment and consumption remain buoyant. The Institute for Supply Management (ISM) manufacturing composite index rose from 59.1 in January to 60.8 in February, while the nonmanufacturing composite index declined from 59.9 to 59.5. A reading above 50 indicates expansion. Chart 2 shows ISM nonmanufacturing values since 2014, with the last two months (highlighted in red) at relatively high levels. The three-month moving average is also rising.

The Conference Board's Consumer Confidence Index continues increasing, reaching 130.8 in February from 124.3 in January. February's value is the highest since November 2000. The University of Michigan's Consumer Sentiment Index also increased, from 99.7 in February to 102.0 in March, both relatively high readings. Overall, these indicators point to optimism about future growth.

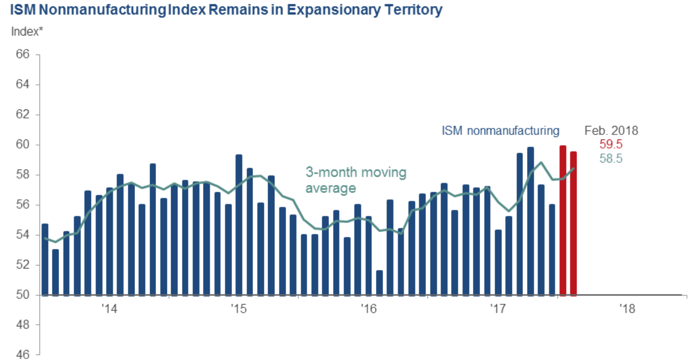
Looking forward, real GDP growth is expected to increase each quarter this year, with forecasts moving higher. Chart 3 shows recent GDP growth on a yearly basis and comparisons to recent Survey of Professional Forecasters (SPF) releases. The SPF's latest release in February of 2.8 and 2.5 percent year-over-year growth in 2018 and 2019, respectively, reflects an upward revision from November's 2.5 and 2.1 percent.

Chart 1
Consumption and Investment Contribute to GDP Growth



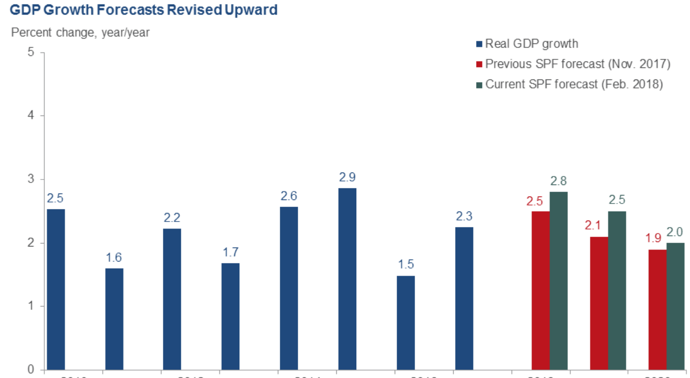
*Quarter/quarter, seasonally adjusted annual rate.
NOTE: PCE refers to personal consumption expenditures.
SOURCES: Bureau of Economic Analysis; Federal Reserve Bank of Atlanta.

Chart 2
ISM Nonmanufacturing Index Remains in Expansionary Territory



*Values above 50 indicate expansion.
SOURCE: Institute for Supply Management (ISM).

Chart 3
GDP Growth Forecasts Revised Upward



NOTE: SPF is the Survey of Professional Forecasters.
SOURCES: Bureau of Economic Analysis; Federal Reserve Bank of Philadelphia.

On a quarterly basis, the SPF's latest report in February predicts real GDP growth will reach 3.0 percent in first quarter 2018 and 2.9 percent in second quarter 2018.

Solid Employment Growth

Payrolls increased by 313,000 in February, the latest employment report shows (*Chart 4*). The result exceeds consensus estimates, with the headline unemployment (the U-3 rate) remaining at 4.1 percent.

The broader U-6 rate, which includes discouraged workers, other marginally attached workers and those working part time for economic reasons, remained at 8.2 percent. The labor force participation rate ticked upward, from 62.7 percent to 63 percent, but demographic developments imply a gradual softening in coming years. The latest SPF release forecasts unemployment to decline further to 3.8 percent in 2019—levels last seen in early 2000.

Despite the strong employment report, wage growth is still only softly trending upward. Both the Atlanta Fed's wage growth tracker and the noisier average-hourly-earnings measure have moved slightly higher but remain below pre-Great Recession rates. On a year-over-year basis, the wage growth tracker increased from 2.9 percent in December to 3.0 percent in January, while average hourly earnings declined slightly, from 2.8 percent in January to 2.6 percent in February. In contrast, the wage growth tracker grew 4.3 percent in March 2007, prior to the Great Recession, while average hourly earnings increased 3.4 percent.

Inflation Bottoming Out

Although most inflation measures remain below the Federal Reserve's 2 percent target, recent releases have suggested that inflation has bottomed out and will trend toward the target rate. Core Consumer Price Index (CPI) inflation, which excludes food and energy, was little changed at 1.9 percent on a year-over-year basis in February (*Chart 5*).

Core PCE inflation was unchanged at 1.5 percent in January on a year-over-year basis. Meanwhile, the Federal Reserve Bank of Dallas' Trimmed Mean PCE year-over-year inflation measure was also unchanged, at 1.7 percent. Overall, Chart 5 shows that inflation will likely increase.

Inflation expectations remain largely unchanged since January's Federal Open Market Committee meeting. The SPF forecasts core PCE inflation to reach the Fed's 2 percent target by 2019, while the implied five-year/five-year-forward (expected average inflation over the five-year period that begins five years from now) CPI inflation rate stands at 2.3 percent, up from the previous forecast of 2.2 percent in November. The five-year/five-year-forward Treasury inflation-protected securities (TIPS) breakeven inflation rate, a market-based measure of expected inflation, stood at 2 percent as of March 19, little changed from January.

—Daniel Chapman

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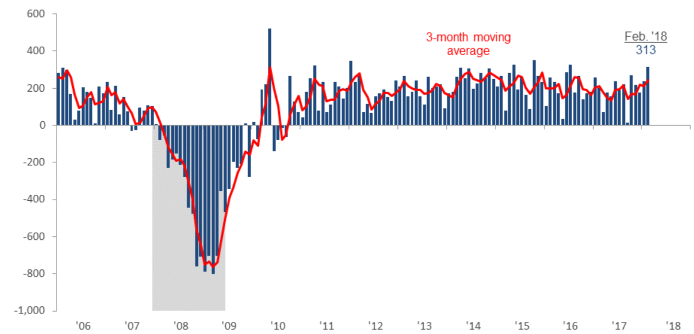
About the Author

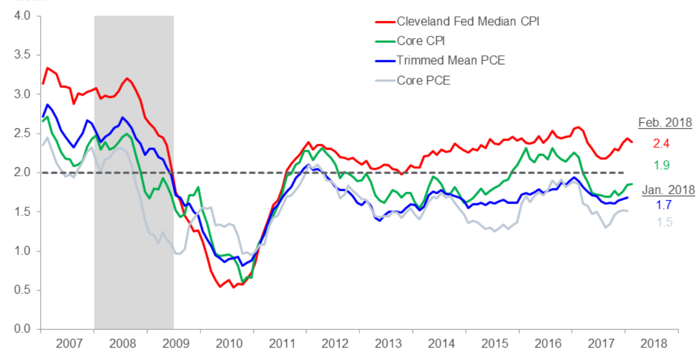
Chapman is a research assistant in the Research Department at the Federal Reserve Bank of Dallas.

Chart 4
Payroll Growth Shows Employment Strength



NOTE: Shaded area indicates recession.
SOURCE: Bureau of Labor Statistics.

Chart 5
Inflation Appears to Have Bottomed Out



NOTE: Shaded area indicates National Bureau of Economic Research-designated recession.
SOURCES: Bureau of Labor Statistics; Bureau of Economic Analysis; Federal Reserve Banks of Cleveland, Dallas and New York; National Bureau of Economic