Economic Update
UNITED STATES
Federal Reserve Bank of Dallas

Slower Growth in First Quarter Appears Temporary

May 8, 2018

The U.S. economy entered 2018 with strong momentum, but it slowed in the first quarter. The advance estimate of 2.3 percent real gross domestic product (GDP) growth in the quarter trailed previous quarters. Higher, above-potential growth is expected throughout the rest of 2018 and into 2019, given the underlying fundamentals—a tight labor market and robust consumer expectations—appear strong.

Recent data show that headline personal consumption expenditures (PCE) inflation reached 2 percent year over year in March, matching the Federal Reserve's target and up from 1.7 percent in February. Core inflation also advanced in March to 1.9 percent year over year from 1.6 percent in February. Still, long-term inflation expectations remain firmly anchored.

The U.S. economy reflects the impact of stimulus from expansionary fiscal policy—the federal tax cuts approved earlier this year—and a generally supportive outlook for the global economy. Overall, the risks to the U.S. outlook are balanced.

Real GDP Slows in First Quarter

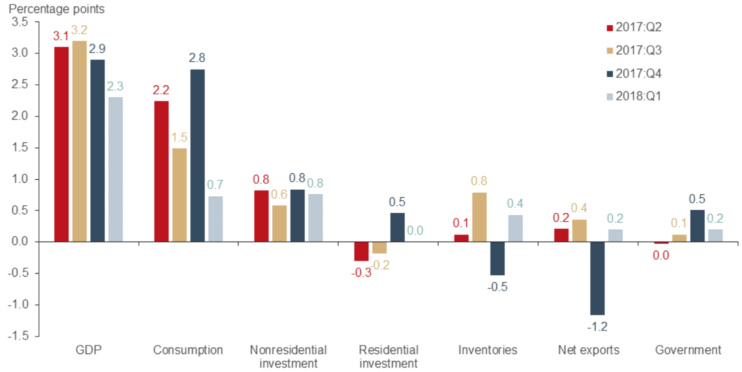
The advance estimate of real (inflation-adjusted) GDP for first quarter 2018 indicated a slower pace of growth from previous quarters as output grew at a seasonally adjusted annual rate of 2.3 percent, compared with 3.2 percent in third quarter 2017 and 2.9 percent in the fourth quarter (*Chart 1*). Much of the deceleration in first-quarter GDP growth can be attributed to slower consumer spending, which added only 0.7 percentage points to output growth—a sizeable decline from the 2.8 percentage-point contribution in fourth quarter 2017.

A reduction in the consumption of durable goods helps explain consumer spending's smaller number. Monthly consumer spending estimates for March show a rebound in PCE. Nonresidential investment, which contributed 0.8 percentage points to GDP growth, was the main driver of growth for the quarter. Inventories and net exports both added to overall expansion, reversing their negative contributions from the previous quarter.

The GDP slowdown is expected to be temporary; the economy is operating above full employment, and survey-based indicators for investment and consumption remain elevated, signaling strong underlying fundamentals.

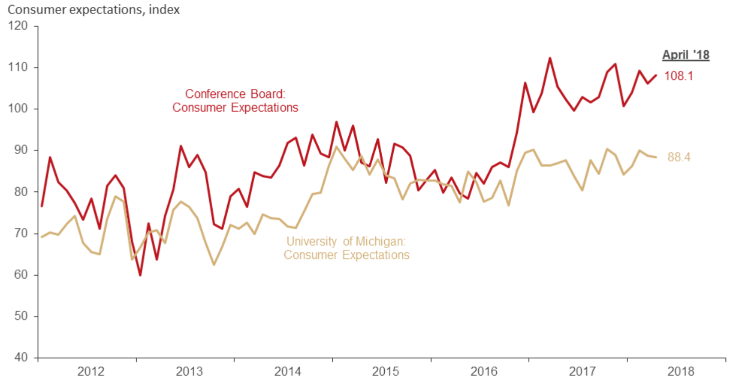
The Institute for Supply Management manufacturing index at 57.3 and the nonmanufacturing composite index at 56.8 remained well into expansionary territory in April. A reading above 50 indicates expansion.

Chart 1
Weak Consumer Spending Cools GDP Growth in First Quarter



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

Chart 2
Consumers Remain Optimistic



SOURCES: University of Michigan; Conference Board.

Measures of consumer sentiment also remain elevated (*Chart 2*). The Conference Board's Consumer Expectations Index increased from 106.2 in March to 108.1 in April. The University of Michigan's Consumer Expectations Index was little changed in April at 88.4, compared with 88.8 in March. Overall, survey-based indicators are consistent with temporary weak growth in the quarter and suggest a pickup as the year progresses.

Labor Market Remains Tight

The April employment report showed that the labor market continues to tighten. The headline unemployment rate (U-3) fell to 3.9 percent from 4.1 percent in March, reaching its lowest rate since December 2000. The broader U-6 rate, which includes discouraged workers, other marginally attached workers and those working part time for economic reasons, ticked down from 8.0 percent to 7.8 percent (*Chart 3*). The unemployment rate is currently overshooting its long-run level of 4.6 percent, as estimated by the Congressional Budget Office.

The labor force participation rate decreased slightly to 62.8 percent in April from 62.9 percent in March. Similarly, the prime-age (25 to 54 years) labor force participation rate ticked down 0.1 percent to 82.0 percent. Since 2015, the prime-age labor force participation rate has gradually risen, while the broader participation rate has been little changed, even though the underlying demographic trend in participation is downward. The working population is aging, and labor force participation tends to decline with age.

Recently, wage inflation has trended higher (*Chart 4*). The 12-month rise in average hourly earnings was 2.6 percent in April, unchanged from March. The employment cost index (ECI) of wages and salaries for civilian workers increased to 2.7 percent year over year for first quarter 2018 from 2.6 percent in fourth quarter 2017. The index for private industry workers rose 2.8 percent, compared with a 2.3 percent gain a year earlier.

Inflation Matches Federal Reserve's Target

Recent inflation data show headline measures at the Federal Reserve's 2 percent inflation target, while core measures remain slightly below (*Chart 5*). The 12-month headline PCE rose to 2.0 percent in March from 1.7 percent in February.

While inflation measures have gradually increased, almost all of the rise can be attributed to the replacement of unusually weak inflation readings from spring 2017 with stronger readings in recent months. Year-over-year core PCE inflation, which measures all items excluding food and energy, increased to 1.9 percent in March from 1.6 percent in February. The Federal Reserve Bank of Dallas' Trimmed Mean PCE inflation measure in March ticked up 0.1 percent to 1.8 percent year over year.

Inflation Expectations Remain Well-Anchored

Both survey- and market-based inflation expectations remain well-anchored. Chart 6 shows the anticipated future path of Consumer Price Index (CPI) over the next 120 months as suggested by the Federal Reserve Bank of Philadelphia's Aruoba Term Structure of Inflation Expectations. The recent survey shows long-term CPI inflation of roughly 2.25 percent. CPI inflation typically runs about 30 basis points higher than PCE inflation, thus implying an expected long-term PCE inflation of roughly 1.95 percent.

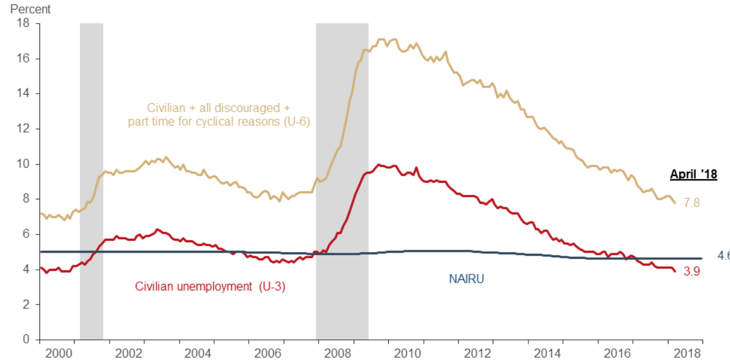
Market-based inflation expectations, as measured by the Treasury-Inflation-Protected-Securities implied five-year/five-year-forward CPI inflation expectations (expected average inflation over the five-year period that begins five years from now) have ticked up slightly to 2.26 percent.

—Laton Russell

About the Author

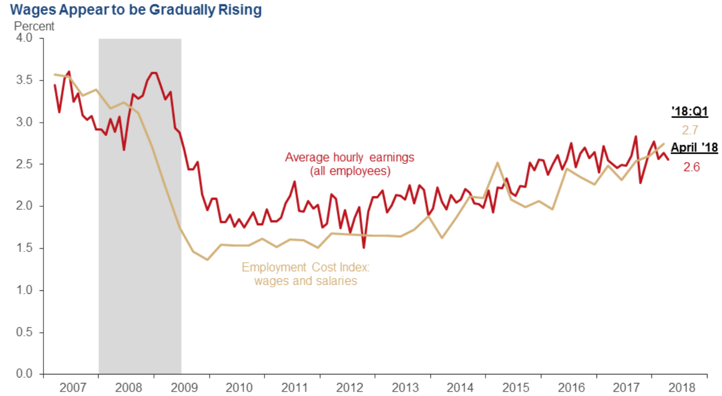
Russell is a research assistant in the Research Department at the Federal Reserve Bank of Dallas.

Chart 3
Unemployment at Historic Low Levels



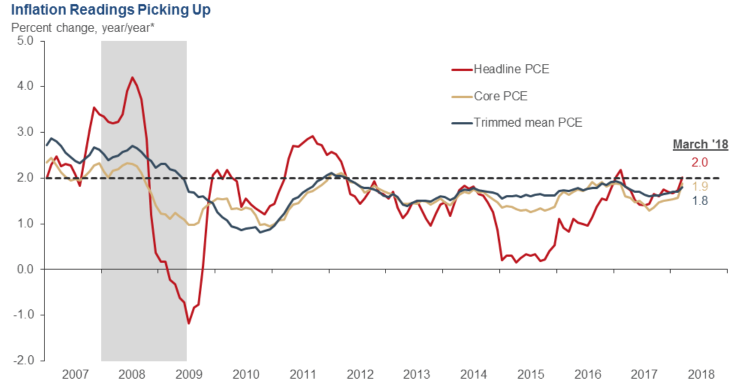
NOTE: Shaded areas indicate National Bureau of Economic Research recessions; long-run unemployment shown by the nonaccelerating inflation rate of unemployment (NAIRU).
SOURCES: Bureau of Labor Statistics; Congressional Budget Office; National Bureau of Economic Research.

Chart 4
Wages Appear to be Gradually Rising



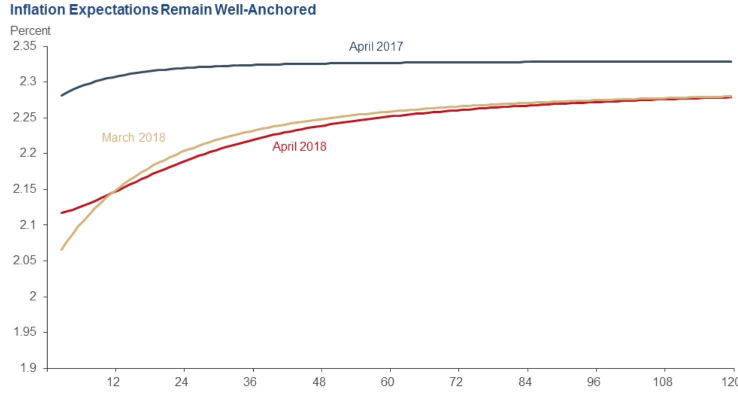
NOTE: Shaded area indicates National Bureau of Economic Research recession.
SOURCES: Bureau of Labor Statistics; National Bureau of Economic Research.

Chart 5
Inflation Readings Picking Up



*Seasonally adjusted.
NOTES: Shaded area indicates National Bureau of Economic Research (NBER) recession. PCE is personal consumption expenditures.
SOURCES: Bureau of Economic Analysis; Federal Reserve Bank of Dallas; NBER.

Chart 6
Inflation Expectations Remain Well-Anchored



SOURCE: Federal Reserve Bank of Philadelphia.