Grant Thornton

Debt-Financed Growth

Seeding a Boom/Bust Cycle

MONTHLY ECONOMIC OUTLOOK

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The stock market is not the economy. Some sayings never get old, they just get better and more pertinent with time. The economy remains on firm footing despite recent market gyrations. The Federal Reserve appeared to welcome a market correction that released steam from bubbling asset prices. More reasonable asset prices today mean there will be less to counteract than if prices had continued their upward trajectory with no interruption.

New York Fed President Bill Dudley referred to recent market moves as "small potatoes" in an interview with Bloomberg. He later underscored that "the little decline that we've had in the equity market today has virtually no implications for the economic outlook."

The economy is poised to grow faster in 2018 than it was just a month ago. Recently passed federal spending increases by Congress will add as much as the tax cuts to the pace of growth. The sticking point is rising deficits, which market participants now realize have a price: higher bond yields.

We are also likely to see acute labor shortages because we are adding an accelerant to overall economic growth when the unemployment rate is already extremely low. Fiscal stimulus of the magnitude we are seeing is typically reserved for recessions, not more mature expansions, because of the threat of overheating.

Some companies are already rethinking who they hire and how to train people. Former convicts are being given a second chance and proving their value in loyalty and low turnover rates.

Programs for veterans are being expanded. Some Northern states are actively advertising to attract millennials to offset out-migration by older workers and retirees; Maine and Wisconsin are just two examples. The loss in labor force participation to retirements is so significant that we could see growth in the U.S. labor force turn negative by 2020 if immigrants are excluded, according to a recent study by Pew Research.

The migration from Puerto Rico is the only near-term offset; Puerto Ricans are U.S. citizens. Nearly 370,000 have made it to Florida in the wake of Hurricane Maria and the devastation it wreaked. Those figures include children and the elderly, but not enough working age adults to buck the slower trends in labor force growth or participation. The economy generated an average of about 180,000 jobs a month in 2017.

The unemployment rate is now expected to plummet to 3.5% in late 2018, the slowest pace since the height of the Vietnam War in the late 1960s. That was an era that helped to seed the stagflation of the 1970s.

This report takes a close look at how the economy is expected to respond to the return of fiscal stimulus so late in the economic cycle. We saw a preview with the recent rise in market volatility and higher bond yields. What once would have been viewed as good news - wage acceleration in the January employment report - is now seen as a sign the economy may be headed toward overheating, or a short-lived boom in growth followed by a recession.

> "Our elected officials have behaved much like children given the choice to eat dessert before dinner; they have a sugar high that will soon dissipate."

2018 Outlook

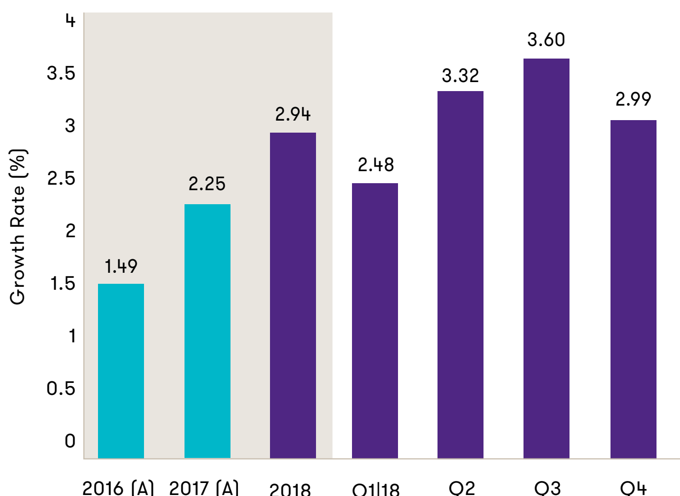
A Boomlet

Chart 1 shows the forecast for 2018. Tax cuts and recently passed spending increases will push growth close to the 3% threshold in 2018, the strongest pace since the start of the expansion:

- **Consumer spending** will accelerate in 2018 in response to rising wages and increased access to credit. Vehicle sales are sliding but that's being offset by a surge in spending on homes and travel. Consumers saved less during the fourth quarter in response to skyrocketing financial market returns. Tapping saving and credit to fund holiday shopping helped reduce the saving rate to 2.4% in December. That is the lowest since the height of the housing market bubble in 2005, though we expect the low pace of saving to ease. Defaults on student and vehicle debt, however, continue to rise.

- **Housing demand** continues to outpace supply, most notably in the single-family housing market, which means that more of the activity in housing will show up in price, not volume of sales. Existing homeowners are choosing to expand and remodel instead of trying to trade up. Contractors are in short supply. Builders cannot afford to move downstream and build entry-level homes as costs for land, materials and labor are escalating. This is despite a resurgence in first-time buyers in the market. (We are finally seeing that older millennials are like earlier generations in their desire to own a home.) The result is a surge in prices and a drop in affordability.

Chart 1: Accelerating Economic Growth
Real GDP Growth Rates



Notes: Annual figures are year-over-year growth. Quarterly figures are annualized growth rates. Sources: BEA and Grant Thornton/Diane Swonk

The only outlier is the apartment market, which has been overbuilt since developers bet millennials would refuse to leave urban areas for the suburbs. Rents in many cities are dropping in response to rising apartment vacancies. Watch for continued backlash to Airbnb from current apartment occupants and large hotel companies, as cash-strapped developers attempt to fill vacancies with temporary rentals.

- **Business investment** is expected to pick up at the fastest pace of this expansion. Orders and shipments were already gaining traction in the second half of 2017, which set the stage for a strong start to 2018. A pickup in both domestic and foreign demand has been cited. The aircraft industry has a whopping seven-year backlog. Orders for heavy trucks are nearing previous peaks. Business leaders predict that the tax cuts will prompt additional investment. Firms can now fully expense investments made in new equipment. The problem for some is timing: Orders placed for new equipment prior to the tax cuts do not qualify for immediate expensing; the airline industry is one the biggest losers.

- **Business inventories** are expected to be rebuilt after being drained in 2017. Retailers were particularly careful in managing inventories during the holiday season, which was obvious to anyone who waited to shop; sizes and selections were limited. In response, we will see a tailwind for domestic manufacturing and imports as we move into 2018.

- **Government spending** is poised to accelerate at the fastest pace since 2010 when fiscal stimulus passed during the height of the crisis was still working its way through the economy. Gains at the federal level are expected to far outpace gains at the state and local levels. Curbs on deductions for state and local taxes are expected to increase the costs of financing state and local spending. Infrastructure spending by state and local government could be particularly hard-hit. The administration's budget for $200 billion in infrastructure spending with private sector matching is unlikely to be approved by Congress, who control the purse strings of government. Members have already agreed on an FY 2018-19 budget.

- **The trade deficit** is the economy's Achilles' heel and expected to worsen in 2018. Exports and imports will both gain momentum. Imports, however, will continue to outpace exports because of the sheer size of the U.S. economy in buying power relative to our trading partners.

Risks to Growth

Tax cuts. Firms may be surprised by problems stemming from the haste with which the tax cuts were passed. Lobbyists played an unusually large role in drafting the legislation, which ups the ante on conflicts of interests and unintended consequences. The airline industry is only one example; lobbyists are working on members of Congress to rectify the timing glitch that prevents airlines from expensing orders for planes. Partisan bickering remains an obstacle. Republicans in the Senate do not have the votes needed to execute changes, while their Democratic colleagues are expected to be reluctant to lend a hand to fix legislation that they were locked out of constructing. This contrasts with the 1986 tax reforms, which were bipartisan; both parties had a hand in crafting that legislation so both parties had an interest in fixing problems when they arose.

Separately, there is a lot of skepticism with regard to how much additional investment the tax cuts will actually trigger. Many firms expect their clients to invest more because of the tax cuts but plan little new investment themselves. Recent company surveys indicate that the overwhelming majority of the saving associated with tax cuts will go toward stock buybacks and dividend increases. Reductions in debt also rank high on survey lists, which makes sense given the rise in interest expenses that we have already experienced. The irony is that much of that borrowing was used to finance stock buybacks and increases in dividends.

Our own internal Grant Thornton tax specialists are betting on a surge in mergers and acquisitions in response to the tax cuts. That could also boost returns to shareholders but do little to stimulate the overall economy. There are concerns that the consolidation we have already seen is actually undermining overall growth.

Trade. NAFTA negotiations are on thin ice as the Canadians now threaten to pull out entirely. About 40% of every car that enters the U.S. from Mexico is made with U.S. content, which means that any loss in Mexican production will also hurt vehicle manufacturers here. The transportation industry is highly dependent on trade with Canada and Mexico and could suffer a substantial blow if the treaty fails. This is at the same time that the administration is threatening to levy tariffs on other countries, which would erode purchasing power by boosting inflation faster than incomes.

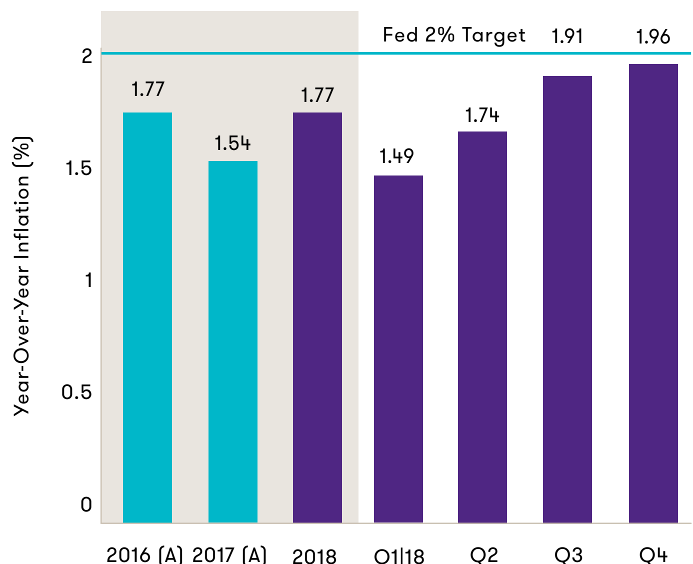
"We expect bond yields to average 3.4% in the fourth quarter, the highest level since the debt ceiling crisis in 2011."

Inflation Creeps Higher

Chart 2 shows the forecast for the Fed's preferred measure of inflation, the core (excluding food and energy) index for personal consumption and expenditures (PCE), which is the most reliable. Year-over-year changes in the core PCE will hit the Fed's target of 2% in the fourth quarter:

- Wages will accelerate in response to labor shortages, an increase in the minimum wage and recent changes in laws affecting pay equity and pay bands, all of which will put upward pressure on costs; and,
- Producer prices have already moved higher, suggesting the pressure to pass at least a portion of those increases onto consumers is intensifying.

Chart 2: Core PCE Inflation



Notes: Quarterly figures are year-over-year index growth. Annual figures are annual averages of year-over-year growth. Source: BEA and Grant Thornton/Diane Swonk.

Separately, the administration appears to be making good on promises for more tariffs on imports, most notably from China, before midterm elections. Tariffs raise the costs for goods coming into the country without raising wages. The result tends to be an acceleration in inflation without any offset in higher wages. Tariffs only benefit the industries they are intended to protect and, even then, only for a limited period of time because of the negative impact they tend to have on demand for goods protected by tariffs.

Risks to Inflation

Waiting for inflation has been a bit like waiting for Godot, the character in Samuel Beckett's famous play who never actually shows up. There is still considerable debate over whether inflation will return this year. The proliferation of price-disrupting technologies is the primary concern for inflation skeptics. They argue that even the service sector, which was once immune to technological change and foreign competition, has experienced a shift in its pricing structure.

Uber, Lyft, Airbnb and Hotel Tonight are just a few examples. Hotel rates posted an inflation-adjusted decline in 2017 for the first time since the recession despite record occupancy rates. These shifts, coupled with the impact that Amazon is having on retail models, could mean another year of waiting for inflation.

Powell Steps Up the Pace on Rate Hikes

Federal Reserve Chairman Jay Powell is expected to follow in his predecessor's footsteps and continue raising short-term interest rates in 2018. The most recent Fed consensus for rate hikes was published in December 2017. At that time, members expected to raise rates three times this year, the same as last year.
Our forecast calls for four instead of three rate hikes in 2018:

- Expectations for growth, inflation and wages have all moved up considerably since the Fed released its forecast;
- The statement following the January meeting included the word "further" before the phrase "gradual adjustment to monetary policy" to acknowledge the risk that there could be more rate hikes in 2018 than initially anticipated;
- The voting members of the Federal Open Market Committee (FOMC), the policy-setting arm of the Federal Reserve, are more hawkish on rates than their predecessors last year;
- Inflation looks poised to finally reach the Fed's 2% target; and,
- Unemployment will likely hit new lows.

Only three of the seven positions at the Board of Governors are currently filled, which leaves the board grossly understaffed. This and the fact that Powell is not a trained economist mean the board will have to rely even more on the Fed's staff in Washington when making policy decisions than in the past. The staff is laser-focused on the Fed's Congressional mandate for stable inflation and full employment. They will not hesitate to recommend additional rate hikes if wages and inflation accelerate in line with our forecast.

The Federal Reserve is on track to continue removing support by buying fewer Treasury and mortgage-backed bonds and allowing more assets to roll off its bloated balance sheet; this trend will accelerate in 2018 and raise the ceiling the Fed has provided for long-term rates in recent years.

That in turn will bring concerns about who will fill the Fed's shoes when it comes to buying what is expected to be a surging supply of Treasury debt. The Fed has also played a key role in the demand for mortgage-backed securities, recreating a market for this debt during the height of the crisis when demand had evaporated. What if private sector demand fails to materialize?

Risks to Fed Funds

If inflation remains subdued, the Fed will hold back on rate hikes, despite strong economic growth. The result could stoke emerging asset price bubbles and cause a larger problem for the Fed down the road. Recessions triggered by bursting asset price bubbles are inherently more difficult to recover from than those caused by a more traditional acceleration in consumer prices. Add to that the fact that low rates leave little room for the Fed to "mop up" after a bubble as they did in the past, and the Fed would be well-served to do all it can to dampen asset price bubbles. The only real tools the Fed has are regulations. The Fed has agreed to roll back some but not all regulations. Recent moves the Fed has made against at least one major bank suggest that they are moving cautiously when easing up on regulations.

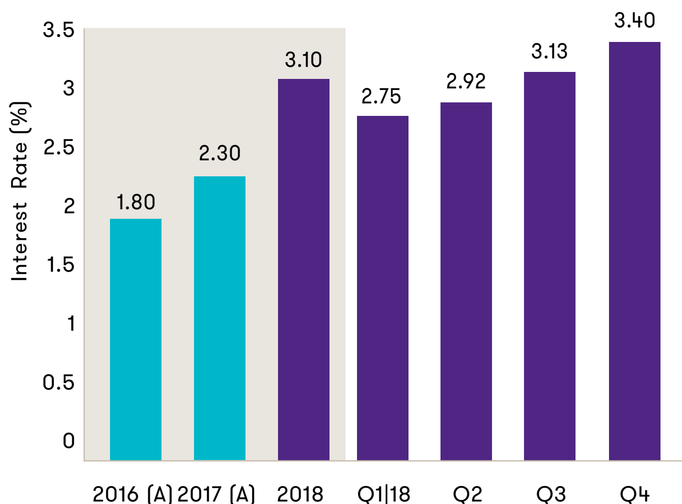
Rising federal budget deficits and the upward pressure that they exert on long-term interest rates further complicate the Fed's job. Rising long-term rates could tighten credit conditions more than the Fed intends and later limit its ability to stimulate the economy with lower rates. The yield on the 10-year bond has jumped from a low of 1.5% to 2.9% in a little more than a year; that represents a near doubling of interest costs on debt tied to those rates.

Treasury Yields Jump

Chart 3 shows the forecast for the 10-year Treasury bond. We expect bond yields to average 3.4% in the fourth quarter, the highest level since the debt ceiling crisis in 2011:

- The Fed is expected to raise short-term rates a full percentage point in 2018;
- Inflation will rise moderately;
- The federal deficit is expected to surge; fiscal year 2019 forecasts for $1 trillion dollar deficit now look conservative; and,
- Reductions in the Fed's balance sheet could diminish demand and raise the yields on Treasury bonds.

Chart 3: Ten Year Treasury Rate
Constant Maturities



Source: Federal Reserve and Grant Thornton/Diane Swonk.

Separately, recent research on the effect that debt and deficits have on long-term rates suggests that the trajectory of rates is more important than the level of overall debt. That means that recent moves by Congress to abandon any semblance of fiscal discipline could increase the risk premia we have to pay investors to buy debt that was already forecast to rise because of an aging population.

Risks to Bonds

Cooler inflation and a slowdown in rate hikes by the Fed could dampen near-term increases in long-term yields. The trajectory on long-term rates, however, is clearly to the upside unless Congress were to discover fiscal discipline. I am not holding my breath.

Bottom Line

Fiscal stimulus will act as an accelerant to growth in 2018 but at the price of growth down the road. A failure to extend recent increases to federal spending for fiscal year 2020 alone could trigger a recession in 2020, if not sooner. It seems unlikely that Congress would suddenly cut that additional spending in an election year.

Our elected officials have behaved much like children given the choice to eat dessert before dinner; they have a sugar high that will soon dissipate. Worse yet, they are undermining the nutrition of the entire economy, putting us on a yo-yo diet, which usually fails. Enjoy your Valentine's Day chocolates while you can.

Economic forecast — February 2018

	2017	2018	2019	2017:4	2018:1	2018:2	2018:3	2018:4	2019:1	2019:2	2019:3	2019:4
National outlook												
Chain-weight GDP[1]	2.25	2.83	2.88	2.55	2.4	2.9	3.42	3.12	2.96	2.84	2.63	1.46
Personal consumption	2.74	2.83	2.21	3.79	2.84	2.63	2.49	2.21	2.22	2.12	1.97	1.94
Business fixed investment	4.7	5.58	7.34	6.83	2.87	5.91	8.04	7.69	7.86	7.46	6.8	5.02
Residential investment	1.71	3.04	1.85	11.61	3.19	4.29	2.48	2.14	1.26	0.54	2.26	2.81
Inventory investment	13.59	55.09	75	9.17	43.13	54.09	58.05	65.11	72.78	77.78	78.18	71.25
Net exports	-621.5	-701.43	-739.98	-652.61	-690.58	-701.83	-702.58	-710.74	-718.33	-730.84	-748.38	-762.38
Exports	3.36	5.91	6.34	6.94	7.96	3.98	7.79	6.88	5.99	6.26	6.29	5.93
Imports	3.94	7.45	6.14	13.88	11.74	4.61	6.03	6.38	5.61	6.46	7.12	6.33
Government expenditures	0.11	1.24	2.34	2.95	-0.26	0.81	2.78	3.02	1.91	2.96	3.53	-1.47
Federal	0.18	1.88	4.19	3.53	-1.29	0.48	7.26	4.59	2.88	5.81	7.66	-5.21
State and local	0.06	0.85	1.22	2.6	0.35	1	0.18	2.07	1.33	1.23	1.02	0.94
Final sales	2.38	2.59	2.78	3.25	1.61	2.65	3.33	2.97	2.79	2.74	2.63	1.62
Inflation												
GDP deflator	1.8	1.92	2.59	2.36	1.76	1.25	2.8	2.01	2.96	2.74	2.83	2.9
CPI	2.14	2.38	1.92	3.72	2.8	0.78	4.99	-0.19	1.66	2.15	2.39	2.85
Core CPI	1.85	2.16	2.59	2.27	2.5	2.18	2.22	2.75	2.75	2.54	2.63	2.7
Special indicators												
Corporate profits[2]	8.15	0.65	2.63	22.91	-5.97	-2	8.91	2.25	4.31	4.2	3.82	-1.68
Disposable personal income	1.22	3.26	3.91	1.13	6.86	2.94	2.37	4.38	5.59	3.53	3.17	2.54
Housing starts (mil.)	1.21	1.29	1.33	1.25	1.25	1.29	1.31	1.33	1.33	1.32	1.34	1.34
Civilian unemployment rate	4.35	3.87	3.24	4.09	4.07	3.98	3.8	3.63	3.42	3.25	3.13	3.16
Total nonfarm payrolls (thous.)[3]	2171.66	2643.94	2578.29	551.33	549.48	604.72	676.79	812.94	753.49	688.34	621.46	515
Vehicle sales												
Automobile sales (mil.)	6.27	5.85	5.75	6.29	5.9	5.8	5.8	5.9	5.9	5.8	5.7	5.6
Domestic	4.54	4.23	4.22	4.59	4.2	4.2	4.2	4.3	4.3	4.3	4.2	4.1
Imports	1.73	1.62	1.52	1.7	1.7	1.6	1.6	1.6	1.6	1.5	1.5	1.5
Lt. trucks (mil.)	10.85	10.75	10.12	11.5	11.1	10.8	10.6	10.5	10.3	10.1	10.1	10
Domestic	8.95	8.88	8.4	9.4	9.1	8.9	8.8	8.7	8.5	8.4	8.4	8.3
Imports	1.9	1.88	1.73	2.1	2	1.9	1.8	1.8	1.8	1.7	1.7	1.7
Combined auto/Lt.truck	17.12	16.6	16.4	17.79	17	16.6	16.4	16.4	16.2	15.9	15.8	15.6
Heavy truck sales	0.4	0.47	0.46	0.4	0.4	0.5	0.5	0.5	0.45	0.5	0.5	0.4
Total vehicles (mil.)	17.52	17.08	16.34	18.19	17.4	17.1	16.9	16.9	16.65	16.4	16.3	16
Interest rate/yields												
Federal funds	1	1.86	2.61	1.2	1.51	1.7	2.02	2.23	2.38	2.45	2.73	2.88
10-year treasury note	2.33	3.06	3.77	2.37	2.8	2.93	3.1	3.4	3.6	3.7	3.78	4
Corporate bond BAA	4.44	4.72	5.48	4.27	4.43	4.63	4.77	5.08	5.26	5.39	5.5	5.79
Exchange rates												
Euro/Dollar	1.13	1.12	1.14	1.18	1.12	1.13	1.1	1.13	1.13	1.14	1.1	1.2
Dollar/Yen	111.91	114.04	114.44	112.05	112.89	114.32	113.73	115.23	114.21	116.21	115.21	112.14

1. In 2016, GDP was $16716.164 billion in chain-weighted 2009 dollars.
2. Corporate profits before tax with inventory valuation and capital consumption adjustments, quarterly data represents four-quarter percent change.
3. Total nonfarm payrolls, quarterly data represents the difference in the average from the previous period. Annual data represents 4Q to 4Q change.

Quarterly data are seasonally adjusted at an annual rate. Unless otherwise specified, $ figures reflect adjustment for inflation. Total may not add up due to rounding.

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