Macro Research

US

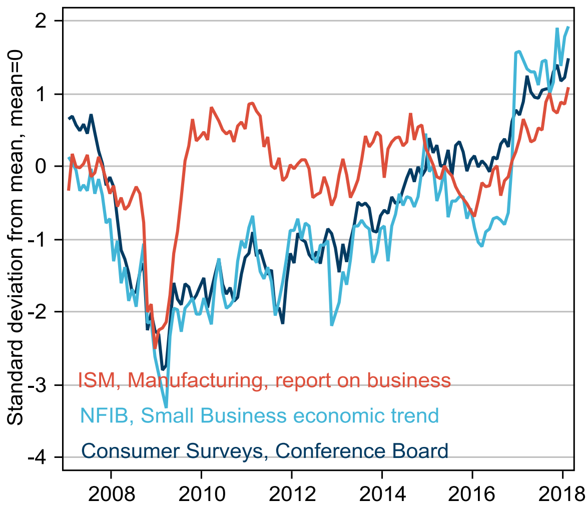
Short-term fiscal boost, but increasing risks

Substantially more expansionary fiscal policy indicates stronger growth for both 2018 and 2019 than in our January forecast. However, the demand impulses from the tax reform and budget deal also increase the risks of overheating. The Federal Reserve will, in our view, respond and raise the policy rate three more times this year. Moreover, we believe that financial conditions will tighten more than households and firms expect. Thus, even if we now expect growth to be maintained for longer, we are still more pessimistic than consensus about the longer-term performance of the US economy and believe that the US will lead the next global downturn.

Fiscal policy set to boost demand

At the end of 2017, President Trump signed a law reforming household and corporate tax codes, with large tax cuts. In addition to the tax reform, a new budget bill was passed at the beginning of the year in a bipartisan agreement. Among both households and corporates in US, confidence in economic performance has increased, presumably due to the strong global trend, as well as due to hopes that the tax reform will yield positive effects. Small enterprises are particularly optimistic.

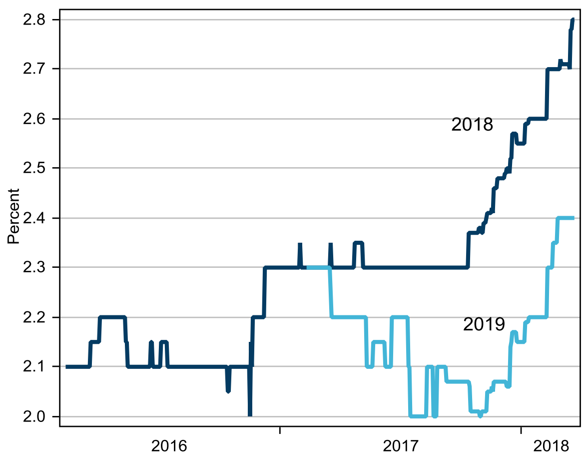
Business and consumer surveys



Source: Macrobond

For the same reasons, since the end of 2017, forecasters have continuously been raising their US growth forecasts for 2018 and 2019, as shown in the next chart.

GDP forecasts from Bloomberg survey



Source: Bloomberg

Tax reform and budget deal

The tax reform bill amounts to USD 1.5 trillion over the next decade. It slashes the corporate tax rate to 21 percent from 35 percent, thereby enhancing the position of the US compared to other industrialised economies that have an average corporate rate of 22.5 percent. It also provides five years of full expensing, giving firms tax incentives for capital expenditures. It also includes changes in how multilateral corporations will be taxed, giving incentives for earnings to be repatriated to the US. Furthermore, individuals will get a temporary rate cut, which tends to favour the highest earners. Most middle-class workers will also get short-term relief. Moreover, the bill repeals a major piece of the healthcare legislation: the individual mandate that requires people to have insurance coverage.

The new budget bill adds nearly USD 300 billion in discretionary spending for 2018 and 2019. The agreement includes increased caps on defence and non-defence spending, additional funds for disaster relief and funding of various healthcare-related programmes.

The tax reform and the budget bill taken together increases the federal deficit by around 2 percentage points of GDP on average 2018-2020. But remember that the effect on growth will be less, as not all fiscal spending leads to a higher GDP. Tax cuts and spending increases can generate varying degrees of additional output depending on how they are implemented, at what point in the business cycle they occur, and how the Fed would be expected to respond. We think a reasonable estimate of the total effect on GDP is just over 0.5 percentage points this year and closer to 1 percentage point in 2019.[1]

We had expected headwinds to subside

For quite some time now, we have taken the view that the US economy is heading for an overheating labour market. Unemployment is very low and companies are stating that they are having problems finding workers to increase production. Since 2014, there has been an increase to the labour force from discouraged workers returning. However, the cyclical rise in the participation rate now appears to have reached its end, and with an ageing population the trend in labour force participation is expected to be negative.

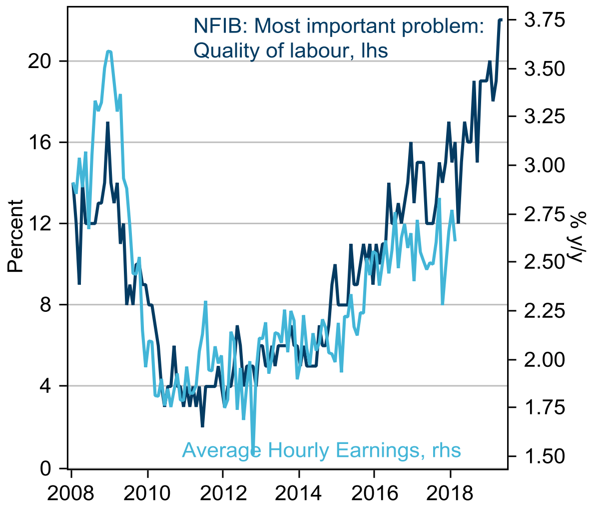
In our latest Global Macro Forecast from January, "Mature business cycle changes the risk profile," our assessment was that the beginning of 2018 would be strong, and we adjusted our forecasts upward, mainly for 2018. However, we foresaw capacity limitations slowing growth in late 2018, and the US economy putting the brakes on sharply in 2019. We assumed that the tight labour market would lead to labour costs starting to rise markedly, and that profits would therefore be squeezed. In addition, we expected financial conditions to tighten, not only because higher key rates will increase interest payments, but also due to lower asset prices and tighter credit conditions. We assumed that investments would then decrease, and that increasing uncertainty regarding the economic trend would spread throughout the US economy.

We also highlighted the risk that lower growth expectations, increased inflation and interest rates should lead to higher volatility and tailwinds for asset markets.

Upward revisions in the pipeline…

Our assessment now is that growth will be maintained for longer than we previously expected. This is due partly to rising public expenditures, and partly to increasing corporate profits in the wake of the tax reform. Thus, in the short term, there is less risk of companies having problems with higher labour costs. In addition, wage increases have been modest, and employment has continued to increase, despite the great shortage of labour.

Labour shortage, but still modest wages



Source: Macrobond

We will make a detailed forecast of the US economy when we publish our next Global Macro Forecast in April. A reasonable assumption is that we will increase public consumption this year and next year. In addition, we expect higher household consumption, although the beginning of the year looks weak. To some extent, we also expect increasing investments, which is important for long-term growth. At the same time, there are several question marks surrounding how increased trade barriers will affect exports (and imports). The higher demand will probably mean that unemployment may be somewhat lower, but we believe that the scope for further growth in the labour market is limited.

…but risks remain

However, there is a great deal of uncertainty, particularly about whether the tax reform can generate long-term positive effects via higher investments and thus increased productivity, or not. Without a clear pickup in productivity, the economy will be more and more constrained. There is a risk that the

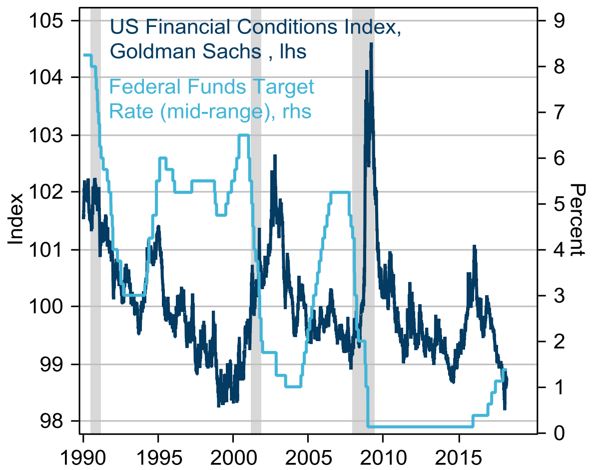
[1] More and more independent calculations have gradually emerged regarding the size of the effects of the tax reform and the budget agreement on GDP. For example, the IMF recently stated that it estimates the cumulative effect to GDP in 2020 from the tax reform at around 1.2 percentage points. The effects from the budget bill are in addition to that.

increasing public expenditures will only fuel growth in a situation where the economy is already running at full steam, thereby leading to major overheating and rising inflation.

This would in turn mean that the Fed would need to raise the funds rate more than expected, which would increase the risk of financial market turbulence, and of financial conditions being tightened in an undesirable manner. As we saw earlier this year, when volatility increased, financial markets can react significantly to the probability of higher inflation and interest rates.

As seen in the chart below, broader financial conditions (also capturing exchange rates, asset prices, credit conditions, etc.) do not normally move in tandem with Fed's policy rate. Additionally, in a crisis, financial conditions worsen rapidly as asset prices fall and credit conditions tighten, despite rate cuts from the Fed. With indebted companies becoming accustomed to low interest rates, the effect of tightening financial conditions can have substantial impacts on investment and employment.

Financial conditions deviate from Fed's policy rate



Source: Macrobond

A further risk is that the budget deficit is now expected to increase in a manner not seen outside of wartime and times of crisis. Even though the dollar has traditionally been a reserve currency, and the international market has always been willing to fund US deficits, we see a risk that this may cost more, resulting in rising interest rates. This would further increase the risk of an economic downturn.

Finally, we have to mention the risk of increased protectionism affecting both global growth and the US economy, even if we do not expect any significant effect on growth for now.

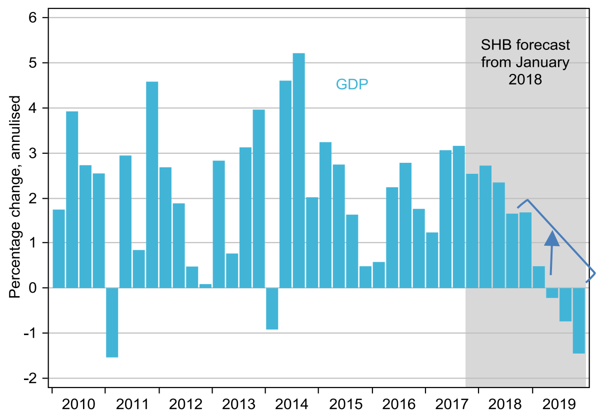
Strong momentum in the short term

To summarise, there is strong momentum in the US economy, and the expected positive effects of expansive fiscal policy mean that we will need to revise our US growth forecast upward when we publish our next Global Macro Forecast in April. We previously assumed that the US would enter a recession in 2019, but our assessment now is that growth will be maintained for longer.

Our revised view of the economic situation will affect our assessment of the Fed's actions. We now expect Fed to raise the policy rate four times this year, including the hike in March, and at least one more time in 2019 (compared to our previous estimate of three more increases this year, and cuts in 2019).

We still remain more pessimistic than consensus about economic performance in the slightly longer term, mainly for two reasons: 1) fiscal policy is set to boost demand when the labour market is already constrained; and, 2) we are worried that financial conditions will tighten more than people expect when the Fed increases interest rates. That said, there is of course a chance that investment and productivity will pick up more substantially, thereby making the economy more resilient to shocks.

Revisions in pipeline



Sources: Macrobond and Handelsbanken

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