BBVA Research

ECONOMIC ANALYSIS

Higher Expected GDP Growth: Solid Momentum, Short-Term Fiscal Stimulus and Improving Global Performance

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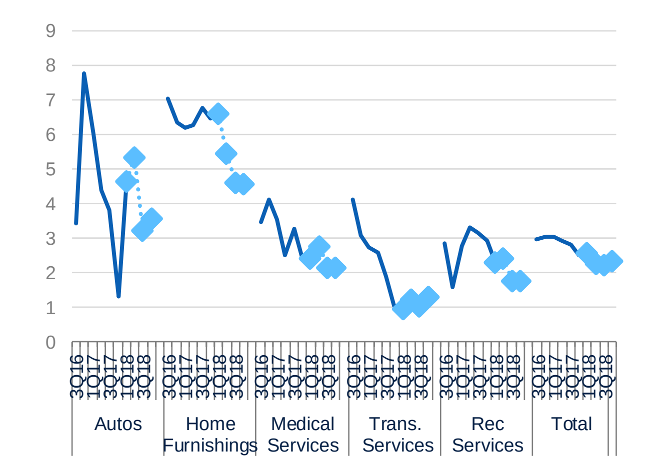
U.S. GDP growth to be 2.6% in 2018 and 2.5% in 2019

Heading into 2017 there was a high degree of uncertainty as to how economy would recover from the tepid growth in 2016 given the unknowns associated with the incoming administration. Corporate welfare was also in doubt as profits at U.S. companies after adjusting for inventory adjustment and taxes was ~$127Bn below their peak in mid-2014. In addition, global downside risks remained elevated with high-stakes elections scheduled in Europe and political instability growing in Emerging Markets. In spite of this, we expected growth return to rates above the U.S. potential growth rate, as labor market conditions improved, confidence rose and the investment outlook tilted to the upside.

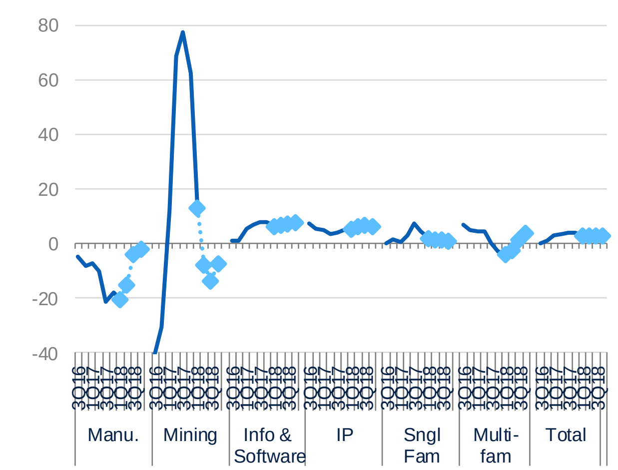
In terms of our outlook for the fourth quarter, we expect growth to trend closer to its longer run potential despite a balanced risk environment. We now expect growth of 2.2% in the fourth quarter, which is slightly below preliminary empirical estimates (NY Fed Nowcast: 3.2%QoQ SAAR, ATL Fed Nowcast: 3.2%QoQ SAAR). This deceleration is consistent with slowing investment in inventories, less auspicious investment conditions due to the expectations for future tax cuts (2018), weaker export growth and a recovery in imports, and less auspicious consumption conditions, as the short-term boost from the rebuilding efforts from hurricane Harvey and Irma fades.

Figure 1. Real Personal Consumption, year-over-year %



Source: BBVA Research & BEA

Figure 2. Real Private Fixed Investment, year-over-year %



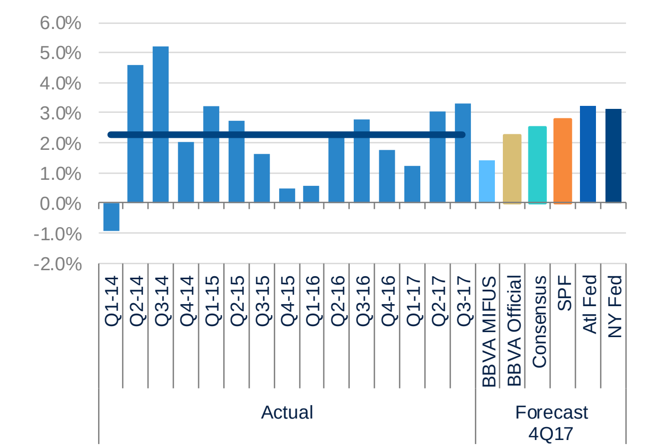
Source: BBVA Research & BEA

However, after estimates for GDP growth beat expectations in the second and third quarter, we are revising up our forecast for the year to 2.2% in 2017— from 2.1%. The modest upward revision does not signal a major departure from our baseline scenario of gradual rebalancing between consumption in investment. Rather, this revision reflects greater resiliency at the consumer level and stronger than expected business fixed investment and the accumulation of inventories.

Although sky-high consumer and business expectations explain part of the stronger than expected growth there are fundamental explanations that underlie the strength of the U.S. economy in 2017. Gains in oil prices and a depreciation in the dollar translated into a historic recovery in investment in mining equipment, and resurgence in manufacturing and investment in equipment and software. Global growth has also remained upbeat, as concerns of geopolitical instability, populist and nationalist uprising and isolationism have moderated, leading to stronger global trade flows and an upward surprise in global growth. In fact, net exports have positively contributed to U.S. growth for three consecutive quarters, which is a first since 2012-2013.

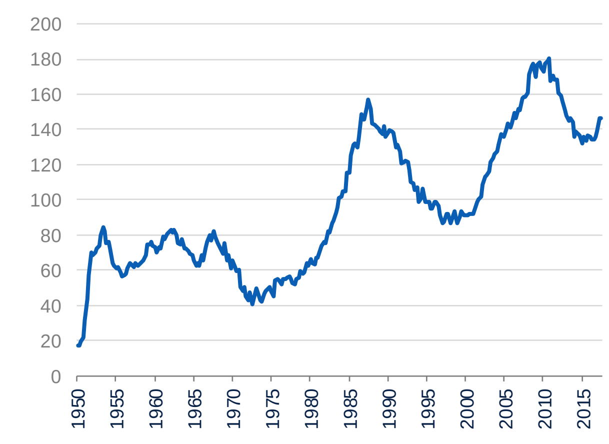
In addition, consumption exceeded expectations despite cyclical headwinds related to the long expansion cycle, slowing job gains and tighter credit conditions. Furthermore, government spending has contributed more positively to overall growth after Congress agreed to increase the caps on discretionary spending for the fiscal year by $118bn or 0.6% of GDP. Around 70% of the increase was in defense spending and 10% for disaster relief and natural disasters.

Figure 3. Real GDP,SAAR, quarter-over-quarter %



Source: BBVA Research & NY FED, ATL Fed, Bloomberg, Philadelphia Fed

Figure 4. Real Federal Investment in Defense, Bil, 2009$



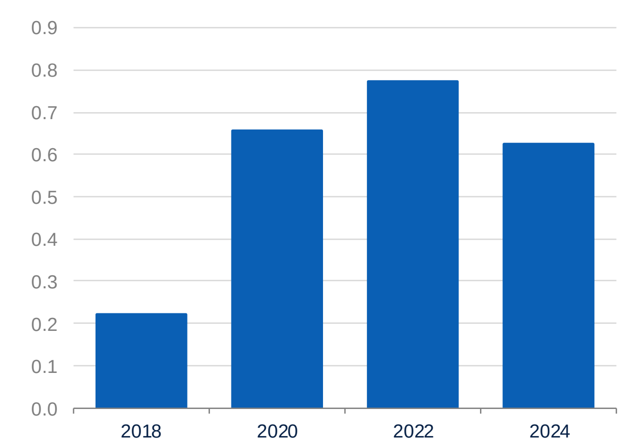
Source: BBVA Research, BEA & Haver Analytics

We expect the cyclical momentum and optimism to continue to support above average growth rates as we enter 2018. Monetary policy will also remain accommodative even despite the increased rate of balance sheet attrition (caps will reach terminal level of $30Bn in Treasuries and $20bn MBS per month in October) and additional rate increases; our revised outlook now assumes three rate increase in 2018 (previously two) and two more in 2019. Furthermore, our baseline is for global growth to continue to trend above 3.0% with strong contributions from both Emerging and Developed Markets.

Without major fiscal reform, our bias in 2018 and 2019 was for growth to be 20-30bp higher given the momentum from both domestic and international factors. However, with the passage of the tax reform in Congress our baseline is now for growth to be to be 2.6% and 2.5% in 2018 and 2019, respectively. While individual tax cuts will give a slight boost to average after tax incomes, the greatest source of improvements will come from the changes to the corporate tax code. The reduction in marginal tax rates to a more globally competitive level, increased ability to deduct new investment, lower marginal rates on pass-through income from small business, and the shift to a territorial system with anti-abuse rules and a base erosion anti-abuse tax (BEAT) will provide the biggest bang for the buck.

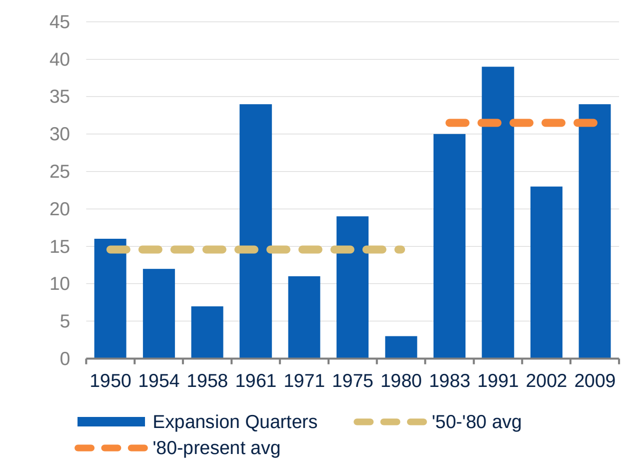
However, expiring tax cuts and marginal rate cuts skewed towards the highest income earners have the potential to lower the marginal propensity to consume, suggesting that the impact from the demand-side will be muted. Moreover, the net impact over time could be smaller than expected. A large portion of the tax cuts could end up as higher savings rather than investment. Borrowing costs could also edge up as inflation and interest rates increase; there could also be unexpected outcomes at the firm level given that some provisions are going to sunset and that Congressional leaders have tacitly admitted the proposal could face revisions in 2018 and beyond. Based on these factors, we estimate the net cumulative impact on GDP will be about 0.2% by 2018 and 0.6% by 2024.

Figure 5. Impact from TCJA, % of GDP, cumulative



Source: BBVA Research

Figure 6. U.S. Business Cycle Duration, quarters



Source: BBVA Research, NBER & Haver Analytics

To the upside, there is also the potential for additional policy related tailwinds from lower regulatory burdens. In fact, after the first year in office the new administration has revised or eliminated 31 environmental and 7 financial regulations by way of congressional review or executive order. Trump has also appointed officials to the Consumer Financial Protection Bureau (CFPB) and the vice-chair of regulation at the Fed as well as to the Department of Energy, Commerce and the Treasury that should favor business-oriented reforms. The economy is also likely to benefit from improved lending conditions. Healthy financial conditions for households, businesses and banks coupled with positive expectations could lead to increased leverage, consumption and investment, which in turn should help extend the expansion cycle.

With respect to downside risks, there remains a nontrivial probability that domestic policy uncertainty remains high given the ongoing budget impasses and looming debt-ceiling negotiations in 2018. Monetary policy could also take a more hawkish course if the new appointments to the Federal Reserve decide to transition to a more conservative rules-based approach. However, the implicit bias of the FOMC seems to be positive with respect to the tax reform given its supply-sided nature, which limits the risks of the Fed increasing the pace of normalization in anticipation of inflationary pressures.

Trade and immigration will also remain salient concerns. After Trump's decision to pull the U.S. out of the TPP, the remaining countries are continuing to negotiate a deal where China would fill the vacuum left by the U.S. In addition, NAFTA renegotiation talks, which promise a vast opportunity to modernize the agreement, have soured and are set to resume in 2018 without a clear idea of what lies ahead. Furthermore, Congress has to address the status of undocumented immigrants brought here as children (Dreamers) who face an uncertain future when there status official status is set to be revoked in 2018.

Given that we expect the U.S. business cycle to gain some momentum from the tax reform there is a high probability that the U.S. will manage to expand a further 18 months, which will mark the longest cyclical expansion in modern history. However, there is an open question as to whether tax reform, in and of itself, can alter the long-term potential growth rate of a country and lift living standards. If this bill fails to do so, there could be intergenerational costs, particularly in terms of public debt and social tensions related to political and social inequality, and reduced social investment in human and physical capital that could come at the price of lower potential for future generations.