RSQE FORECASTS

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For Release: 11/19/2015

The U.S. Economic Outlook for 2016–2017
Executive Summary: November 2015

On Firmer Ground

Economic growth has proceeded unevenly so far this year, but the economy has continued to heal from the Great Recession. Despite several headwinds, we currently project that 2015 real GDP growth will be on par with last year. That middling performance, however, masks a stronger domestic economy slowed by sluggish growth in its trading partners. Labor market conditions are improving, wage growth is picking up again, vehicle sales are booming, and the housing market is continuing its recovery.

Real GDP growth in 2015q3 measured only 1.5 percent at an annual rate due to a major inventory correction. Removing the effects of inventory investment and net exports, however, shows that domestic final demand grew by 2.9 percent in the third quarter and 2.8 percent year-over-year, a pace we see likely to be sustained going forward.

The average monthly payroll jobs gain for 2015 is the second highest since 2006, and the monthly average of initial jobless claims for October was the lowest it has been since 1974. As a result, the unemployment rate has fallen to 5.0 percent in October, while broader measures of unemployment indicate that the percentage of individuals employed part-time for economic reasons is also on the decline.

This year, real hourly wages—nominal wages deflated by CPI—have accelerated, growing at a nearly 2 percent rate. They have been bolstered by the unexpected decline in inflation brought on by the commodity bust. While still slow by historical standards, this 2 percent pace is better than the 1 percent growth we saw during most of the recovery. Nominal wage growth also accelerated in recent months, suggesting that real wage gains may sustain their recent pace.

Clouds on the Horizon

Not all, however, is rosy. The turmoil in financial markets earlier this year served as a reminder that the United States is not insulated from economic events in the rest of the world. Over the past year, several of our trading partners experienced weakness in their economies, prices for a wide range of globally traded commodities declined sharply, and the dollar appreciated substantially.

The recent sharp appreciation of the dollar and the ongoing collapse in oil prices reduced inflation and adversely affected net exports. In the third quarter, the core Personal Consumption Expenditures (PCE) price deflator was 1.3 percent year-over-year and headline PCE inflation was 0.3 percent year-over-year. Weak growth in Europe and developing economies contributes to a strong dollar, which spells a substantial negative contribution of net exports to GDP growth.

Growth in the service sector is robust, but indicators of industrial activity remain weak. The Industrial Production Index has declined in all but one month this year and was up just 0.4 percent year-over-year in September. Large idle capacity in mining accounts for low total capacity utilization of 77.5 percent. The ISM manufacturing index for October barely exceeded 50, held down by sluggish exports and commodity-driven weakness in primary metals, petroleum and coal products, and machinery.

Fasten your Seatbelts, Prepare for Lift-Off

We project departure from the zero lower bound at the Fed's December meeting. While weakness in inflation is pushing against a rate hike, we expect this effect to fade, and the improvement in labor markets to push the Fed to raise rates for the first time in over nine years. We expect the Fed to raise rates cautiously given muted inflation and jittery global financial markets. We anticipate a 25 basis point hike in the target range per calendar quarter.

The 3-month Treasury bill rate is projected to follow the fed funds rate closely, rising to 1.3 percent by the end of 2016 and to 2.2 percent by the end of 2017. The 10-year Treasury bond yield is projected to reach 2.7 percent by the end of 2015, and 3.1 percent by the end of 2017. We expect mortgage rates to rise from 4.0 percent at the end of 2015 to 4.7 percent at the end of 2017.

Bipartisanship in More than Name Only

The Bipartisan Budget Act of 2015, which was passed in October, is significant primarily for the certainty it provides about the ability of the federal government to operate without the threat of a shutdown for a longer time horizon than in recent memory. The Act raises the debt limit through March 2017 and relieves the sequester through fiscal 2017.

As GDP and employment grow, federal receipts are expected to grow by 4.7 percent in fiscal 2016, and 5.4 percent in fiscal 2017. ACA subsidies and Social Security payments lead to a rise in federal expenditure growth to 4.6 percent in fiscal 2016. We expect the effect of the ACA rollout on expenditure growth to be complete by 2017, but Social Security payments will continue rising as baby boomers retire, leading to slightly slower growth of federal expenditures of 4.1 percent in fiscal 2017.

The 2016–2017 Outlook

We expect all major components of domestic final demand to expand at a robust pace over our forecast horizon. GDP growth is 2.6 percent in 2016, which is the fastest the economy has grown since 2006, and 2.9 percent in 2017.

The housing sector continues to contribute to overall economic growth as residential investment expands in response to higher prices. Annual housing starts will grow at a solid pace, rising from 1.31 million in 2016 to 1.47 million in 2017. Nearly 70 percent of the increase will come from new single-family homes.

Lately, the vehicle market has been booming. Light vehicle sales are projected to increase from 17.4 million units in 2015 to 18 million in 2016, and end at 18.1 million in 2017. Light trucks, which include the increasingly popular CUVs and SUVs, are the main driver of growth in this category. The truck share of light vehicles is projected to increase from 53 percent in 2014 to almost 58 percent in 2017.

Employment and Inflation

As the economic recovery matures, the unemployment rate continues its decline, falling to 4.9 percent in 2016 and 4.6 percent in 2017. Job gains slow from 2.9 million jobs in 2015 to 2.4 million in 2016 and 2.3 million in 2017 as labor markets tighten.

Inflation remains stubbornly below the Fed's 2.0 percent target. Recently, the cause has been the collapse in energy prices and the appreciation of the dollar, which led to just 0.1 percent headline CPI inflation in 2015. We expect the downward pressure on inflation to dissipate soon. Headline CPI inflation will rise to 1.6 percent in 2016 and 2.3 percent in 2017. Core CPI inflation will accelerate moderately, from 1.9 percent in 2016 to 2.0 percent in 2017.

	Actual	RSQE Forecast		
	2014	2015	2016	2017
GDP (billions of current $)	17348.1	17948.9	18683.0	19560.9
Real GDP (billions of chained 2009 $)	15961.7	16351.4	16775.5	17256.3
% change: year-over-year	2.4	2.4	2.6	2.9
% change: 4th-qtr-to-4th-qtr	2.5	2.2	2.8	2.8
Nonfarm payroll employment (millions)	139.0	141.9	144.3	146.6
Civilian unemployment rate (%)	6.2	5.3	4.9	4.6
Capacity utilization, total industry (%)	78.1	77.8	77.2	78.2
Inflation (private nonfarm GDP deflator, % change)	1.5	1.0	1.4	1.8
Inflation (CPI-U, % change)	1.6	0.1	1.6	2.3
Inflation (core CPI, % change)	1.7	1.8	1.9	2.0
Light vehicle sales (millions)	16.4	17.4	18.0	18.1
Private housing starts (thousands)	1000.5	1126.8	1315.0	1470.5
3-month Treasury bill rate (%)	0.0	0.0	0.9	1.9
10-year Treasury note rate (%)	2.5	2.1	2.6	3.0
Conventional mortgage rate (%)	4.2	3.9	4.2	4.6
Real disposable income (billions of chained 2009 $)	11836.3	12223.0	12595.7	12978.9
% change	2.7	3.3	3.0	3.0
Corporate profits after tax (billions of current $)	1693.9	1826.1	1907.1	1976.2
Value of U.S. $ (FRB broad index), % appreciation	3.1	12.3	2.7	0.3
Current account balance (NIPA basis, billions of current $)	–401.1	–452.9	–516.7	–616.3
Federal surplus (FY, NIPA basis, billions of current $)	–609.7	–606.6	–631.1	–613.0