Grant Thornton

Economic update

Reliving the 1990s?

EMERGING TRENDS

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I was dreamin' when I wrote this, forgive me if it goes astray
But when I woke up this mornin', could've sworn it was judgment day
The sky was all purple, there were people runnin' everywhere
Trying' to run from the destruction, you know I didn't even care

Say say two thousand zero zero party over, oops, out of time
So tonight I'm gonna party like it's nineteen ninety-nine

Prince, "1999"

The artist formerly known as Prince wrote his 1983 iconic hit in response to the escalating Cold War and fear of a nuclear Armageddon. He had been watching a show about the year 1999 and how bad the world would be. That, combined with his concern about the proliferation of nuclear weapons, inspired him to write about embracing life for the moment instead of fear, he told CNN's Larry King in an interview just before the end of the millennium.

The popular song later became an anthem for the actual year 1999. The economy was booming, markets were surging, all while the threat of a man-made glitch in computer programs threatened to end the world as we knew it. The glitch was nicknamed "Y2K" because older computers were not able to recognize the changeover from the 20th to the 21st century, 1999 to 2000. There was widespread concern that computers across industries and sectors - from the financial system to the electrical grid - would crash if old programs weren't rewritten and backup systems weren't upgraded.

GROWTH PICKS UP

Real GDP is expected to rise at a 2.8% pace in the fourth quarter. Consumer spending did particularly well, buoyed by strong holiday spending and insurance payments to repair and replace damaged property in the wake of hurricanes and fires. Business investment improved with gains spreading beyond the oil industry, which had dominated what little investment we had seen. The weak spots include inventories drained in response to strong demand and the trade deficit. Imports tend to surge with consumer spending. Growth for 2017 as a whole is estimated to come in at a 2.3% pace, which is good but still close to the 2.1% post-crisis average.

Prospects for growth in 2018 look better. Overall economic growth is expected to accelerate in response to a pickup in wages, the need to upgrade and replace old equipment, stronger growth abroad and the recent tax cuts. Federal spending could also rise, depending on when Congress passes a budget. The laggards will be state and local government spending; the cap on state and local tax deductions will be particularly hard on high-tax states. The biggest drag on growth will remain trade. Growth overall is forecast to rise to a 2.7% pace in 2018, the strongest year of this expansion.

Fed forced to move aggressively. Upside surprises on wages and inflation (fueled in part by the tax cuts) added to leadership changes on the Federal Reserve Board of Governors will force new Federal Reserve Chair Jerome (Jay) Powell to raise rates four instead of three times in 2018.

Diane Swonk
Chief Economist

Workers once viewed as commodities, easily interchangeable and replaceable, will be seen as diamonds in the rough, worth polishing with training and capital to bridge the skills gap.

New Year's Eve 1999 came and went without computers crashing around the world. Computers had been successfully updated to eliminate the perceived threat. Almost every major news channel ran special coverage to track the clock striking midnight in major developed countries in the event of chaos. By the time the new year arrived in the U.S., it was clear that a crisis had been averted.

The economic expansion still had 13 more months to run. The inherent problems, however, were starting to reveal themselves. Fear of Y2K triggered leapfrog investments in new technologies, which borrowed from investment and growth later in the cycle. Workers trained to fix the Y2K glitch were laid off. Microsoft, which had cornered the software market, lost an antitrust suit brought by the government. The reality that dot.com companies needed to generate profits like traditional companies became clear. When the tech bubble burst in the Spring of 2001, the economy slipped into a mild recession that was over by November, just two months after the September 11 attacks.

Pundits looked back on the post-2001 period and the Great Recession as a lost decade. With the 21st century came a loss of innocence. We were suddenly fighting an unfamiliar foe while the "American Dream" of home ownership and a middle-class lifestyle slipped out of reach for many.

Why think of those analogies today? Because the euphoria in financial markets is reminiscent of the late 1990s. Valuations are high, volatility is low and unemployment is once again close to dipping below the 4% threshold. We haven't seen a 3% handle on the unemployment rate since December 2000.

No two eras or economic expansions are exactly alike. The current expansion, 102 months old in January, is only four months shy of exceeding the second-longest boom of the postwar era: the 1960s. Why is the age important? Because long expansions are like fine wine: They improve over time. Our best chance to lure lost workers back into the labor force is to bid up wages by allowing unemployment to fall further. Indeed, the loss in labor force participation is one of the defining differences between the expansion today and those past.

Federal Reserve Chair Janet Yellen, who is leaving the helm at the Fed at the end of January, was at the cutting edge of acknowledging differences between today's unemployment rate and past lows. She made it the Fed's mission to overshoot on both unemployment and inflation to encourage a rise in labor force participation that could offer new opportunity for those hit hardest by the financial crisis.

The new Fed Chair, Jerome (Jay) Powell, will continue on the same path but face more obstacles. Fiscal stimulus this late in the expansion will likely force the Fed to be more aggressive in raising rates in 2018 than in 2017 and up the risk of a recession occurring sooner. The problem is that any increase in growth today will borrow from growth down the road. Debt-financed tax cuts coupled with the fiscal realities we already face in terms of the rising costs associated with the aging of the population - a surge in spending on Social Security, Medicare and Medicaid - will boost borrowing costs and eventually crowd out the very business investment that corporate tax cuts were supposed to encourage.

This report takes a closer look at emerging economic trends and how they resemble, but do not necessarily replicate, the 1990s. Gains today will borrow from the future. Recessions created by asset price bubbles are inherently more difficult to recover from than recessions triggered by a more typical acceleration in consumer prices. This is in addition to concern that we will have fewer resources to combat a future recession, given the low starting point on short-term interest rates and the debt incurred by fiscal stimulus today. Research on previous tax cuts proves that they drain government coffers and can over time curb instead of boosting growth depending on how much they add to the debt.

A top 10 List

1. Growth is accelerating

Much like the 1990s, we are experiencing an acceleration in growth late in the cycle. Real GDP is expected to rise from 2.3% in 2017 to 2.7% in 2018. Risks are to the upside given the desire by both sides of the aisle in Congress to increase government spending.

The difference in the acceleration today is that it is coming even later than in the 1990s. The divide between rural and urban America is large and expanding. Crime, poverty and the number of households with single parents are surging in rural America. In contrast, the nation's largest city, New York, reported the lowest number of shootings and murders last year since the 1950s.

The result was the divisiveness of the 2016 elections that persists today. Consumer sentiment is higher but remains below the 1990s. Concern about the future is the primary reason for that shortfall. More than two-thirds of millennials believe the country is on the wrong track.

2. Unemployment plummets

The unemployment rate held at 4.1% in December, a 17-year low. It won't take much additional growth to push it below 4%. The forecast suggests it could dip to 3.6% by the end of the year, the lowest since 1969.

Reductions in the unemployment rate today, however, are not the same as they were in the past. Participation among prime-aged men (25-54) is much lower. The participation rate among women has fallen below that of other developed nations including Japan. Everything from an erosion of skills, a loss in middle-income jobs, the high cost of child and elderly care, surging incarceration rates and the opioid crisis can be blamed. The gap in participation rates between rural and urban areas has widened. This marks a sharp reversal of the 1970s and 1980s when urban areas faced the worst problems.

Labor shortages became so acute near the end of the 1900s boom that the Federal Reserve's Beige Book highlighted a help wanted sign that read, "Now Hiring – Must Have a Pulse." We aren't likely to get to that point in 2018 but we are seeing a change in whom employers consider "employable."

We expect stronger economic growth, accelerating wages and inflation to force the Fed to raise rates at least four times.

3. Human resource departments will be restructured
HR will function as a gateway instead of a barrier for prospective employees. Workers once viewed as commodities, easily interchangeable and replaceable, will be seen as diamonds in the rough, worth polishing with training and capital to bridge the skills gap.

I recently participated in an Untapped Talent Conference at Microsoft where the tight labor market was the focus. Silicon Valley is scrambling to think out of the box and tap overlooked talent pools, such as candidates on the autism spectrum. They tend not to look recruiters in the eye, but other talents may make them brilliant computer programmers. Former convicts, people with prolonged illnesses and disabilities are also being considered and hired for jobs paying as much as double the minimum wage.

HR departments will also have to invest more in treating addiction. The opioid crisis in many rural areas has reached epidemic proportions, with little to no funding from the government.

This is in addition to overcoming the broader challenges of diversity. Millennials represent the largest part of the labor force. They are the most educated and diverse generation ever; nearly 30% of millennials are "new minorities," which include Hispanics, Asians and people of more than two races. Harnessing the differences is no longer a nicety, but a necessity. Firms who do will perform better. Diversity, when leveraged, has proven to boost the bottom line.

4. Wages will accelerate
College students are receiving job offers well before graduation, signing bonuses are returning even for low-wage jobs and minimum wages are rising at the state and local levels. Walmart recently raised wages, which the company attributed to tax cuts. The increases, however, merely matched the wages Target is paying.

Some firms have announced one-time bonuses linked to the tax cuts, which is welcome news in the short term. Our analysis indicates that fewer than one percent of all workers will receive those bonuses. A permanent increase in wages could be attained if companies allocated tax savings to invest in training and equipment to boost worker productivity.

5. Inflation will accelerate, but not flare
Stronger wages, rising producer prices, a weaker dollar and higher oil prices will add to inflation in 2018. The spillover effects of higher oil prices on transportation and shipping costs are significant, given the shift to online shopping and return of discretionary spending. Increased travel, especially by well-to-do seniors, has pushed up even weekend rates for hotels in big cities. Recent natural disasters have led to higher insurance costs. Vehicle rates were already on the upswing before the costs associated with fires in California.

Separately, the administration is threatening to raise tariffs on Chinese imports and pull out of NAFTA. That would represent a less welcome warming trend for the Federal Reserve as tariffs tend to erode purchasing power.

6. Deficits will surge, causing government debt to balloon

Republicans in Congress need Democrats to pass a budget and are willing to increase spending on social programs in exchange for much higher spending on defense and border security. Increases in government spending, debt-financed tax cuts and the rise in spending created by swelling ranks of retirees are expected to blow up federal deficits and debt. Deficits alone will likely exceed one trillion dollars in fiscal year 2019, if not sooner.

Rising government debt tends to raise interest rates and crowd out business investment. Recent research suggests that an upward trajectory for a country's debt, which is now a given in the U.S., undermines economic performance more than a high level of debt.

7. The Federal Reserve will be forced to raise rates faster than most expect

The Federal Reserve's "dot plot" or consensus among the regional Fed presidents and the Board of Governors points to three rate hikes in 2018. We expect stronger economic growth, accelerating wages and inflation to force the Fed to raise rates at least four times. President Bill Dudley of the New York Fed is now warning that rates could move up faster than some of his colleagues are predicting.

Reductions in the Fed's balance sheet could put upward pressure on mortgage rates and Treasury yields. The Fed plans to shrink its bloated balance sheet more rapidly in 2018. A larger number of assets are scheduled to mature and roll off the balance sheet. New additions to the Board of Governors, including nominee Marvin Goodfriend of Carnegie Mellon University, have argued that the Fed should reduce its balance sheet more rapidly. He has taken particular issue with mortgage-backed securities because he doesn't like to see the Fed supporting specific industries, in this case the housing market.

8. Treasury bond yields will cross 3%

A combination of stronger global growth, an end of crisis-era monetary policies, mounting federal deficits and higher U.S. inflation will put upward pressure on long-term interest rates. The yield on the 10-Year Treasury bond is expected to approach 3.5% by year-end, the highest level since the "taper tantrum" in 2013.

9. Market volatility will return

There is no such thing as a free lunch and financial markets are going to have to come to terms with this. Debt-financed fiscal stimulus has a price in terms of higher rates and a crowding out of investment down the road.

The good news is that valuations, albeit high, are more justified than they were in 1999 given how low interest rates are currently. The bad news is that the Fed will have less latitude to counter a correction in asset prices, given that low level of rates. The fed funds rate peaked at 6.5% in 2000, more than 5% above its target today.

10. Unintended consequences of tax cuts will compound

Something was lost in translation in the rush to make the corporate tax code more competitive. The usual vetting process was circumvented, resulting in reforms being abandoned for cuts. Few in Congress actually read the entire bill before voting on it. (Some last-minute additions actually contradict earlier amendments.) The number of glitches and loopholes is staggering.

The IRS is short-handed, which will delay implementation. The administration is now lobbying Congress to boost funding for the IRS to expedite the implementation of recent tax cuts. One would hope Congress can resolve some of the inconsistencies before incenting unwanted behavior. Prospects for a quick fix are dim, considering the partisan nature of the vote.

This is at the same time that other countries are reducing their tax rates in efforts to retain the business of U.S multinationals. China has offered foreign investors a tax waiver if they keep profits in the country and reinvest them as the government directs.

Deficits alone will likely exceed one trillion dollars in fiscal year 2019, if not sooner. Rising government debt tends to raise interest rates and crowd out business investment.

Bottom line

In many ways, the expansion at this late stage resembles the 1990s, at least on the surface. Asset prices are bubbling, unemployment is hitting historic lows and growth is accelerating but borrowing from later in the cycle. The similarities end there. The unemployment rate represents a significantly smaller share of the working-age population, which means that we are partying like 1999 but with fewer people on the dance floor. The Federal Reserve is watering down drinks at the bar by raising short-term interest rates. We have little left in the medicine cabinet to cure a hangover. It might be a good year to invest in Alka-Seltzer.

Economics forecast — January 12, 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]	2.27	2.67	2.38	2.78	2.31	2.62	2.68	2.54	2.48	2.09	2.17	1.96
Personal consumption	2.72	2.74	2.35	3.55	2.75	2.49	2.44	2.3	2.51	2.12	2.35	2.28
Business fixed investment	4.8	5.63	5.43	8.45	4.08	5.23	5.6	5.73	5.38	5.38	5.42	4.82
Residential investment	1.68	0.96	1.72	11.16	1.58	-2.54	0.87	0.55	2.31	1.44	4.06	5.18
Inventory investment	17.75	50.35	66.64	25.83	37.8	46.59	54.72	62.3	66.56	68.44	67.15	64.4
Net exports	-618.67	-665.15	-713	-641.28	-661.41	-660.6	-666.06	-672.54	-686.03	-700.72	-721.32	-743.92
Exports	3.39	5.82	5.07	7.37	7.26	6.53	4.94	5.05	4.67	5.3	4.87	5.19
Imports	3.85	6.2	5.54	12.45	8.56	4.92	4.58	4.81	5.46	6.08	6.5	6.96
Government expenditures	-0.04	0.4	0.69	0.52	-0.16	0.55	0.92	0.83	0.76	0.57	0.62	0.2
Federal	-0.18	-0.38	-0.15	-2.33	-0.58	-0.26	-0.23	0	0.02	-0.19	-0.22	-0.77
State and local	0.04	0.86	1.19	2.26	0.09	1.04	1.61	1.31	1.19	1.02	1.1	0.77
Final sales	2.37	2.48	2.29	3.09	2.04	2.42	2.5	2.37	2.39	2.05	2.21	2.03
Inflation												
GDP deflator	1.78	1.75	2.3	1.99	1.34	1.68	2.11	2.23	2.39	2.42	2.43	2.59
CPI	2.13	1.82	1.88	3.5	2.23	0.82	0.95	1.69	1.79	2.58	2.08	3.27
Core CPI	1.84	2	2.18	2.19	2.26	2.13	2.03	2.07	2.11	2.3	2.37	2.47
Special indicators												
Corporate profits[2]	3.6	0.38	0.94	3.49	-4.98	1.62	2.77	2.33	0.77	0.57	1.42	1.01
Disposable personal income	1.27	3.65	3.85	2.07	6.62	3.29	4.16	3.92	5.09	2.95	3.22	2.58
Housing starts (mil.)	1.21	1.24	1.3	1.27	1.21	1.23	1.24	1.26	1.28	1.28	1.31	1.33
Civilian unemployment rate	4.36	3.81	3.53	4.08	3.96	3.85	3.8	3.63	3.57	3.53	3.5	3.54
Total nonfarm payrolls (thous.)[3]	2096.07	2410.78	2041.49	588.75	594.36	575.39	665.82	575.21	597.55	542.04	469.33	432.57
Vehicle sales												
Automobile sales (mil.)	6.27	6.17	5.95	6.29	6.3	6.2	6.1	6.1	6	6	5.9	5.9
Domestic	4.54	4.55	4.42	4.59	4.6	4.6	4.5	4.5	4.4	4.5	4.4	4.4
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	10.38	10.07	11.5	10.7	10.4	10.2	10.2	10.2	10.1	10.1	9.9
Domestic	8.95	8.57	8.3	9.4	8.8	8.6	8.5	8.4	8.4	8.3	8.3	8.2
Imports	1.9	1.8	1.77	2.1	1.9	1.8	1.7	1.8	1.8	1.8	1.8	1.7
Combined auto/Lt.truck	17.12	16.55	16.35	17.79	17	16.6	16.3	16.3	16.2	16.1	16	15.8
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	17.02	16.49	18.19	17.4	17.1	16.8	16.8	16.65	16.6	16.5	16.2
Interest rate/yields												
Federal funds	1	1.76	2.54	1.2	1.41	1.62	1.78	2.23	2.38	2.45	2.62	2.7
10-year treasury note	2.33	3.06	3.62	2.38	2.74	2.98	3.22	3.31	3.53	3.59	3.66	3.72
Corporate bond BAA	4.44	4.87	5.48	4.27	4.56	4.78	5.03	5.1	5.35	5.43	5.52	5.63
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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