ECONOMIC AND FINANCIAL MARKET UPDATE

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US economy turned on the afterburners in Q4/17

Headline US GDP growth slowed a touch to 2.6% in Q4/17 following back-to-back gains of more than 3% in Q2 and Q3. The composition was more favourable with domestic spending rising at a 4% annualized rate in Q4, the best pace in three years. That reflected impressive growth in consumer spending, a rebound in the residential sector following two quarters of decline, and another solid increase in business investment as companies continued to spend on machinery and equipment. Housing and consumer spending got a lift from post-hurricane rebuilding and the replacement of autos, although underlying fundamentals for both look solid as well. A pullback in inventory investment and a surge in imports that outpaced decent exports weighed on overall GDP growth. But the Q4 gain was still well ahead of the economy's longer run speed limit. All told, the US economy entered 2018 with solid momentum and is set to get a shot in the arm from tax cuts passed late last year. Our forecast assumes GDP growth will rise to 2.6% this year from 2.3% in 2017, with much of the pickup reflecting tax changes.

But are consumers burning through their savings?

One eye-catching number in the latest national accounts was a further dip in the household savings rate, which at 2.6% in Q4/17, was the lowest in more than a decade. A lower savings rate isn't surprising given rising equity values and strong consumer confidence, but the recent dip has raised some concerns that consumers are close to being tapped out. We don't think that's the case. Even with personal savings expected to rebound somewhat this year, solid income growth—due to both rising wages and a boost to take home pay from lower taxes—will keep consumer spending volumes rising at a near-3% pace. Consumers have certainly been heavily relied upon for GDP growth in recent years, but given solid fundamentals, we think they'll come through again in 2018.

Finally some signs of life in US wages

2017 was another impressive year for the US labour market with average monthly job gains of 181k—well ahead of underlying demographic growth—pushing unemployment down to its lowest rate since 2000. The one missing piece was wage growth which remained stuck around 2-1/2%. But January's jobs report showed tentative signs that the story will be different this year. Wage growth picked up for a third consecutive month to 2.9% in January, the fastest year-over-year increase since 2009. That level shouldn't stoke fears of an imminent spike in inflation, but the recent increase certainly has investors thinking that tight labour market conditions are finally feeding through to labour costs, and eventually, will fuel higher consumer prices. That prospect has shifted market pricing, which now points to the Fed following through with plans to raise rates another three times this year.

Chair Yellen hands off a strong economy

As expected, the Fed left interest rates unchanged on January 31—Chair Yellen's final meeting before Jerome Powell took over in early-February. Economic conditions are certainly strong enough to warrant higher interest rates, but in keeping with the gradual, predictable policy changes under her tenure, Yellen and company opted to leave fed funds unchanged and simply set the table for a move in March. We too look for a hike at the upcoming meeting and think a once-a-quarter pace of rate increases will continue through next year. Our call for four rate hikes this year remains slightly ahead of market pricing and the Fed's latest dot plot showing three hikes. In our view, any pause in tightening risks the Fed falling behind the curve at a time when tax cuts are set to push the economy into excess demand and could stoke inflation.

The central bank's latest meeting came before equity market volatility reared its head. But in comments since then, Fed officials didn't sound overly concerned about the stock market correction. We don't think the Fed's March rate hike will be derailed by volatility as policymakers focus on underlying strength in the US economy. We also doubt the new Chair will want to be seen as capitulating to investors' concerns about rising rates.