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US posts strongest quarterly growth in four years

Q2's advance GDP report lived up to high expectations with a 4.1% annualized increase that ranks among the fastest in the last decade. The economy was firing on all cylinders with domestic demand up almost 4%, led by a rebound in consumer spending and another solid increase in business investment. A nearly-10% rise in exports also helped, though that's not likely to be sustained amid growing trade tensions. A number of countries implemented counter-tariffs on US goods in June and July, and there was already evidence of exports tapering off toward the end of the quarter. But while trade isn't expected to provide the support it did in Q2, we think domestic spending will remain strong in the coming quarters. Both business and consumer sentiment remain near cycle highs despite the threat of higher prices posed by tariffs (and for businesses a potential pullback in external demand). We think solid gains in consumer spending and nonresidential investment will keep the economy growing at an above-trend pace (just short of 3%) over the second half of the year. That would push the US economy further into excess demand, which raises the risk of inflationary pressure picking up.

Trade tensions remain a downside risk…

Trade tensions continue to dominate headlines with both positive and negative signals from US policymakers of late. Nafta negotiations have been on hold since Mexico's July 1 presidential election but bilateral talks between the US and Mexico, focusing on the auto sector, are reportedly making progress. US proposals that seek to reduce the trade deficit in autos with Mexico have been a sticking point in Nafta talks, so a resolution of the issue would be a positive step toward a new agreement. Trilateral talks are expected to resume in August and some have speculated that a deal could be reached by the end of the month. But we note that similar optimism in May turned into disappointment when the US refused to back down on several contentious demands—and there have been few signs thus far that negotiators are giving way on issues like dispute resolution, supply management and a sunset clause.

Relations with trading partners outside North America have been mixed. An agreement with the EU to not escalate tariffs, while light on details, was a welcomed improvement in the two economic powers' recently strained relationship. The same cannot be said for US-China relations. In July the US raised tariffs on $34 billion in Chinese imports (to which China responded in kind) and this month duties on an additional $16 billion in goods will take effect. There were reports that a dialogue was opening up between the two countries in an effort to reduce tensions. But those hopes were dashed when the US threatened even more punitive tariffs on an additional $200 billion in Chinese imports.

…but won't keep the Fed from raising rates in September

The Fed's August meeting was largely a non-event with rates held steady and only minor tweaks to the policy statement reflecting the latest data. Those few changes leaned hawkish—a sign the next rate increase isn't far off. Looking ahead to September the case for a hike is, to borrow a word the Fed used five times in August, 'strong.' US GDP growth has trended steadily higher on a year-over-year basis since mid-2016 and was sitting at 2.8% in Q2. That is well above the pace of potential output growth—in an economy that is already pushing up against capacity limits. Core inflation has been close to or above the Fed's 2% objective for several months. The labour market remains strong, and while it would be a stretch to say wages are taking off, pay growth has picked up this year. As noted above, tariffs remain a downside risk to the US economy. But the Fed's scant mention of trade issues in August speaks to their limited impact thus far. Unless tensions ratchet up significantly or start to dent the outlook more noticeably we think the Fed will continue to steadily scale back accommodation. We expect two more rate increases over the second half of the year, and look for 100 basis points of hikes in 2019 as well.