US NATIONAL OUTLOOK

Overview

"The road to success is always under construction"
— Arnold Palmer

These words have never rung truer than during the past eight years, when hopes for a self-sustained robust recovery have waxed and waned frequently, becoming an integral part of what’s euphemistically known as "the new normal" – a world of sluggish growth and permanently lower potential output. Indeed, this time around, the road to a complete recovery has seemed interminable and always under construction, with many false dawns and dashed expectations. Going as far back as 2010 – when the recovery began to take hold – an onslaught of shocks (both domestic and international) has managed to beset the economy at every turn: the Eurozone sovereign debt crisis, the fiscal cliff, budget sequestration, "taper tantrum", a collapse in oil prices, a dollar surge, concerns over China’s economy, and worries about a looming recession in the US. It is a wonder things have not turned out worse; through it all, the economy has continued to grow, albeit at a sluggish pace.

Our view is that some of the gloom and doom that has dogged the recovery since its onset is about to lift. By and large, we expect a synchronized broad-based economic upswing to take hold both in the US and abroad. However, we are cautious in our assessment for the outlook: though we expect an improvement over the forecast horizon and certainly a better showing than in 2016, we are also a bit less exuberant than the market and the consensus forecast. Indeed, we are quite struck by the yawning gap between soft data (expectations) and hard data: since the election, consumer and business confidence has shot up to levels last seen in the heyday of the housing boom, while hard data has been rather subdued. The gulf of separation between the two can be best seen in the first quarter GDP forecasts produced by Atlanta Fed (hard data) and the New York Fed (a combination of hard and soft data): as of mid-April, the Atlanta Fed forecast for Q1 GDP growth stands at 0.5% growth, while the New York Fed forecasts a significantly higher 2.8% (Figure 1).

Our view is that the reality lies somewhere between these two extremes: the fundamentals of the US economy are certainly stronger than what the recent hard data shows, and even though activity has certainly slowed down in the first quarter, the balance of the year will bring a stronger showing. Soft first quarters followed by more robust growth are nothing new: last year shaped up very similarly. Real GDP grew by 1.6% in 2016, the slowest pace since 2011. Much of this had to do with weakness in the first half of the year: a plunge in commodity prices, concerns about a potential hard-landing in China, weak corporate profits, and worries about a US recession – all took a toll on growth. The second half, told a different story: growth perked up, commodity prices stabilized and reversed course, business fixed investments grew robustly, and the stock market soared. Real GDP grew by 3.5% in the third quarter and 2.1% in the fourth quarter of 2016.
The recent buoyant sentiment on the part of businesses and consumers is motivated in part by these improving fundamentals, but the primary driver appears to be a dramatic shift in expectations regarding the regulatory and fiscal environment under the new administration. Expectations are sky high on major issues, such as tax reform, reduced regulatory burden, a one-time “tax holiday” for repatriation of overseas profits, and fiscal stimulus in the form of higher defense spending and infrastructure projects (Table 1). Our view is that, at this stage, expectations appear to be running ahead of political reality given that the legislative process is long and arduous and requires the cobbling together of various factions with different agendas, which may undo big bold plans (witness the failure of the American Health Care Act). This is, unfortunately, a missed opportunity, as a big bold multi-prong agenda on all these fronts is necessary to jump-start growth and nudge the economy from the torpor of the past few years. However, the more change is necessary, the more it seems to be (politically) impossible.

Moreover, the reduction in tax rates will likely end up being of a lower magnitude than what the consensus expects: instead of the 15% tax rate on corporations (or the 20% proposed by the Republicans in Congress), we might end up with a rate of 25% (and perhaps even north of that). Part of the reason has to do with the fact that the border-adjustment tax, which was supposed to offset the reduction in revenue from corporate tax cuts and add roughly around $1.2 trillion to the coffers, appears to be on life support. In addition, failure to repeal and replace the ACA has also reduced the tax revenue baseline by roughly $1 trillion, which means that there is now less room for maneuver if tax cuts are to remain budget-neutral as required under the rules for budget reconciliation. More importantly, given the legislative calendar, any agreements on taxes or fiscal policy are likely to materialize in late 2017, potentially impacting growth in 2018 and beyond, but not in the current year.

Regardless of the political compromise that ultimately gets hammered out in Congress, there are genuine signs that point to a continued improvement in the outlook. Consumer optimism is at the highest level since 2001, and though this has yet to translate to higher spending (retail sales fell for two consecutive months this year), consumers will continue to remain the engine of growth over the forecast horizon (Figure 2). Though we expect some pullback in consumer sentiment as expectations rightsize to fit the more difficult political reality, we believe that some of this confidence stems from genuine improvements in fundamentals: a strong labor market, higher disposable income, higher wealth, and improving wages.

### Table 1
Corporate Tax Proposal: House Republicans vs. the Administration

<table>
<thead>
<tr>
<th>Proposal</th>
<th>Current Law</th>
<th>House Republicans</th>
<th>Trump</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate Tax</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rates</td>
<td>35%</td>
<td>20%</td>
<td>15%</td>
</tr>
<tr>
<td>Top Pass Through Rate</td>
<td>39.6%</td>
<td>25%</td>
<td>15%</td>
</tr>
<tr>
<td>Offshore Profits</td>
<td>NA</td>
<td>One –time tax of 8.75% on cash; 3.5% on other earnings</td>
<td>One-time tax of 10% on cash; 4% on other earnings</td>
</tr>
<tr>
<td>Border Adjustment Tax</td>
<td>NA</td>
<td>20%</td>
<td>NA</td>
</tr>
<tr>
<td>Tax Credits</td>
<td>Current</td>
<td>Eliminate</td>
<td>Eliminate but for R&amp;D</td>
</tr>
<tr>
<td>Depreciation</td>
<td>Allowed</td>
<td>Full Expensing Up-Front</td>
<td>Full Expensing Up-Front</td>
</tr>
<tr>
<td>Corporate AMT</td>
<td>Current</td>
<td>Eliminate</td>
<td>Eliminate</td>
</tr>
</tbody>
</table>

Having said that, we do expect agreements on a number of issues that should deliver a boost to the economy, though at a smaller scale than what is expected by most market participants. In a sense, our disagreement with the consensus view is more in terms of depth than breadth. For example, instead of a radical overhaul of the tax code – which would be much more preferred – Congress is likely to settle simply on tax cuts for corporations and individuals. Though these are certainly welcome, tax reform would pack a stronger punch.
Indeed, household wealth has never been so high and balance sheets never as pristine as they are now. Household net worth is now $25 trillion higher than in 2007 and a staggering $38 trillion above the trough of the recession (Q2 2009). This is mostly due to the spectacular gains in equity markets: financial wealth is now $22 trillion above pre-2007 levels and a more impressive $30 trillion above the recession trough. More importantly, home equity wealth has almost fully recovered from its epic collapse during the housing crisis: of the $7.3 trillion losses, $7.2 trillion have been recovered.

Aggregate credit for US households has soared, rising to levels last seen in 2008. New mortgage originations (which also include refinances) rose by $617 billion in fourth quarter, the highest level since Q3 2007. Delinquency rate for mortgages and credit cards is low and within historical ranges; however, a sizable uptick is evident in student loans (11.2% 90+ days delinquent) and auto loans (3.8%). Though student and auto loans are areas of concern given their entrenchment well into subprime territory, their combined size is only $2.4 trillion, less than a third of the mortgage debt liability in 2007, right before the subprime mortgage crisis (Figure 3). The much more manageable size of this type of debt means that it poses much less systemic risk than the mortgage market did back in 2008.

Other labor market indicators are equally upbeat: the unemployment rate is now down to 4.5% having breached the 5% level that is commonly ascribed to an economy consistent with full employment. The broader measure of unemployment (U6), which includes the discouraged and marginally attached workers, has declined from a recession high of over 17% to a current 8.9% (historical average is 8.7%). Long-term unemployment (those unemployed for longer than 27 weeks) has declined to a current 1.7 million from a crisis record of 6.8 million (historical average is around 1.4 million), while the number of discouraged workers is down to 1.7 million from a high of 2.6 million (historical average is 1.4 million). Importantly, there has been a meaningful improvement in the mix of full-time vs. part-time jobs: full-time employment is now 3.5 million above its pre-crisis level (a full 15.5 million higher since end-2009), while part-time jobs have currently edged down by nearly 1 million since the end of the recession (Figure 4).

The housing market has improved in fits and starts, but has generally lagged behind the broader economy during the recovery. Residential construction as percent of GDP has improved from 2.4% at the height of the crisis to a current 3.8% of GDP; however, the bulk of the rise has come from the apartment market (which has been booming) rather than from the more traditional single-family homes. Construction of single-family homes has been restrained by land development costs and onerous zoning requirements. An incredibly lean housing inventory means that home prices have firmed up much faster than wages and income, even as demand perks up in the wake of the housing hangover.
We expect the housing market to continue to improve this year and the next, boosted primarily by job and income growth. Favorable demographics should also help: the oldest millennial cohort will turn 35 years old in 2017, an age when most people look to buy their first home. Household formation and homeownership rates have firmed up, with the number of homeowners posting the biggest increase in over a decade in the second half of 2016 (nearly 1.2 million). Builder sentiment and buyer traffic have shot up and are now back near the levels last seen in the heyday of the housing boom. We expect single-family housing starts to average around 900,000 in 2017 and 1.1 million in 2018.

Improvements on other fronts are also evident. A number of other factors that have weighed on growth since the start of the recovery seem to have finally dissipated. The hangover from the financial crisis is distant enough and the process of deleveraging of the private sector appears to be complete, freeing up households and banks from the unsustainable debt burdens accumulated in the run-up of the housing market boom. Household debt levels as percent of GDP have fallen by nearly 20 percentage points since 2007, while bank debt (as percent of GDP) has plunged by a full 40 percentage points (Figure 5). Recent data point to a plateauing and a reversal of this trend, which bodes well for the economy in the near term.

Two other major developments that weighted on growth over the past six quarters, the collapse in oil prices and the surge in the dollar, also appear to be behind us. On a trade-weighted basis, the broad dollar index rose by 22% from mid-2014 until early 2016; it has appreciated only by 0.6% since then despite the fact that the Fed tightened rates twice since. This has helped the production sector and manufacturing in particular: after spending much of 2016 in negative territory, industrial production and manufacturing grew by 0.5% and 1.5%, respectively, relative to the previous year values. More importantly, small business sentiment is at the highest level since 2007, reflecting growing optimism that Congress and the new administration will adopt policies that are more supportive of small businesses and economic growth.

Oil prices have rebounded appreciably since the trough in February 2016, hovering in the $50-$55 range over the past few months. This has spurred investment in the beleaguered energy sector: the rig count has risen from an all-time low of 404 (last May) to a current 808. Corporate earnings and revenues are also set to grow in Q1 2017 by 7.1% and 9.1%, respectively, the fastest pace since 2011. In addition, the inventory cycle, which subtracted nearly 0.4 percentage points from real GDP growth in 2016, is finally set for a correction, adding an average of 0.7% over the last two quarters.

Elsewhere in the world, the outlook is brighter than it has been since 2012. Concerns about a China hard-landing have dissipated, and while the recalibration from investment to consumption-based growth will continue to hamper growth, the authorities appear ready to soften the adjustment, at least for the time being. The Eurozone has awakened from the slumber of two back-to-back crises and grew by 1.7% in 2016 – faster than the US for the first time since the recovery began. Unemployment rate in the Eurozone has steadily declined, pent-up demand is perking up, and bank loans have nudged up. Even hard hit countries like Brazil and Russia are poised to add to world GDP this year instead of subtracting, as has been the case the past few years.

Despite strong fundamentals underpinning this year’s outlook, output growth will likely slow in the first quarter to 1%, reflecting an inventory correction and further drags from international trade. Consumer spending is also expected to come a bit softer as a relatively mild winter lowered demand for heating oil while higher gasoline prices demanded higher payments at the pump. However, we expect the economy to perform better over the balance of the year and become particularly robust in 2018 as fiscal stimulus propels growth. Our projections are for real GDP growth of 2.3% in 2017 and a more robust 2.6% in 2018.
Recoveries and Old Age: Is the End Near?

What this recovery has lacked in strength it has partially made up in length: at 94 months, this recovery is now officially the third longest in the post-war era. The market rally has also been long-lasting: this is the second longest bull market since WWII (Figure 6). Indeed, because of its length, the recovery has generated more growth than a number of previous more robust but shorter-lived expansions. It is natural to ask whether the mature age of this recovery may be a cause for concerns especially in light of the fact that real GDP growth in 2016 came in at a paltry 1.6%, the lowest since 2011.

We have argued in the past that the end of expansions does not come from old age but is rather precipitated by three main culprits: excessive imbalances in the economy, abrupt tightening by the Fed in response to an overheating economy, or external shocks.

None of these risks are threatening at this moment. The overhang from financial crisis and the slow recovery have snuffed out any potential imbalances that typically pop up at this stage of the business cycle. Household debt service and financial obligations are at the lowest level in over four decades; homeownership rates have corrected back to their historical average; and spending on business fixed investments and consumer durables – a good barometer of the business cycle – is still below its historical average.

The risk of a disruptive tightening in interest rates is also low, given that inflation continues to remain below the Fed’s 2% target. There is ample hand-wringing that the much anticipated fiscal stimulus out of Washington, D.C., may overheat an economy that is near full employment, thus pushing the Fed to raise interest rates abruptly. Our view is that these concerns are a bit overblown: first, the final package of tax cuts and fiscal spending will likely be smaller than what the consensus expects and second, there is some remaining slack in the economy, at least for the time being, that should prevent an overheating.

Lastly, although external shocks are always a risk, they appear less threatening now than at any point during the lifespan of this recovery. The fortunes of the global economy have improved considerably since mid-2016, and the outlook over the next two years is brighter than in the last two. The long-awaited cyclical revival in manufacturing and trade seems to have finally materialized: the survey of global purchasing managers (a leading indicator for manufacturing output and employment) has risen for the past six months, indicating increased expectations for a robust pick-up in factory production. Worldwide spending on equipments grew at an annualized pace of 5.25% in the last quarter of 2016. Exports from South Korea and Taiwan – normally leading indicators for global trades – have surged: in February 2017, exports from Taiwan were up by a staggering 28%, while those from South Korea rose by 20% compared to 2016. China’s exports were 11% higher in the first two months of 2017 relative to their year-ago levels.

Risks to the Outlook

Perhaps the biggest risk to the outlook rests with the fiscal agenda: if Congress is unable to deliver on the tax reform, regulatory, and fiscal spending agenda, this may seriously threaten the spectacular rally in stock prices that began the day after the election. The market is particularly vulnerable to fiscal policy developments given that favorable policy outcomes appear to have been already priced in. Indeed, some reversal has already set in: after sky-rocketing by 12% from election day to early March, the stock market has shed around 2.3% since then, mostly on dashed expectations about the probability that Congress will pass a big bold pro-growth agenda. Sectors that benefited most from the “Trump trade” (such as financials, industrials, materials) have underperformed the broader market since early March. While some correction is expected (and, at this point welcome, given that expectations have run well ahead of political reality), we are more concerned with a broader disorderly unraveling of financial markets should the final compromise hashed out in Congress bring unexpected and deep disappointment.
External shocks are also not out of the question: China may succumb under the weight of its extraordinary debt levels and though the debt crisis may not be looming on the immediate horizon, it is hard to envision how China may avert it altogether over the next five years. China’s debt levels have exceeded by far elevated levels and have hovered in dangerous territory for quite some time, far surpassing the debt levels of the US at the dawn of its financial crisis (Figure 7). In our view, a Chinese debt crisis is looming large and the question is not whether it will occur, but when and how deep. Our baseline case does not expect a full-blown debt crisis to materialize over the next couple of years, but it is a distinct possibility over a longer horizon (five years).

Political risks are also high in the Eurozone: elections will be held in France and Germany and while it is unlikely that populist parties may outright win national elections, it is likely that they may make serious inroads in parliamentary seats. A potential banking crisis may also stem from Europe’s beleaguered banking sector, which altogether has about 1.1 trillion euros ($1.2 trillion) in non-performing loans, almost three times as much compared to the US. Though European governments have intervened more proactively recently to stem the tide of defaults and avert a financial crisis (as the Italian government did in the case of the troubled bank Monte Dei Paschi), the long shadow casts by Europe’s banking sector cannot be easily dismissed.

**Figure 7**
Danger Zone: China’s Debt Growth Extremely Elevated
(credit growth gap from trend GDP, percent)

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**NATIONAL FORECASTS**

<table>
<thead>
<tr>
<th>Year</th>
<th>RGDP</th>
<th>Consumer Prices</th>
<th>Unemployment Rate</th>
<th>Payroll Employment</th>
<th>Federal Funds Rate (end-period)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2014</td>
<td>2.4</td>
<td>1.6</td>
<td>6.2</td>
<td>1.9</td>
<td>0.25</td>
</tr>
<tr>
<td>2015</td>
<td>2.6</td>
<td>0.1</td>
<td>5.3</td>
<td>2.1</td>
<td>0.27</td>
</tr>
<tr>
<td>2016</td>
<td>1.6</td>
<td>1.3</td>
<td>4.9</td>
<td>1.8</td>
<td>0.52</td>
</tr>
<tr>
<td>2017</td>
<td>2.3</td>
<td>2.1</td>
<td>4.6</td>
<td>1.5</td>
<td>1.25</td>
</tr>
<tr>
<td>2018</td>
<td>2.6</td>
<td>2.4</td>
<td>4.5</td>
<td>1.3</td>
<td>2.00</td>
</tr>
</tbody>
</table>
ORANGE COUNTY AND SOUTHERN CALIFORNIA OUTLOOK

California job growth fell slightly in 2016 to 2.5% from the rapid 3% growth (highest since 2000) in 2015, but the state still added over 425,000 jobs in 2016. Southern California (counties of Orange, Los Angeles, Riverside, San Bernardino, Ventura and Imperial) added 194,000 jobs in 2016, at a similar rate as the state (2.5%). Job growth in Southern California fell slightly from a 2015 rate of 2.8% but was still healthy compared with long-term trends.

Orange County’s employment growth continued to be robust in 2016. Total county payroll jobs across all industries rose by 35,700 jobs (2.3%) in 2016 to 1,581,000 jobs, which was about double the growth of 1.2% annually for the previous 25 years and roughly in line with overall job growth in California. The trend downshifted a bit relative to the 2012-2015 annual average of 2.7%, and it came in lower than the 3.2% rate in 2015. However, this should not come as a surprise since the County’s economy is rapidly approaching full employment and any future gains likely will occur at the slower clip than in previous years.

Orange County job growth in 2016 was led by rapid growth in the construction and leisure and hospitality sectors (Figure 8). Construction employment grew by over 5,200 jobs to 95,700 jobs, a 5.7% increase over 2015. Within the construction sector, building construction employment grew by 2.9%, while specialty contractor employment grew by 7%. Leisure and hospitality employment grew by over 8,000 jobs to 208,700 jobs, a 3.9% increase. Growth in professional and business service employment was also strong at 3.3%, a gain of over 9,500 jobs to 297,750 jobs. Only one major sector experienced a decline in employment: manufacturing employment fell by 0.4%, led by a 4.1% decline in fabricated metal product manufacturing and a 1% decline in nondurable goods manufacturing.

Other counties in the region experienced similar continued healthy employment growth. Los Angeles County gained just under 110,000 jobs in 2016 to reach 4,395,700 jobs, a 2.5% increase over 2016. Employment growth for Los Angeles County has averaged just over 2.1% each year for the last four years. Similar to Orange County, the winning sectors have been Construction and Leisure and Hospitality, with Manufacturing losing jobs. Importantly, Los Angeles County has also experienced a dramatic increase in employment in the information technology industry, up by 11.2% in the past two years, led by rapid hiring in the motion picture and sound recording industry.

However, the most robust job growth in Southern California was in the Inland Empire (Riverside and San Bernardino Counties), where employment grew by a healthy 3.5% rate in 2016. Growth was led by the construction sector (7.9% growth) and transportation and warehousing (7.3% growth) sectors. Though these sectors were the best performers in 2016, continuing their streak in the previous year, the 2016 figures were lower than those recorded in 2015. The construction sector grew by 10.5% in 2015 while transportation and warehousing by a staggering 13%. This also does not come as a surprise: we were expecting some pull back in the construction, transportation and warehousing sectors given the sizzling rate they posted in 2015. The cooling of these over-performing sectors has led to a more muted job growth in the region: employment growth fell from a 4.9% rate in 2015 to 3.5% in 2016, reflecting the mature stage of the business cycle.

Unemployment rates have fallen across the region as employment gains continue. The unemployment rate fell from 4.5% to 4% in Orange County in 2016, and has continued to fall to 3.7% in February 2017. Los Angeles County and the Inland Empire have also seen declines in the unemployment rate. The unemployment rate declined in Los Angeles County from 6.7% in 2015 to 5.2% in 2016, and the unemployment rate in the Inland Empire fell from 6.6% in 2015 to 5.9% in 2016.
Construction and Housing

The Orange County housing market continues to sizzle. Median housing prices according to CoreLogic rose to their highest level ever in March 2017 to $720,000, a 5.1% increase over March 2016 (Figure 9). As indicated above, construction employment growth led jobs growth in Orange County, and over 12,000 building permits were issued in 2016, an increase of 1,000 permits from 2015 and the most permits issued since 2000.

Housing price growth has been more rapid in surrounding counties. In Los Angeles County, median housing prices rose to $570,000 in March 2017, a 7.5% increase over March 2016. Median housing prices rose to $350,000 (7.5% growth) and $285,000 (9.6% growth) in March 2017 in Riverside County and San Bernardino County, respectively.

Forecast Outlook

One positive indicator for the local economy is local business leaders’ expectations of growth. The Woods Center for Economic Analysis and Forecasting conducts a quarterly survey of business leaders’ expectations of their own firm’s growth and the growth of the local economy. The center provides the OCBX index, which is a combined score of leaders’ expectations of their own business’ and local economy’s overall growth. The index tends to trend with local economic conditions, and in particular with employment growth. The OCBX index was at its highest level ever in the first quarter of 2017, indicating unrivaled optimism about local business conditions (Figure 10). The OCBX only declined slightly in the second quarter, so optimism continues.
When business leaders were asked about the most significant external concern facing their company, there was significant concern about both the state of the overall economy (29.6%) and government regulations (27.8%) (Figure 12). Concerns about the state of the overall economy have fallen from 37% recorded last year, but there was similar concern about government regulation as in last year’s survey (29.6%). The consistent third most significant concern about businesses recently has been labor costs. Concerns about labor costs rose slightly from 11.1% in 2016 to 13% in the second quarter of 2017. Inflation may soon be a more pressing concern as it rose from being negligible last year, to becoming the top concern of 5.6% of those surveyed in the second quarter of 2017.

Based on our analysis of employment data for the region, national economic scenario as outlined earlier in the report and factoring in the local information from surveys and other sources, our forecasts for employment growth are represented in Figure 13. While the region overall will continue to grow at healthy rates, Inland Empire growth will approach its historical levels, and Los Angeles County too will continue at levels consistent with recent trends. Given the very low unemployment rate and higher housing costs for Orange County, the growth here is expected to get closer to its historical trends of approximately two percent. More details are available upon request from the Woods Center.