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ECONOMIC REPORT

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RECENT DATA GOOD BUT NOT GREAT; MANUFACTURING CONTINUES TO EXPAND IN EARLY 2017

SUMMARY

- The ISM manufacturing index dipped slightly in March, but continues to indicate expansion.
- Factory orders rose 1.0 percent in February, but details were softer.
- Light vehicle sales dropped in March, and sales in 2017 are lagging behind last year's pace.
- The U.S. trade deficit narrowed in February as exports rose and imports fell.
- Construction spending rose 0.8 percent in February, with an upward revision to January.
- Growth will be soft in the first quarter, but will pick up over the rest of 2017.

The ISM manufacturing index fell slightly to 57.2 percent in March, from 57.5 percent in February, but remained comfortably above the 50 mark that indicates expansion. Four of the five major components were above 50 in March. The new orders component fell slightly, but was still strong at 64.5 percent. The employment component jumped from 54.2 percent to 58.9 percent, while production fell from 62.9 percent to 57.6 percent. Seventeen of the eighteen industries covered reported expansion over the month, with the strongest growth in electrical equipment, appliances and components, and printing.

Factory orders rose 1.0 percent in February, matching the consensus expectation; this was the third consecutive increase. However, the underlying details were not as strong. Core capital goods orders—non-defense capital goods, excluding aircraft, and a proxy for business investment—fell 0.1 percent in February, although that followed four straight months of increases. Shipments of manufactured goods rose 0.3 percent, with a 1.0 percent increase for core capital goods.

Manufacturing contracted in late 2015 and early 2016 because of reduced investment in energy production after energy prices plummeted and a stronger U.S. dollar. But now that energy prices and the dollar have stabilized, U.S. manufacturing is now expanding (see Chart 1). The industry is also benefitting from continued consumer demand. Manufacturing growth will lag slightly behind U.S. growth this year, in part because the strong U.S. dollar will encourage imports and discourage exports.

Light vehicle sales fell to 16.6 million units at an annual rate in March, down from 17.6 million units in both January and February. This was the softest month for cars and light trucks since October 2014, as a snowstorm on the East Coast weighed on sales over the month. For the first quarter of 2017 sales were 17.3 million, down 4.5 percent from the fourth quarter and down 0.8 percent from one year earlier.

After hitting records in 2015 and 2016, vehicle sales in 2017 are likely to match last year's pace of 17.5 million units. The fundamentals for sales are good: more jobs and rising wages are boosting household income; interest rates, although rising, are still very low on an historical basis; gasoline prices are down significantly from a couple of years ago; and stronger homebuilding is boosting sales of pickup trucks. However, after two years of strong sales, the need to replace older vehicles has diminished somewhat.

The U.S. trade deficit narrowed to $43.6 billion in February, from $48.2 billion in January (revised from $48.5 billion). Exports rose 0.2 percent over the month to $192.9 billion, while imports fell 1.8 percent to $236.4 billion. Some of the drop

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in imports came from the Lunar New Year in Asia, which pushed some imports into January from February, and was not fully accounted for in the seasonal adjustment process.

The goods trade deficit was $65.0 billion in February, down from $69.5 billion in January, while the services surplus was unchanged at $21.4 billion. Adjusted for inflation, the goods trade deficit narrowed to $59.7 billion in February, from $65.1 billion in January.

Trade will be a drag on U.S. growth in the first quarter, even with the smaller deficit in February. Global growth is picking up, a positive for U.S. exports, but an expanding U.S. economy is boosting imports. Even though the U.S. dollar has stabilized since early 2016, it is still up about 27 percent over the past few years; this makes exports from the U.S. more expensive, and imports into the U.S. less expensive (see Chart 2). The dollar is likely to remain strong, boosting the U.S. trade deficit, until foreign central banks follow the lead of the Federal Reserve and start to raise interest rates.

Construction spending rose 0.8 percent February, a bit softer than the consensus expectation for a 1.0 percent increase. Still, the level of spending in February was the highest in almost eleven years. Spending in January was revised upward, to a 0.4 percent decline from the initially reported 1.0 percent drop. There was a big 1.8 percent increase in private residential construction spending in February, as mild weather encouraged building. Private nonresidential spending fell 0.3 percent in February. Public spending rebounded somewhat in February, rising 0.6 percent, after big drops in December (down 2.6 percent) and January (down 1.9 percent).

Chart 1: Manufacturing Is Now Expanding, And Will Continue to Improve

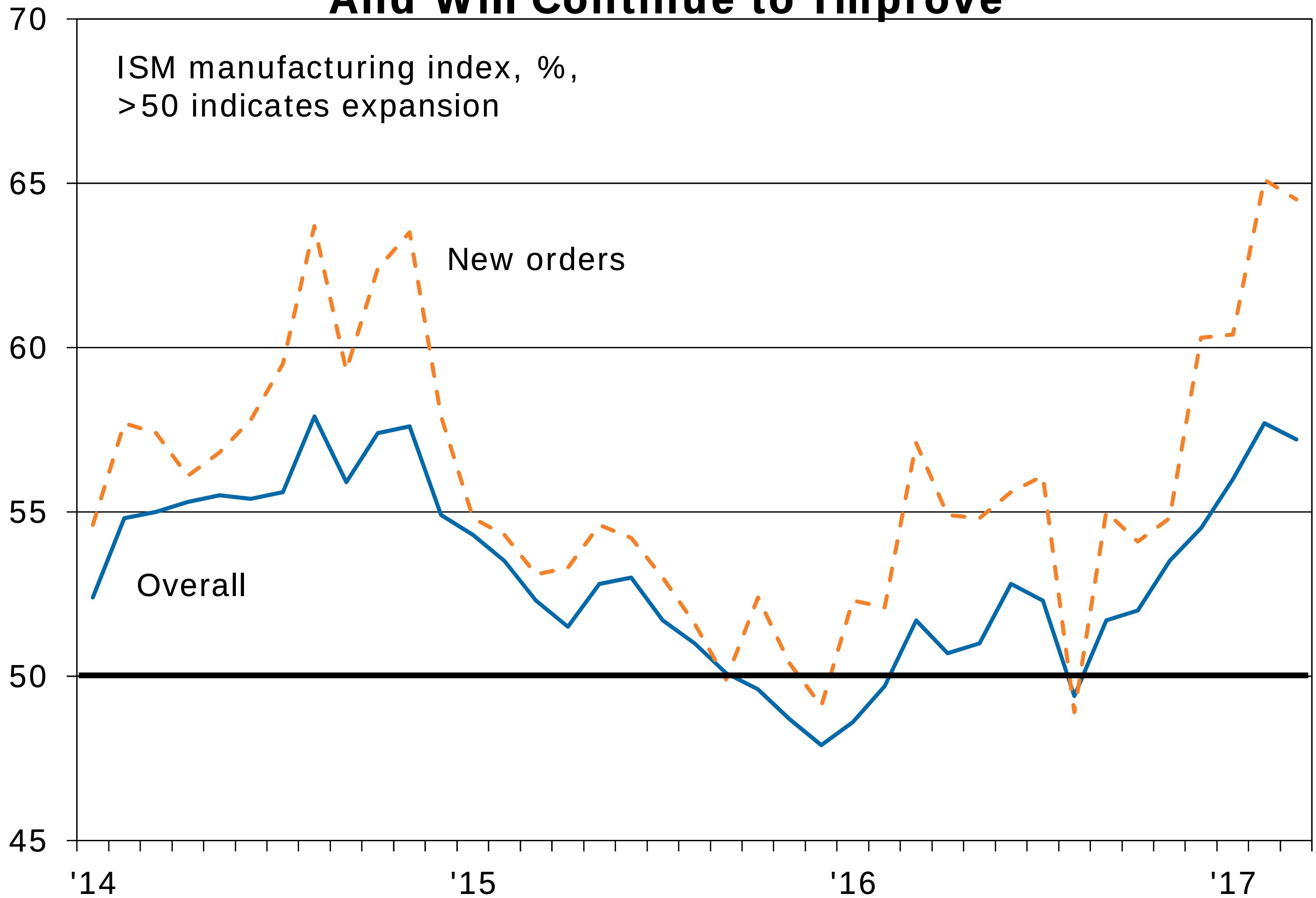

Chart source: Institute for Supply Management

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With a mild winter, construction added to economic growth in the first quarter. Activity is solid, with homebuilding continuing to recover from the housing bust and commercial development responding to falling vacancy rates and rising rents. However, construction will be less beneficial for growth in the second quarter, with the normal seasonal uptick in activity in the spring muted as projects were pushed forward into the start of the year.

After expanding at a 2.6 percent annualized pace in the second half of 2016, real GDP growth in the first quarter of 2017 is coming in softer, at about 1.1 percent. Some of this is due to problems with seasonal adjustment, and some is due to weaker consumer spending on utilities because of a warmer-than-usual winter. But the fundamentals for the economy remain solid, and growth for all of 2017 should be about 2.3 percent. Consumer spending and homebuilding will lead growth this year, with households benefitting from more jobs and accelerating wage growth. Tax cuts later this year could provide an additional boost to growth in late 2017 and 2018.

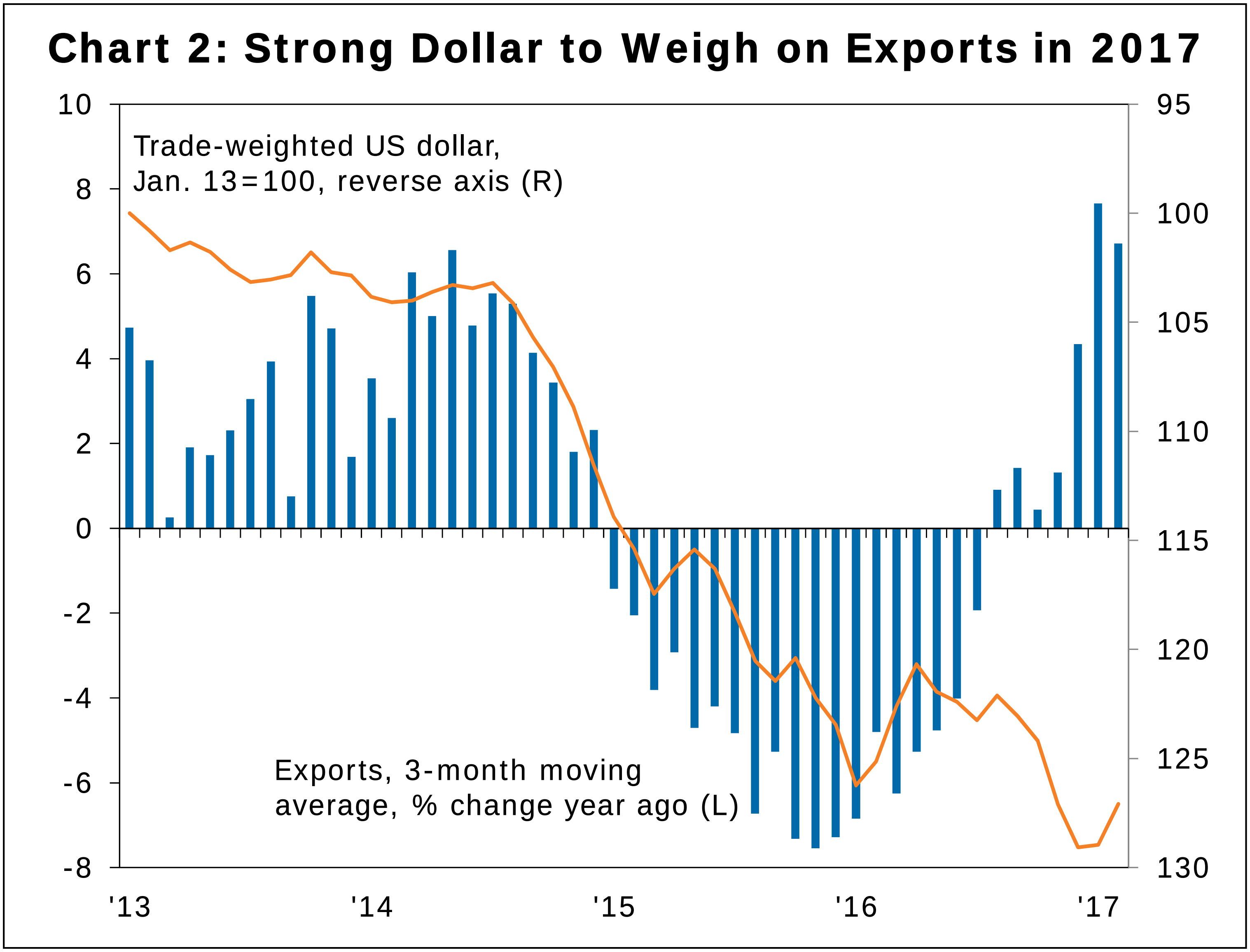

Chart sources: Census Bureau, Federal Reserve

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