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US Economics

US Economic Outlook: Key Debates

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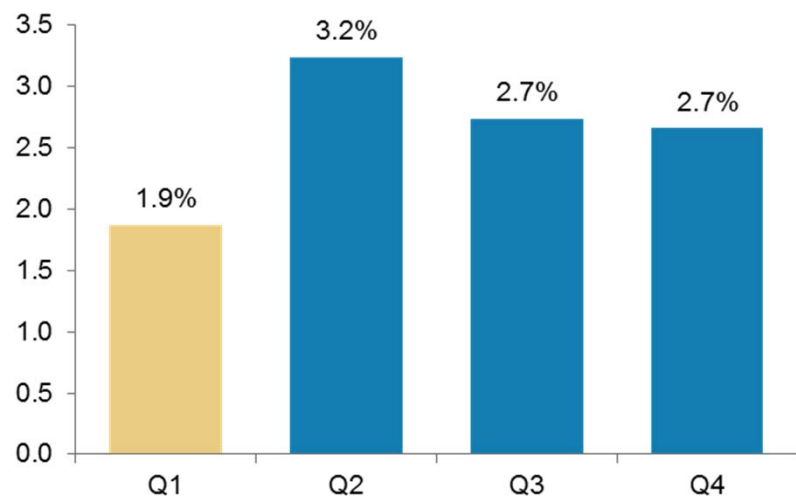
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Residual Seasonality in 1Q GDP

We find that a downward seasonal bias still exists in 1Q GDP data, though the magnitude of its effect is less certain. Combined with other transitory factors depressing 1Q growth, expectations are locked in for a 2Q rebound.

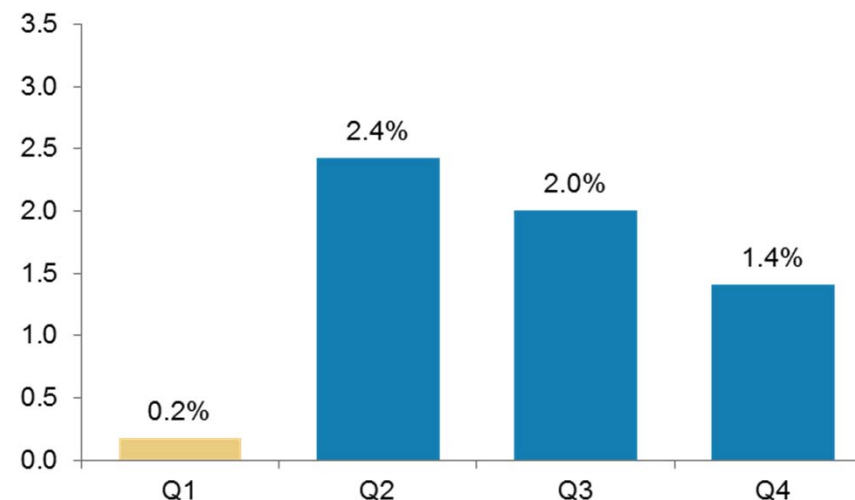
Average GDP growth by quarter since 1985

%Q SAAR, Average 1985-2017



Average GDP growth in the last 10 years

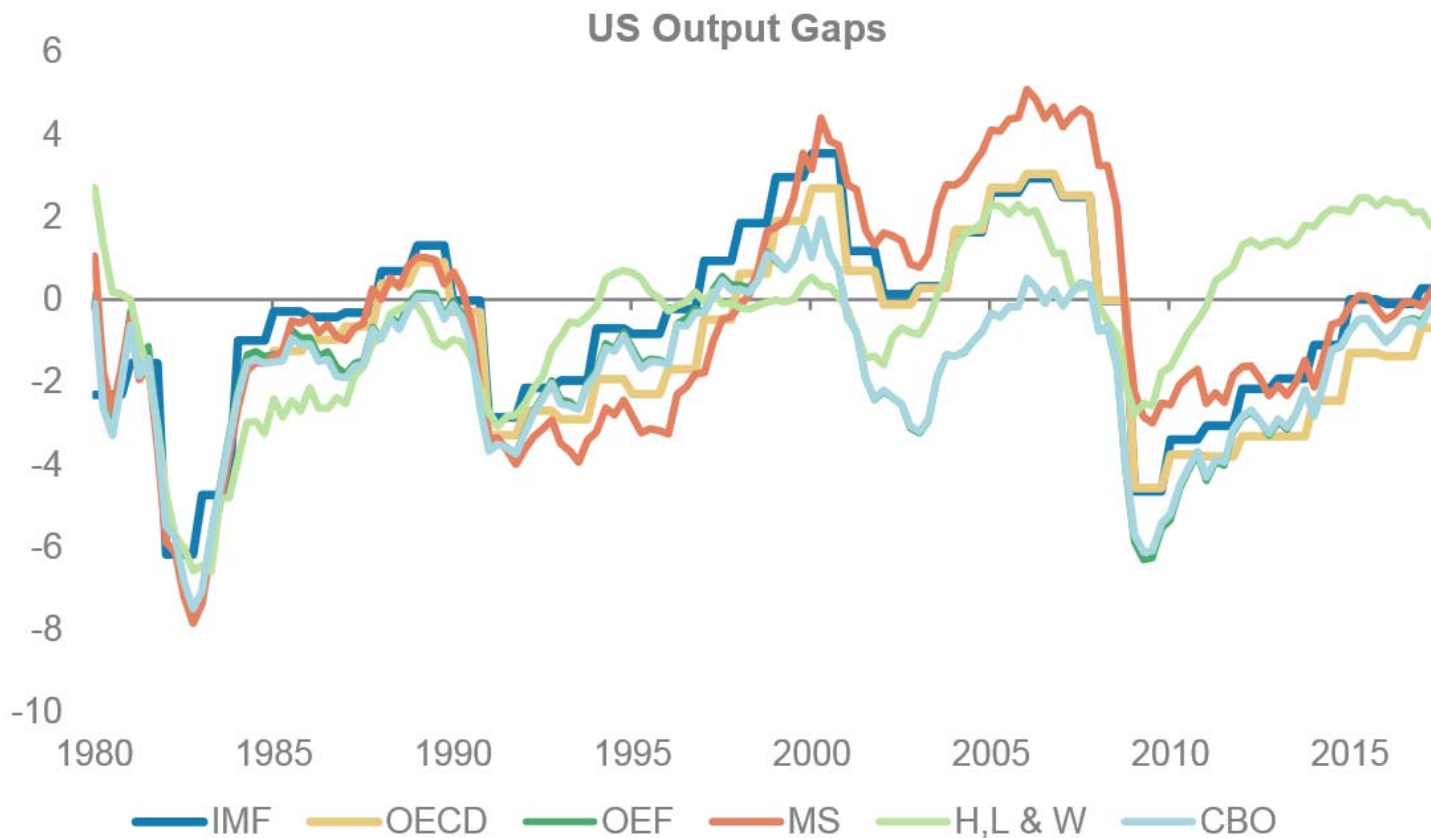
%Q SAAR, Average 2007-2017



Note: See [Residual Seasonality in GDP](#), April 12, 2018.
 Source: Bureau of Economic Analysis, Morgan Stanley Research

Late-Cycle Stimulus is Less Effective

Little remaining slack points to late-phase expansion when stimulus risks increasing pro-cyclical behavior.



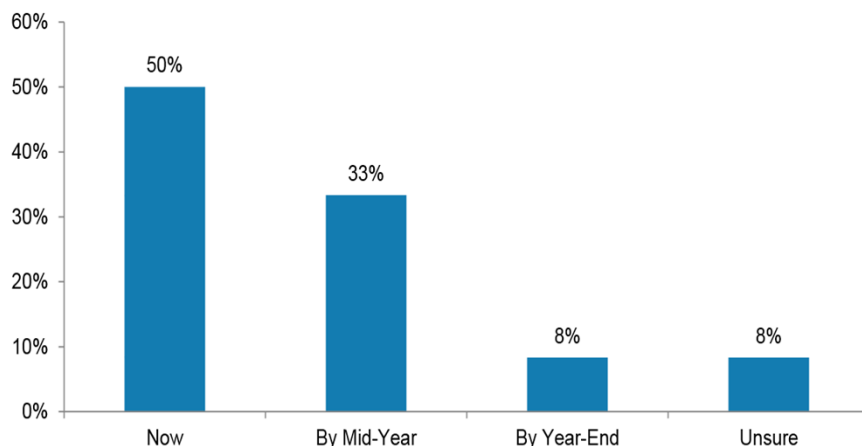
Note: See [The Great Cycle Debate](#), April 12, 2018. Morgan Stanley estimate (MS) takes a simple univariate approach, using a Hodrick-Prescott (HP) filter with a Lambda of 400,000 to estimate potential GDP. HP filters extract a trend from the real GDP data amid a trade-off between goodness of fit to the underlying series and the amount of smoothness in the trend measure. Estimate = 0.8% as of 4Q17.

Source: CBO, Holston, Laubach and Williams, IMF, OEF, OECD, Morgan Stanley Research

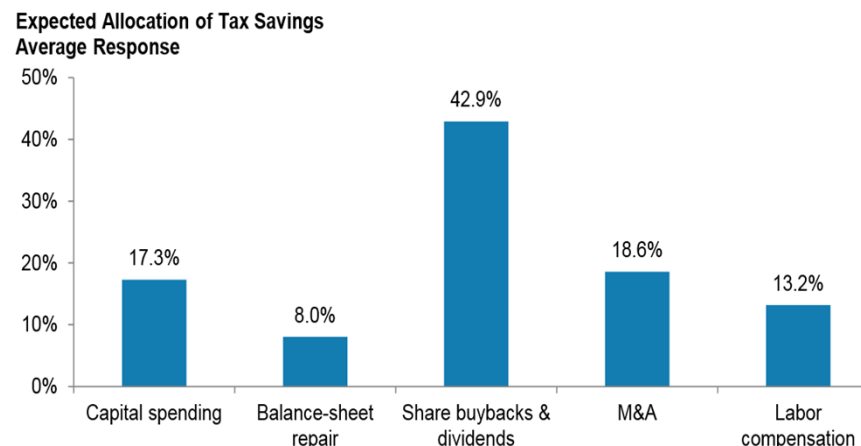
Where Will Corporates Spend the Tax Savings?

In our February Business Conditions survey (MSBCI), we asked analysts how companies are likely to use the proceeds from reduced corporate taxes. On average analysts expect most of the tax savings to go towards share buybacks and dividends (42.9%). Analysts on average expect 17.3% of corporate tax savings to be allocated to capital spending while they expect 18.6% of corporate tax savings to be allocated to M&A. Analysts expect the remainder of corporate tax savings to be split between labor compensation (13.2%) and balance sheet repair (8.0%).

When will companies have a clear sense of how tax reform affects their bottom line?



On average, how are companies likely to allocate their tax savings?

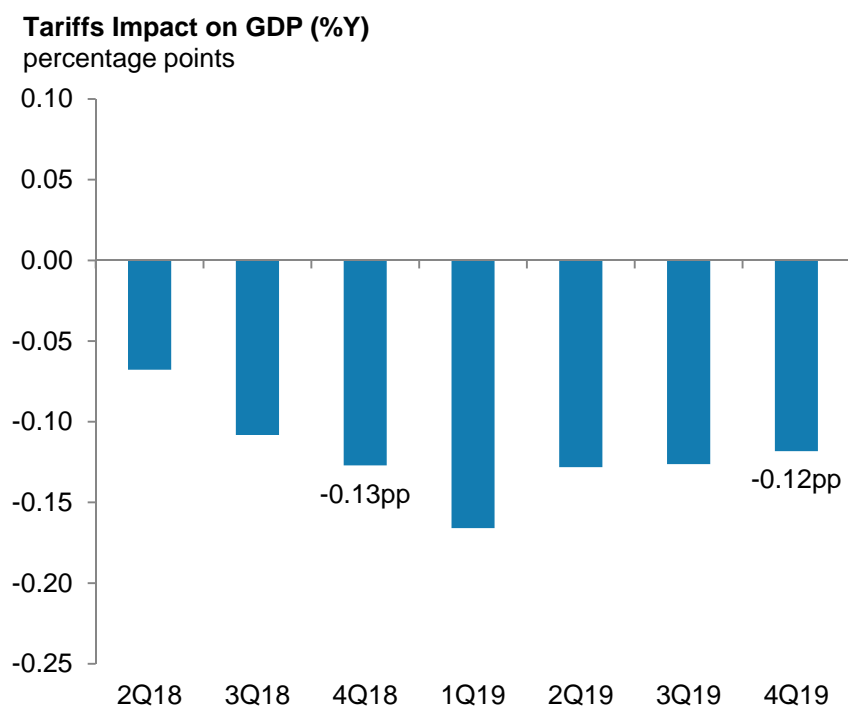


Note: See [Business Conditions: Sentiment Smooths Over Rocky Markets](#), February 8, 2018
Source: Morgan Stanley Research

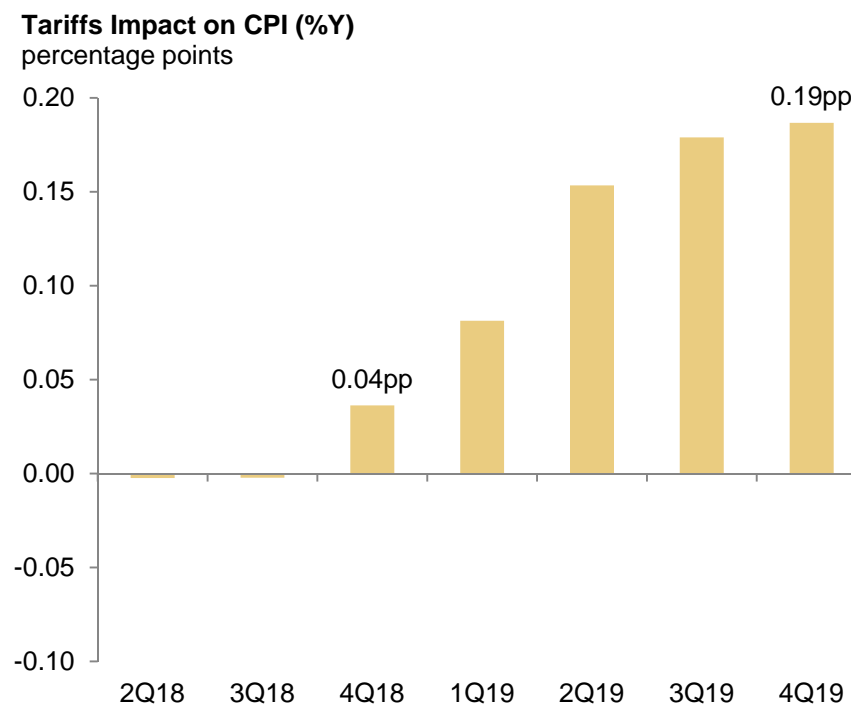
Will Trade Tensions Offset Tailwinds from Fiscal Stimulus?

China's response to US 301 tariffs was proportionate in size, but faster and more aggressive than expected. We still see these moves as an aim towards an eventual negotiation, but note this intrinsically increases risks of a 'protectionist push', forcing markets to reflect elevated uncertainty.

Impact of tariffs on real GDP growth



Impact of tariffs on CPI inflation

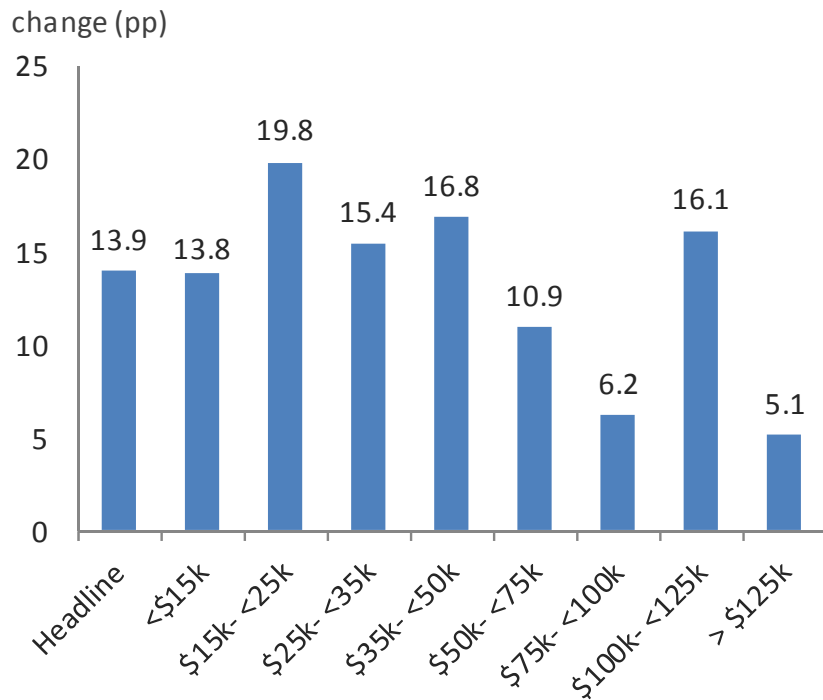


Note: See [Cards on the Table](#), April 4, 2018
Source: Morgan Stanley Research

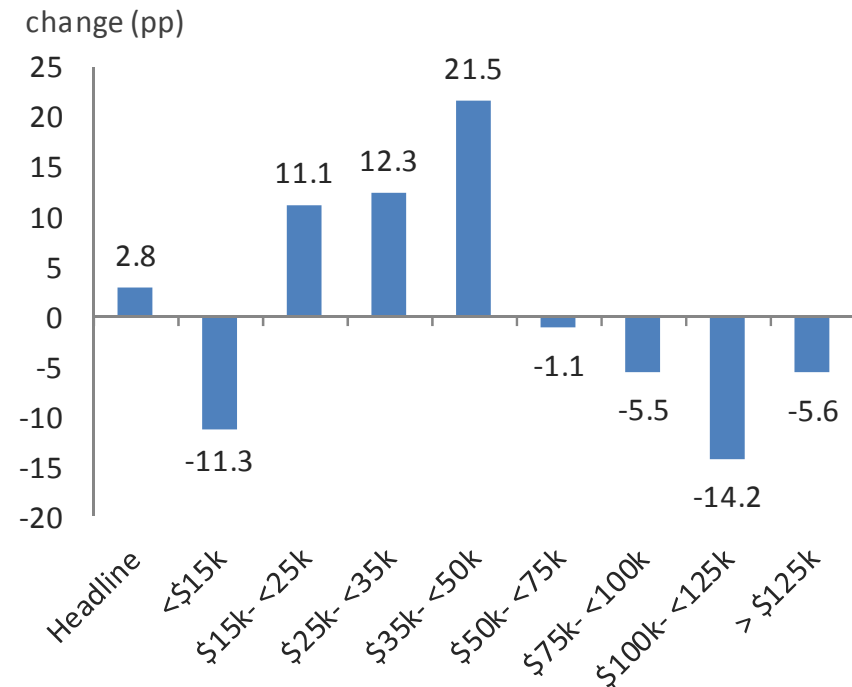
Will Market Volatility Bleed Into Household Spending?

Impact on consumer sentiment primarily falls on upper income groups via the wealth effect with direct references to tariffs and prices in the latest sentiment surveys. The top income quintile represents ~40% of all spending.

**Consumer confidence: one-year-ago change
Feb 2018**



**Consumer confidence: one-year-ago change
Mar 2018**



Source: Conference Board, Federal Reserve Board, Morgan Stanley Research

Will We Get Infrastructure Spending?

While prospects for 2018 are dim, we see a policy-driven increase in infrastructure spending as likely over time. Hence, investors should start studying its implications today.

□ **Base Case: Patch up America**

- A broad infrastructure package is passed amounting to \$1.1 trillion over 10 years, with a gradual ramp up in spending. Pace of infrastructure spending is enough to return net government investment (gross investment less depreciation) back to its longer-run average share of GDP.

□ **Bull Case: Rebuild America**

- A bold infrastructure package is passed amounting to \$2.4 trillion over 10 years, with a gradual ramp up in spending. Pace of infrastructure spending is enough to return net government investment (gross investment less depreciation) back to its longer-run average share of GDP, with a modest overshoot at first to make up for past shortfall.

□ **Bear Case: Let America Erode**

- No spending package is passed and infrastructure assets continue to decay. Aging infrastructure and underinvestment in public capital damage economic activity and productivity growth.

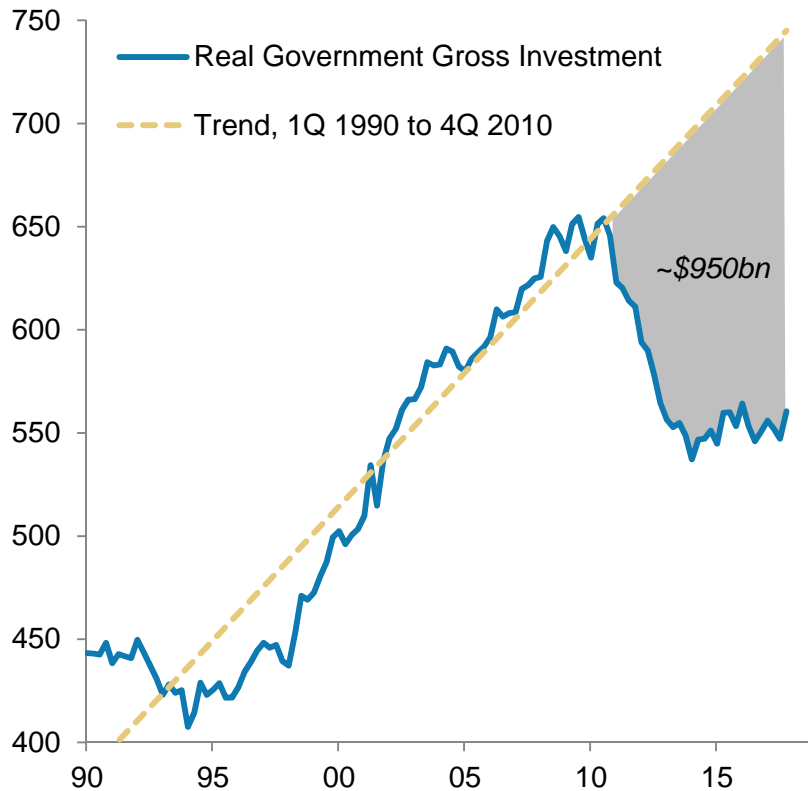
Note: See [Rebuilding America: Infrastructure: Laying an Investment Foundation](#), April 9, 2018.

Source: Morgan Stanley Research

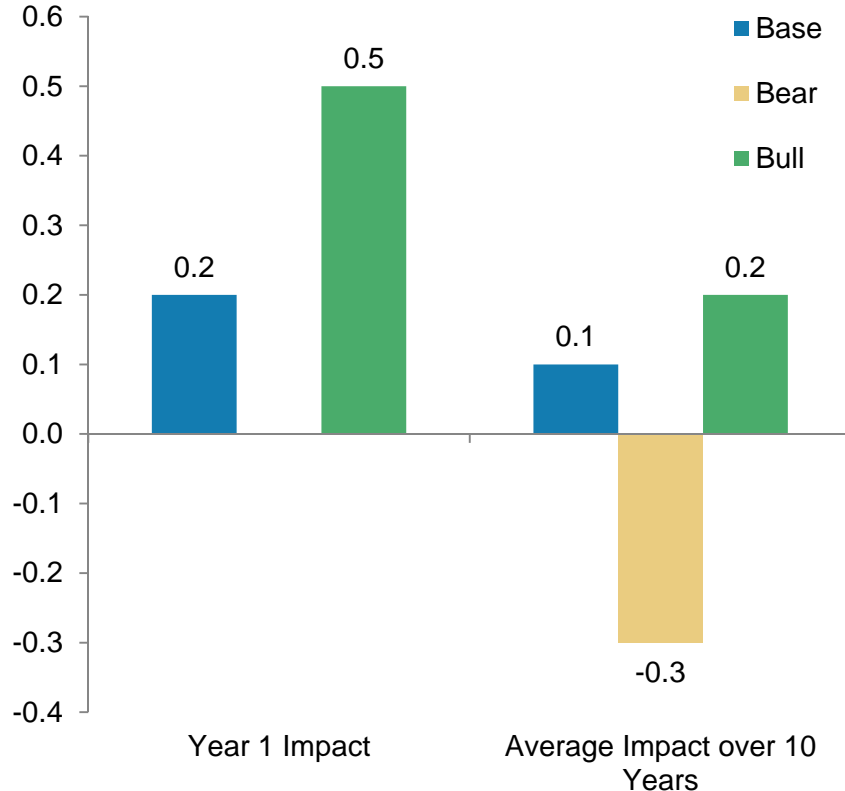
Infrastructure Spending – Economic Considerations

Government investment has been running below trend since 2010. Our base case roughly closes the gap on spending, while the bull case closes the gap and goes further to make up for past shortfalls.

Real Government Gross Investment
Bil. Chn. 2009\$



Infrastructure Spending Impact on GDP Growth
percentage points

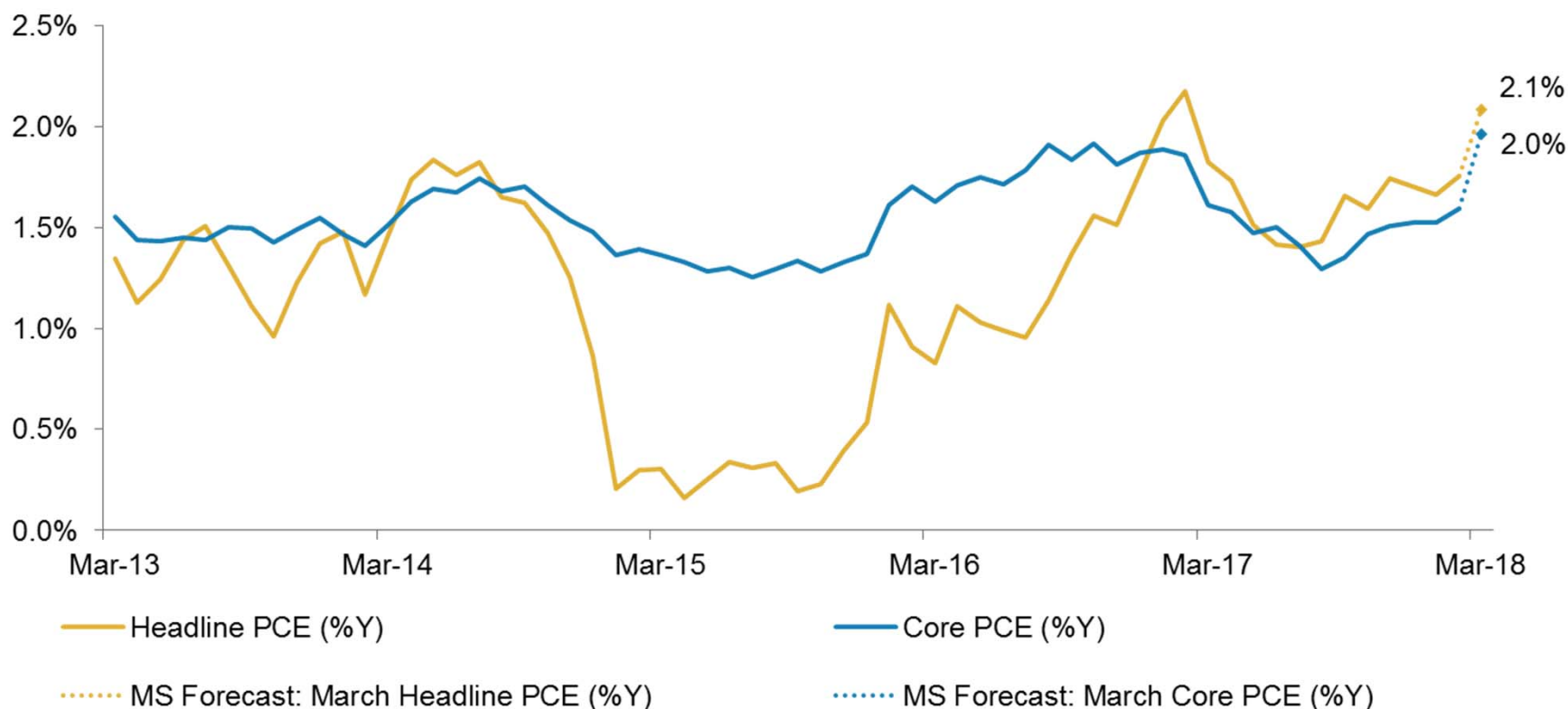


Note: See [Rebuilding America: Infrastructure: Laying an Investment Foundation](#), April 9, 2018.
Source: Bureau of Economic Analysis, Morgan Stanley Research

In March PCE Inflation May Reach 2%

Now that inflation is at or above target, what is the tradeoff that determines how fast the FOMC normalizes policy?

Headline and Core PCE Y/Y with Morgan Stanley March forecast



Source: Bureau of Economic Analysis, Morgan Stanley Research

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