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2018 ANNUAL NATIONAL AND COMMONWEALTH FORECAST

U.S. economy will surge to 3.0% growth while Virginia will grow faster than 2.0%

Norfolk, VA, January 31, 2018 – The Economic Forecasting Project at the Dragas Center for Economic Analysis and Policy projects that the U.S. economy will surge in 2018 due to increasing global demand, the short-term impact of the Tax Cuts and Jobs Act and increased discretionary spending, along with increases in business and consumer confidence. The Commonwealth of Virginia's annual real Gross Domestic Product (GDP) growth rate will also increase in 2018 but will continue to lag that of the U.S. due to political uncertainty in Washington, D.C. We do not forecast a recession in 2018 but are increasingly concerned about a steeply rising federal deficit, near historically high price-earnings ratios in the stock market, and the forecasted return of wage and price inflation in the second half of 2018.

U.S. real GDP increased at an annual rate of 2.3% in 2017, although this rate understates the performance of the U.S. in the 2nd through 4th quarters of 2017. After an anemic performance of 1.2% in the 1st quarter of 2017, the U.S. economy grew at an annual rate of 3.1% and 3.2% in the 2nd and 3rd quarters of 2017, respectively. In the 4th quarter, real GDP growth slowed to 2.6% but this was still the highest 4th quarter rate of economic growth since 2013.

In February 2017, the U.S. will enter the 104th month of economic expansion and in May 2017 will surpass the second longest expansion (February 1961 to December 1969) since the end of World War II. There is a distinct possibility that the U.S. will exceed the current record expansion of 120 months (March 1991 to March 2001) in early 2019.

We forecast that U.S. real GDP will increase at an annual rate of 3.0% and that Virginia real GDP will increase at an annual rate of 2.2% in 2018.

Labor market conditions continue to improve in the United States and Virginia. The U.S. has added 17.65 million jobs since the trough of the Great Recession in February 2010 and Virginia has added 400,400 jobs over the same period. U.S. job growth has continued to surge and there are now 6.5% more jobs in the U.S. than there were at peak employment prior to the Great Recession. Virginia has generated 4.7% more jobs over the same period.

Unemployment rates continue to fall in the United States and Virginia, though the gap has narrowed since 2010. In December 2017, U.S. and Virginia unemployment rates were 4.1% and 3.7%, respectively, suggesting that each economy is near full employment. Broader measures of unemployment are also trending downward. The broadest measure (U6) which measures total unemployment, marginally attached workers, and underemployed workers was 8.5% for the U.S. and 7.9% for Virginia at the end of 2017. The U6 rate for the U.S. in 2017 approached the 8.2% rate observed prior to the Great Recession (8.2%) while Virginia remains 1.9% above its pre-recessionary level of 6.0%.

The Virginia labor market performed well in the 1st half of 2017 and struggled in the 2nd half. Virginia's labor force declined from October 2017 to December 2017, offsetting some of the gains from the 1st half of 2017. Employment also declined in November and December 2017, but overall employment in Virginia increased in 2017 when compared to 2016. Part of the underwhelming performance of the Virginia economy in the 2nd half of 2017 can be attributed to political uncertainty emanating from the federal government.

Overall, the labor market is tightening in many major metropolitan areas in the U.S. Worker turnover is increasing as workers leave for higher paying positions. We are already observing numerous wage and salary increases (including bonuses and other benefits) by large firms and expect these increases to accelerate in the near-term. We forecast, however, that employment growth will slow through 2018 due to a scarcity of workers.

One significant concern is that the labor force participation rate, which is the number of people participating in the labor force relative to the number of people eligible to participate in the labor force, has declined in the United States and Virginia since the Great Recession. For the U.S., 69% of men and 57% of women participated in the labor force in December 2017 for an overall rate of 62.7%, below the 66% observed prior to the Great Recession. For Virginia, labor force participation is higher than the U.S. but has still declined from 69.7% prior to the Great Recession to 65.3% in December 2017. Bringing these workers back to the labor force is instrumental for economic growth in 2019 and beyond.

We forecast that U.S. and Virginia unemployment rates will continue to decline in 2018. U.S. unemployment is projected to be 3.8% at the end of 2018 while Virginia's unemployment rate is forecast at 3.5%.

We project modest growth in civilian jobs in 2018. U.S. job growth is projected to average 1.1% while Virginia's job growth is forecast to average 1.3%.

Private sector profitability continues to outperform its historical average at the national level. Corporate profits as a percentage of GDP were 9.53% at the end of 2017, well above the historical average of 6.52%. The business tax changes in the Tax Cuts and Jobs Act of 2017 will likely result in increases in corporate profitability in 2018. Firms will undoubtedly take advantage of the immediate expensing provisions to increase capital investments and larger firms will repatriate retained earnings from overseas. As these earnings are fungible, we expect corporations to increase share buybacks in 2018. Increasing profits and buybacks are likely to fuel a surge in equities prices well into the 2nd half of 2018.

Federal policy changes will also significantly influence the U.S. and Virginia economies in 2018. We project that the Tax Cuts and Jobs Act of 2017 will lift 2018 national real GDP growth by at least 0.3 percentage points in 2018, though the impact will diminish over time. We expect that there will be agreement on modifying the discretionary spending caps of the Budget Control Act of 2011, lifting discretionary federal spending by at least $100 billion in Fiscal Year (FY) 2018. Increases in federal spending will also fuel economic growth in Virginia, where at least 30% of Virginia's economic activity is tied to the federal government.

While the prospects for economic growth in 2018 appear strong, we are growing increasingly concerned about several factors that could undermine real GDP growth in 2018 and beyond.

First, we project the federal deficit will exceed $700 billion in FY 2018. While increasing economic growth will alleviate some of the revenue cuts of the Tax Cuts and Jobs Act, the Act will still significantly reduce revenues through 2027. If Congress and the President do lift the discretionary spending caps for FY 2018, these increases will also add to the deficit. If these trends continue, it is very likely that the federal government will return to $1 trillion deficits by FY 2020.

Second, while the recent increases in equities markets have created over $7 trillion in wealth, we note that 50% of Americans do not participate in equities markets, so these gains are not spread evenly across the population. Cyclically-adjusted price-to-earnings ratios have recently exceeded those observed prior to the Great Depression in 1929 and are well above the historical average. While price-to-earnings ratios have not yet approached the historical high, these ratios are continuing to trend upward, suggesting that equities markets are due for a correction.

Third, given tightening labor market conditions and a global economy that is in sync, input prices will likely rise in 2018, spurring increases in inflation. We expect the Federal Reserve Bank will increase the federal funds rate by at least 75 basis points in 2018. If significant inflation does occur due to expansionary fiscal policy, then the Federal Reserve may have to rapidly increase interest rates in the latter half of 2018, sparking a correction in equities markets than could spill over into the real estate sector.

Fourth, the federal government and states have significantly less fiscal space than prior to the Great Recession. U.S. federal debt exceeds $20 trillion and Virginia's Revenue Stabilization Fund is well below the $1 billion reserve prior to the Great Recession (though there may be significant inflows this year). Simply put, the federal government does not have the fiscal space to add to already large annual deficits and debt without incurring significant increases in interest costs. Many states would, in the event of a decline in revenues, rapidly curtail expenditures, further exacerbating any economic downturn.

Lastly, political shocks have grown increasingly frequent over the last five years. The federal government appears unable to pass appropriations bills in a timely manner, increasing uncertainty and hampering growth in Virginia. The current stalemate in Congress shows no signs of alleviating without a broadbased agreement on immigration, which has so far remained elusive. A significant shock, to include a substantial partial shutdown or failure to raise the debt ceiling, would undoubtedly slow U.S. economic growth. While many private firms are likely to adapt to the 'new normal' of uncertainty emanating from Washington, D.C., Virginia is especially vulnerable given its relatively large dependence on federal spending. Further political uncertainty would likely reduce Virginia's economic prospects in 2018.

With these factors in mind, we project that national and Virginia real GDP growth will increase in 2018. While the risk of an economic correction is increasing, we believe that a recession is unlikely to occur in 2018 but is a distinct possibility in 2019, subject to the usual caveats of economic and political shocks.

2017 Forecasts, Actuals, and 2018 Forecast

	2017 Forecast	2017 Actual	2018 Forecast
U.S. Real GDP Growth	2.2%	2.3%	3.0%
Civilian Job Growth	1.5%	1.2%	1.1%
Unemployment Rate	4.7%	4.1%	3.8%
Consumer Price Index	2.8%	2.2%	2.9%
Core CPI	2.4%	1.7%	2.2%
30-Year Conventional Mortgage	4.3%	4.0%	5.0%
Federal Deficit	---	-$655 Billion	$-750 Billion
Virginia Real GDP	1.5%	1.7%	2.2%
Virginia Job Growth	---	1.4%	1.3%

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The Dragas Center for Economic Analysis and Policy in the Strome College of Business at Old Dominion University undertakes a wide range of economic, demographic, transportation and defense-oriented studies. For eighteen years, the Center and its predecessors have produced the highly regarded State of the Region Report for Hampton Roads and economic forecasts for the region. If you would like more information about this topic, please contact Dr. Robert M. McNab at 757 683 3153 or email at rmcnab@odu.edu.