

US economy shrugs off earlier doubts over recovery

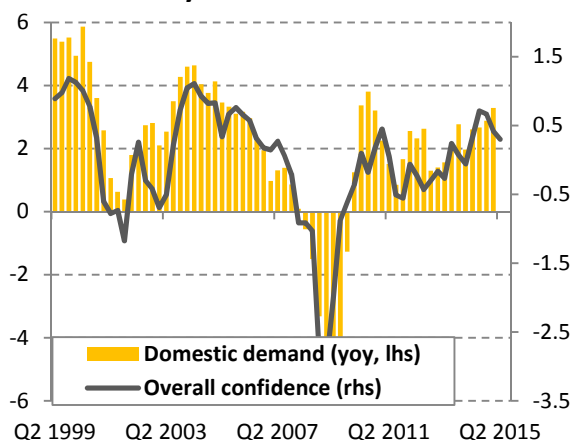
Despite the disappointing start of the year the US economy continues to recover. Leading indicators suggest that economic activity will remain strong enough to translate into further tightening of the labor market. That, in turn, should lead to more upward wage pressure and inflation moving closer to the Fed's target. All this implies the Fed remains firmly on course to start hiking interest rates later this year.

The complete growth stall in the first quarter of this year is not representative for the actual state of the economy. Even though most confidence indicators have softened a touch and momentum slowed down from the spectacular growth rates seen in the spring and summer of 2014 (around 5% annualized), almost all indicators paint a picture of a continuing recovery. Indeed, there are convincing reasons to believe that economic activity earlier this year was largely held down by transitory factors. The unseasonably cold winter, the scaling back of investment in the shale oil industry following the fall in the oil price, the port strikes at the West Coast and the stronger USD have all weighed on economic activity. While the negative effect of the first three factors has largely disappeared, it's very unlikely that the recent dollar appreciation will derail the fairly closed US economy. All in all, in contrast to the complete absence of growth in the first three months of the year, most recent confidence indicators are consistent with growth between 2 and 2.5%, not too far from most estimates of long term potential growth in the US.

Headline inflation, currently at 0%, will increase significantly in the coming months as the drop in energy prices seen earlier starts to have less of a negative impact. But given the recent volatility in energy prices, it's actually more useful to look at underlying measures of inflation. At 1.7% and 1.2% for core inflation and core PCE (personal consumption expenditures) inflation respectively, underlying inflation remain below the Fed's 2% target over the medium term. In fact, over the last five years the Fed has failed to deliver on this front. Looking forward, however, underlying inflation is set to pick up from current levels. Importantly, leading indicators suggest that wage growth will accelerate further. Without seeing an acceleration in productivity growth at the same time (an assumption which remains to be tested) this will translate into higher inflation.

Against the back of a continuing recovery and upward inflation pressures the Fed is still on course to start hiking interest rates before the end of the year. As things currently stand, an increasingly tighter monetary policy stance can be expected in the years thereafter. That said, the Fed is likely to proceed gradually and only if the underlying economic momentum remains strong enough.

US economy continues to recover



Wage growth set to accelerate further

