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The U.S. economy revisited: A southern tailwind for Canada

Our ability to piggyback on the strengthening U.S. economy means that a Canadian recession is not a likely scenario

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It has been more than 18 months since the last time we used this column to discuss the macroeconomic background of the world's largest economy, and our main trading partner, the United States. Those who follow us know that we are very optimistic about the strength of the U.S. recovery, which has in fact entered the expansion phase since late 2013. But like in all things, nothing is ever all black or white, so let's have a look at where we are a quarter into 2015.

A tough start to the year

After a very weak first quarter in 2014, with extreme weather conditions wreaking havoc all over the country (when snow is covering the city of Atlanta, you know the situation is not normal), annual gross domestic product growth came in below our expectations of above 3 per cent. Still, the labour market delivered the best performance since the mid-1990s, with more than three million Americans getting new jobs. That represents quite an impact on aggregate household wealth.

The first quarter of 2015 had some similarities to the start of 2014: The U.S. economy seemed to be dragging its feet, a phenomenon that took the markets a bit by surprise after the second half of 2014, when the labour market was building a strong tailwind. A large part of this was clearly caused by the harsh winter weather, which every year plays tricks on economic forecasters who are typically caught off guard by the impact of changing seasons. A quick look at **Chart 1** shows that economic surprises are in fact often led by weather effects.

Ironically, the main sources of this disappointment are related to U.S. consumers, who alone account for 70 per cent of the size of the world's largest economy.

First, retail sales slowed considerably, when sharp gains in employment should have led to an increase in household consumption. On this front, it is important to remember that retail sales account for only one-third of household consumption, with services making up the major part of spending. The aging of the population is a factor as well, resulting in a growing number of retirees whose spending habits are more highly concentrated in services than durable goods. Today's youth also seem to be behaving differently than their predecessors and are saving more than previous generations.

Second, although we are still expecting wage pressures to materialize given the strong growth in jobs and the economy in 2014, this has not happened yet. While it is difficult to reduce the analysis to a single cause, the surplus in labour – those who had been on the sidelines since the end of the recession – is definitely a major factor. In short, workers probably do not yet have enough negotiating room with their employers to demand wage increases (for example, in January alone, more than one million Americans decided to return to the job market, eliminating some scarcity in workers that had come from the three million jobs added in 2014). Generally speaking, history shows that wage pressures appear when the unemployment rate dips below its long-term equilibrium level (commonly known as the "natural rate of unemployment"), estimated at between 5.2 and 5.5 per cent, which will likely be reached in 2015.

Wealthier households: A solid foundation for continued growth

Falling energy prices have not directly led to more spending by consumers, who seem to prefer to save the extra money instead of buying new goods. The savings rate has risen through this episode of falling energy prices, increasing from 4.9 per cent in December to 5.8 per cent in February. With households cleaning their balance sheets, a solid foundation is being built for the second half of the year.

A lot of ink is also being spilled over the lack of wage increases, and some analysts explain the weakness in retail sales or the sudden slowdown in the housing sector by the fact that the average hourly wage of workers is growing more slowly than in the past. On this topic, we believe that the most important variable for explaining aggregate changes in consumer demand is not the average wage, but rather the growth in the global wage bill (**Chart 2**).

A quick look at the data shows not only that the total wage bill is expanding nicely, bolstered by the historic surge in employment since the start of 2014, but that the consolidated purchasing power of U.S. consumers is growing at a pace similar to the peaks of previous cycles. In short, although household consumption may have stagnated at the beginning of the year (as compared to a pace of 4.4-per-cent growth in the fourth quarter of 2014, an eight-year high), it is certainly not due to a lack of growth in the average hourly wage but rather, as mentioned earlier, to a sharp renewal in the propensity to save.

More piggybacking

The bottom line is that the U.S. economy only just entered the expansion phase after a long recovery, and tailwinds coming from the labour market should sustain growth for a few years to come. The Fed is preparing its first rate hike in almost a decade and is more confident that the economy can keep on growing without an extremely accommodative monetary policy. With Canada progressively shifting towards a manufacturing export-led economic model, this is clearly good news. In the end, in spite of strong headwinds from the oil market, our ability to piggyback the U.S. economy means that a Canadian recession, in our view, is not a likely scenario.

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