

## After a Strong Q2, A Return to Normalcy in H2

The U.S. economy was strong through the second quarter and at the start of the third quarter. Real gross domestic product accelerated at a 4.1 percent annualized rate in Q2, the fastest growth since the 4.9 percent growth rate from 2014Q2. Business decisions are usually based on nominal numbers, and in the nominal GDP numbers we see a year-over-year gain of 5.4 percent over the 12 months ending in Q2. This is the strongest year-over-year growth in nominal GDP since 2006Q3, before the Great Recession. Real consumer spending was healthy in Q2, expanding at a 4.0 percent annualized rate, juiced up by job growth and tax reform. Tax reform also contributed to a good quarter for real business fixed investment, which grew at a 7.3 percent rate. Inventories were an unexpected drag in Q2, shrinking by \$28 billion (\$2012), and subtracting a percentage point from real GDP growth.

In the current quarter, we expect to see less help from consumer spending. July unit auto sales eased from the 17.2 million Q2 average sales rate, to a 16.8 million unit rate. Residential real estate markets look like they are cooling in many areas, keeping a lid on consumer spending and residential fixed investment. We expect business investment to continue to expand, but many businesses are complaining about price pressure and uncertainty due to the trade wars. Inventories are a big question mark for Q3. After the Q2 drag, it is reasonable to expect a bounce back in Q3. We look for a moderate increase in Q3 inventories, possibly adding more than a percentage point to Q3 real GDP growth. All in, it looks like the U.S. economy will expand moderately in Q3, stepping back from a strong 4.1 percent annualized growth rate for real GDP in Q2, to a moderate 2.5-3.0 percent real growth trend over the remainder of this year.

Job growth was good in July, just not quite as good as most were expecting. 157,000 net new payroll jobs were added and the unemployment rate eased back to 3.9 percent. Private-sector average hourly earnings increased by 0.3 percent in July, and were up 2.7 percent over the previous 12-month period. Wages are simply not moving up quickly, even though virtually all labor market indicators are indicating tight supply. The ongoing retirement of baby-boomers, and their replacement with lower-paid younger workers, is a factor in the suppression of the total wage bill.

To date, it is hard to find numerical evidence of a significant impairment to overall U.S. economic activity due to increased trade tariffs and other measures related to the current trade wars. However, there are numerous anecdotal comments complaining about trade in the Federal Reserve's Beige Book, both the ISM Manufacturing and Non-Manufacturing Reports on Business, and in other reports. We look at trade conflicts across three dimensions. The *breadth* of the trade tariffs is a concern, as they expand to include more and more products. The *height* of the tariffs is a concern, placing significant burdens on both importing and exporting companies. The *duration* of the trade measures is a concern. The longer they are in place, the more the drag is passed on to other parts of the economy. Tensions with China still appear to be increasing. The recent visit by European Commission President Jean-Claude Juncker to the White House increased hope for a wind-down of U.S. trade tensions with Europe. The U.S. and Mexico appear eager to finalize a trade deal this month.

The Federal Reserve remains on track with gradualism. We expect to see a 25 basis point increase in the fed funds rate range, to 2.00-2.25 percent, announced on September 26. The CME calculates implied odds of 94 percent for a September rate hike. We expect the Fed to skip a rate hike at the November 7-8 FOMC meeting, and then raise again on December 18. The CME Group reports a 67 percent chance of a December rate hike.

### U.S. Economic Outlook, Summary

|  | 1Q'18a | 2Q'18a | 3Q'18f | 4Q'18f | 1Q'19f | 2Q'19f | 3Q'19f | 4Q'19f | 2017a | 2018f | 2019f |
|--|--------|--------|--------|--------|--------|--------|--------|--------|-------|-------|-------|
| Real GDP (Percent Change Annualized)       | 2.2    | 4.1    | 2.7    | 3.1    | 2.8    | 2.7    | 2.6    | 2.5    | 2.2   | 2.8   | 2.8   |
| CPI (Percent Change Year-over-Year)        | 2.3    | 2.6    | 2.8    | 2.6    | 2.3    | 2.4    | 2.3    | 2.2    | 2.1   | 2.6   | 2.3   |
| Payroll Jobs (Average Monthly Diff., Ths.) | 210.8  | 215.9  | 181.6  | 174.1  | 156.4  | 148.5  | 137.7  | 126.3  | 181.4 | 195.6 | 182.0 |
| Unemployment Rate (Percent)                | 4.1    | 3.9    | 3.8    | 3.7    | 3.6    | 3.6    | 3.6    | 3.6    | 4.3   | 3.9   | 3.6   |
| Federal Funds Rate (Effective)             | 1.45   | 1.74   | 1.96   | 2.19   | 2.45   | 2.69   | 2.94   | 3.13   | 1.00  | 1.83  | 2.80  |
| 10-Yr. Treasury Rate                       | 2.76   | 2.92   | 2.97   | 3.05   | 3.21   | 3.40   | 3.63   | 3.81   | 2.33  | 2.92  | 3.51  |

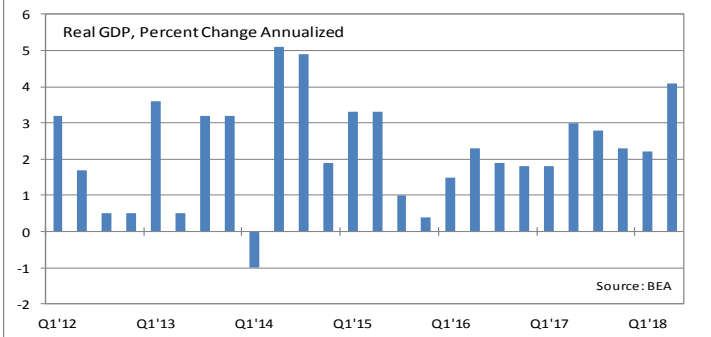
**a = actual f = forecast**

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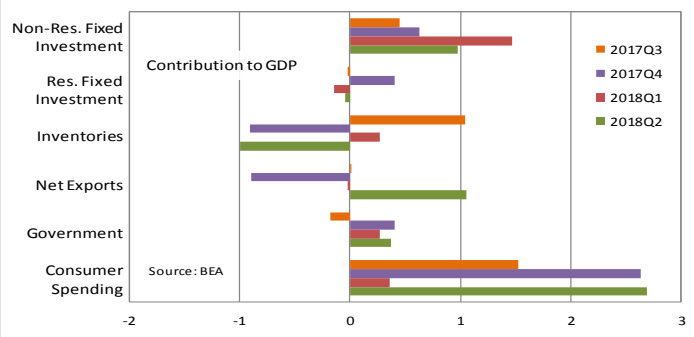
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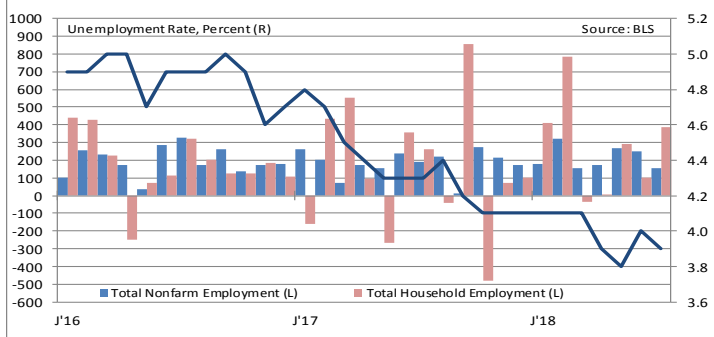
## Q2 GDP 1st Estimate at 4.1%



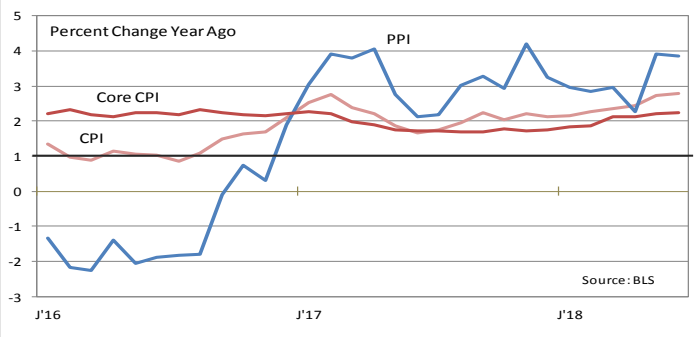
## Net Exports Surged in Q2



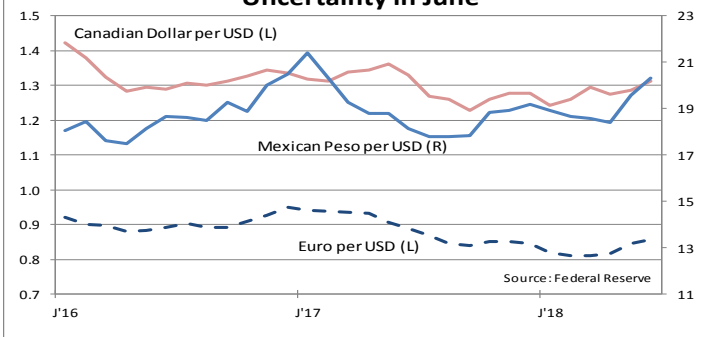
## U.S. Added a Net 157,000 Jobs in July



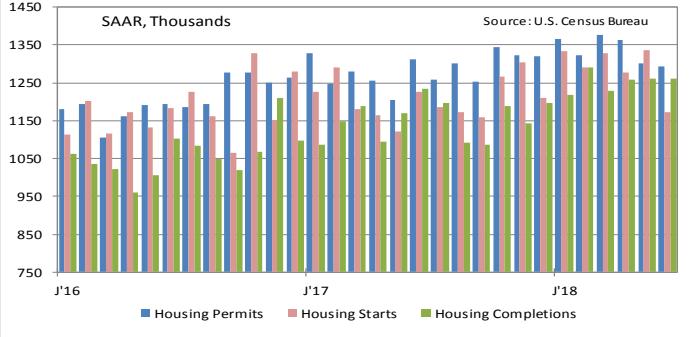
## Inflation Metrics Remain Steady



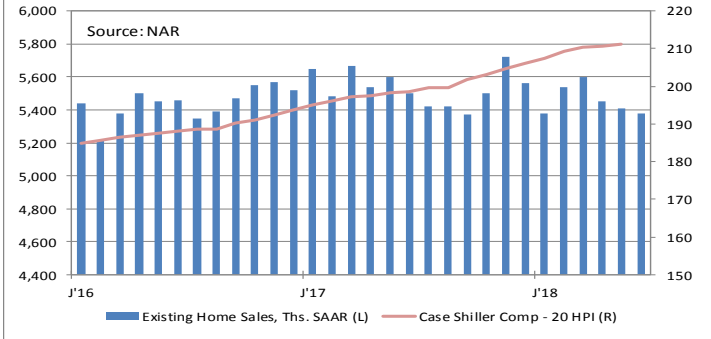
## US Dollar Strengthens on Trade Policy Uncertainty in June



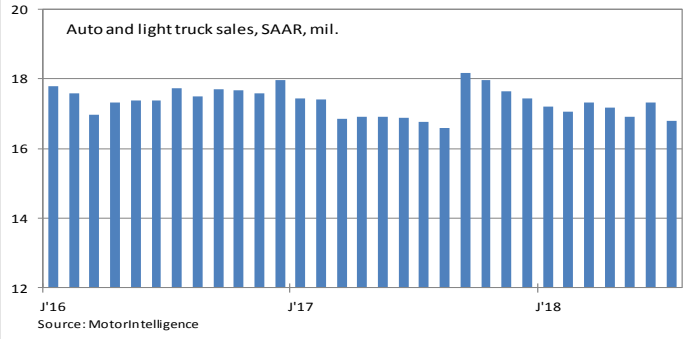
## Housing Starts Drop Off in June



## Existing Home Sales Remain Range Bound



## Auto Sales Dipped in July



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|  | 1Q'18a      | 2Q'18a      | 3Q'18f     | 4Q'18f     | 1Q'19f     | 2Q'19f     | 3Q'19f     | 4Q'19f     | 2017a       | 2018f      | 2019f      |
|--|-------------|-------------|------------|------------|------------|------------|------------|------------|-------------|------------|------------|
| <b>Output</b>                              |             |             |            |            |            |            |            |            |             |            |            |
| Nominal GDP (Billions \$)                  | 20041       | 20403       | 20665      | 20937      | 21196      | 21449      | 21697      | 21941      | 19485       | 20511      | 21571      |
| <b>Percent Change Annualized</b>           | <b>4.3</b>  | <b>7.4</b>  | <b>5.2</b> | <b>5.4</b> | <b>5.0</b> | <b>4.9</b> | <b>4.7</b> | <b>4.6</b> | <b>4.2</b>  | <b>5.3</b> | <b>5.2</b> |
| Real GDP (Chained 2012 Billions \$)        | 18324       | 18507       | 18632      | 18773      | 18902      | 19029      | 19150      | 19268      | 18051       | 18559      | 19087      |
| <b>Percent Change Annualized</b>           | <b>2.2</b>  | <b>4.1</b>  | <b>2.7</b> | <b>3.1</b> | <b>2.8</b> | <b>2.7</b> | <b>2.6</b> | <b>2.5</b> | <b>2.2</b>  | <b>2.8</b> | <b>2.8</b> |
| Pers. Consumption Expenditures             | 12723       | 12848       | 12911      | 12989      | 13064      | 13135      | 13204      | 13274      | 12559       | 12868      | 13169      |
| <b>Percent Change Annualized</b>           | <b>0.5</b>  | <b>4.0</b>  | <b>2.0</b> | <b>2.4</b> | <b>2.3</b> | <b>2.2</b> | <b>2.1</b> | <b>2.1</b> | <b>2.5</b>  | <b>2.5</b> | <b>2.3</b> |
| Nonresidential Fixed Investment            | 2654        | 2701        | 2736       | 2774       | 2812       | 2847       | 2881       | 2912       | 2538        | 2716       | 2863       |
| <b>Percent Change Annualized</b>           | <b>11.5</b> | <b>7.3</b>  | <b>5.2</b> | <b>5.6</b> | <b>5.6</b> | <b>5.1</b> | <b>4.8</b> | <b>4.4</b> | <b>5.3</b>  | <b>7.0</b> | <b>5.4</b> |
| Residential Investment                     | 615         | 614         | 614        | 619        | 623        | 628        | 631        | 635        | 611         | 615        | 629        |
| <b>Percent Change Annualized</b>           | <b>-3.4</b> | <b>-1.1</b> | <b>0.1</b> | <b>3.3</b> | <b>2.9</b> | <b>2.9</b> | <b>2.4</b> | <b>2.0</b> | <b>3.3</b>  | <b>0.7</b> | <b>2.3</b> |
| Change in Private Inventories              | 30          | -28         | 19         | 26         | 31         | 38         | 41         | 41         | 23          | 12         | 38         |
| Net Exports                                | -902        | -850        | -883       | -885       | -892       | -898       | -900       | -899       | -859        | -880       | -897       |
| Government Expenditures                    | 3152        | 3169        | 3181       | 3195       | 3210       | 3223       | 3236       | 3249       | 3130        | 3174       | 3229       |
| <b>Percent Change Annualized</b>           | <b>1.5</b>  | <b>2.1</b>  | <b>1.6</b> | <b>1.7</b> | <b>1.8</b> | <b>1.7</b> | <b>1.7</b> | <b>1.5</b> | <b>-0.1</b> | <b>1.4</b> | <b>1.7</b> |
| Industrial Prod. Index (2007=100)          | 105.9       | 107.5       | 108.5      | 109.2      | 109.6      | 109.9      | 110.1      | 110.3      | 103.7       | 107.8      | 110.0      |
| <b>Percent Change Annualized</b>           | <b>2.4</b>  | <b>6.0</b>  | <b>3.9</b> | <b>2.5</b> | <b>1.7</b> | <b>1.1</b> | <b>0.7</b> | <b>0.5</b> | <b>1.6</b>  | <b>3.9</b> | <b>2.1</b> |
| Capacity Utilization (Percent)             | 77.2        | 77.9        | 78.4       | 78.5       | 78.5       | 78.4       | 78.1       | 77.8       | 76.1        | 78.0       | 78.2       |
| <b>Prices</b>                              |             |             |            |            |            |            |            |            |             |            |            |
| CPI (1982-84=100)                          | 249.4       | 250.5       | 252.1      | 253.6      | 255.1      | 256.5      | 257.8      | 259.2      | 245.1       | 251.4      | 257.2      |
| <b>Percent Change Annualized</b>           | <b>3.5</b>  | <b>1.7</b>  | <b>2.6</b> | <b>2.5</b> | <b>2.4</b> | <b>2.1</b> | <b>2.1</b> | <b>2.1</b> | <b>2.1</b>  | <b>2.6</b> | <b>2.3</b> |
| PCE Price Index (2012=100)                 | 107.5       | 108.0       | 108.6      | 109.3      | 109.9      | 110.5      | 111.1      | 111.6      | 106.1       | 108.4      | 110.8      |
| <b>Percent Change Annualized</b>           | <b>2.5</b>  | <b>1.8</b>  | <b>2.4</b> | <b>2.3</b> | <b>2.3</b> | <b>2.1</b> | <b>2.1</b> | <b>2.1</b> | <b>1.8</b>  | <b>2.2</b> | <b>2.2</b> |
| GDP Price Index (2012=100)                 | 109.3       | 110.2       | 110.9      | 111.5      | 112.1      | 112.7      | 113.3      | 113.9      | 107.9       | 110.5      | 113.0      |
| <b>Percent Change Annualized</b>           | <b>2.0</b>  | <b>3.0</b>  | <b>2.5</b> | <b>2.3</b> | <b>2.2</b> | <b>2.2</b> | <b>2.1</b> | <b>2.1</b> | <b>1.9</b>  | <b>2.3</b> | <b>2.3</b> |
| PPI, Final Demand (Nov. 2009=100)          | 115.1       | 116.0       | 116.8      | 117.6      | 118.4      | 119.2      | 120.0      | 120.6      | 113.0       | 116.4      | 119.6      |
| <b>Percent Change Annualized</b>           | <b>3.4</b>  | <b>3.0</b>  | <b>2.9</b> | <b>2.7</b> | <b>2.9</b> | <b>2.7</b> | <b>2.5</b> | <b>2.2</b> | <b>1.8</b>  | <b>2.1</b> | <b>2.2</b> |
| Crude Oil, WTI (\$/barrel)                 | 62.9        | 68.0        | 71.0       | 73.0       | 75.0       | 75.0       | 75.0       | 75.0       | 50.8        | 68.7       | 75.0       |
| <b>Labor Markets</b>                       |             |             |            |            |            |            |            |            |             |            |            |
| Payroll Jobs (Average Monthly Diff., Ths.) | 210.8       | 215.9       | 181.6      | 174.1      | 156.4      | 148.5      | 137.7      | 126.3      | 181.4       | 195.6      | 182.0      |
| Unemployment Rate (Percent)                | 4.1         | 3.9         | 3.8        | 3.7        | 3.6        | 3.6        | 3.6        | 3.6        | 4.3         | 3.9        | 3.6        |
| Average Weekly Hours                       | 34.5        | 34.5        | 34.5       | 34.5       | 34.5       | 34.5       | 34.5       | 34.5       | 34.4        | 34.5       | 34.5       |
| Population (Millions)                      | 327.5       | 328.1       | 328.7      | 329.3      | 329.8      | 330.4      | 331.0      | 331.6      | 326.0       | 328.4      | 330.7      |
| <b>Percent Change Annualized</b>           | <b>0.7</b>  | <b>0.7</b>  | <b>0.7</b> | <b>0.7</b> | <b>0.7</b> | <b>0.7</b> | <b>0.7</b> | <b>0.7</b> | <b>0.7</b>  | <b>0.7</b> | <b>0.7</b> |
| <b>Personal Income</b>                     |             |             |            |            |            |            |            |            |             |            |            |
| Average Hourly Earnings (\$)               | 26.75       | 26.93       | 27.11      | 27.30      | 27.51      | 27.71      | 27.93      | 28.15      | 26.31       | 27.02      | 27.83      |
| <b>Percent Change Annualized</b>           | <b>3.0</b>  | <b>2.7</b>  | <b>2.8</b> | <b>2.8</b> | <b>3.1</b> | <b>3.0</b> | <b>3.2</b> | <b>3.2</b> | <b>2.5</b>  | <b>2.7</b> | <b>3.0</b> |
| Real Disp. Income (2012 Billions \$)       | 14220       | 14310       | 14404      | 14495      | 14585      | 14673      | 14764      | 14852      | 13949       | 14357      | 14719      |
| <b>Percent Change Annualized</b>           | <b>4.4</b>  | <b>2.6</b>  | <b>2.7</b> | <b>2.6</b> | <b>2.5</b> | <b>2.4</b> | <b>2.5</b> | <b>2.4</b> | <b>2.6</b>  | <b>2.9</b> | <b>2.5</b> |
| Personal Saving Rate (Percent)             | 7.2         | 6.8         | 6.8        | 6.8        | 6.8        | 6.8        | 6.8        | 6.8        | 6.7         | 6.9        | 6.8        |
| <b>Housing</b>                             |             |             |            |            |            |            |            |            |             |            |            |
| Housing Starts (Ths., Ann. Rate)           | 1317        | 1262        | 1261       | 1271       | 1280       | 1285       | 1290       | 1293       | 1208        | 1278       | 1287       |
| Exst. SF Home Sales (Ths., Ann Rate)       | 4903        | 4797        | 4731       | 4739       | 4752       | 4758       | 4758       | 4761       | 4910        | 4793       | 4757       |
| New SF Home Sales (Ths., Ann Rate)         | 656         | 646         | 646        | 648        | 650        | 650        | 651        | 651        | 616         | 649        | 650        |
| Case/Shiller HPI (Jan. 2000=100)           | 199.8       | 201.9       | 204.1      | 206.6      | 209.0      | 211.4      | 213.9      | 216.4      | 191.6       | 203.1      | 212.7      |
| <b>Year/Year Percent Change</b>            | <b>6.4</b>  | <b>6.4</b>  | <b>6.0</b> | <b>5.2</b> | <b>4.6</b> | <b>4.7</b> | <b>4.8</b> | <b>4.8</b> | <b>5.8</b>  | <b>6.0</b> | <b>4.7</b> |
| <b>Consumer</b>                            |             |             |            |            |            |            |            |            |             |            |            |
| Household Economic Stress Index            | 0.0         | 0.2         | 0.5        | 1.0        | 1.3        | 1.3        | 1.1        | 1.0        | 0.6         | 0.4        | 1.2        |
| Auto Sales (Millions)                      | 17.2        | 17.1        | 16.9       | 16.7       | 16.5       | 16.3       | 16.1       | 16.0       | 17.2        | 17.0       | 16.2       |
| <b>Interest Rates (Percent)</b>            |             |             |            |            |            |            |            |            |             |            |            |
| Federal Funds Rate (Effective)             | 1.45        | 1.74        | 1.96       | 2.19       | 2.45       | 2.69       | 2.94       | 3.13       | 1.00        | 1.83       | 2.80       |
| Prime Rate                                 | 4.53        | 4.80        | 5.06       | 5.29       | 5.55       | 5.79       | 6.04       | 6.23       | 4.10        | 4.92       | 5.90       |
| 1-Month LIBOR                              | 1.65        | 1.97        | 2.15       | 2.36       | 2.62       | 2.86       | 3.11       | 3.30       | 1.11        | 2.03       | 2.97       |
| 3-Month LIBOR                              | 1.93        | 2.34        | 2.40       | 2.55       | 2.74       | 2.94       | 3.17       | 3.35       | 1.26        | 2.31       | 3.05       |
| 1-Yr. Treasury Rate                        | 1.94        | 2.25        | 2.48       | 2.60       | 2.75       | 2.93       | 3.14       | 3.31       | 1.20        | 2.32       | 3.03       |
| 5-Yr. Treasury Rate                        | 2.54        | 2.77        | 2.85       | 2.94       | 3.10       | 3.29       | 3.52       | 3.70       | 1.91        | 2.77       | 3.40       |
| 10-Yr. Treasury Rate                       | 2.76        | 2.92        | 2.97       | 3.05       | 3.21       | 3.40       | 3.63       | 3.81       | 2.33        | 2.92       | 3.51       |
| 30-Yr. Fixed Rate Mortgage                 | 4.27        | 4.54        | 4.62       | 4.71       | 4.88       | 5.06       | 5.28       | 5.46       | 3.99        | 4.53       | 5.17       |

a = actual f = forecast

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