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FOR IMMEDIATE RELEASE
May 15, 2018

2018 MIDYEAR NATIONAL AND COMMONWEALTH FORECAST

U.S. and Virginia Economic Growth Projected to Improve in the 2nd Half of 2018

Norfolk, VA, May 15, 2018 – The Economic Forecasting Project of the Dragas Center for Economic Analysis and Policy projects that the U.S. economy will accelerate in 2018 due to the short-term impact of the Tax Cuts and Jobs Act, increases in federal discretionary spending, continuing improvements in business and consumer confidence, and strong global demand. The Commonwealth of Virginia's annual real Gross Domestic Product (GDP) growth rate will also increase in 2018 relative to 2017. With the passage of the Bipartisan Budget Act of 2018, we project that Virginia's economic growth will surge in the second half of 2018. We do not forecast a recession in 2018 but are increasingly concerned about a steeply rising federal deficit, high price-earnings ratios in the stock market, and the return of wage and price inflation.

The U.S. economy 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% real GDP growth 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 2.9% but this was still the highest 4th quarter rate of economic growth since 2013.

The current economic expansion is now in its 106th month, tying the second longest expansion (February 1961 to December 1969) since the end of World War II. April 2018 was the 91st consecutive month of jobs growth, the longest job expansion on record. There is a distinct possibility that the U.S. will exceed the current record expansion of 120 months (March 1991 to March 2001) in 2019.

We forecast that U.S. real GDP will increase at an annual rate of 3.1% in 2018 and that Virginia real GDP will increase at an annual rate of 2.7% in 2018.

In January 2018, we forecast that Virginia's economy would grow 2.2% in 2018. The improvement in our forecast is due to the projected impact of increased federal spending in 2018 and 2019.

Labor market conditions continue to improve in the United States and Virginia. The U.S. has added 18.7 million jobs since the trough of the Great Recession in February 2010 and Virginia has added 391,100 jobs over the same period. There are now 7.2% more jobs in the U.S. than there were at peak employment prior to the Great Recession. Virginia has generated 5.2% more jobs over the same period. The number of unemployed individuals per job opening fell to 1.01 in March 2018 for the U.S., signaling the challenge facing employers to fill open positions.

Unemployment rates continue to fall in the United States and Virginia, though the gap has narrowed since 2010. In April 2018, the U.S. employment rate fell to 3.9%. In March 2018, the Virginia unemployment rate declined to 3.4%. Both the U.S. and Virginia economies are below what is typically considered 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 8.3% for the U.S. and 7.6% for Virginia at the end of 1st quarter of 2018. 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 1.6% 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. Both the size of the labor force and employment have rebounded in February and March of 2018. Part of the underwhelming performance of the Virginia economy in the 2nd half of 2017 can be attributed to political uncertainty.

Overall, the labor market in the U.S. reflect the increasing competition for scarce workers. Job quits continue to increase in 2018 as workers seek out improved wages and salaries. We have already observed numerous wage and salary increases by large firms and anecdotal evidence suggests shortages of skilled trades workers. We forecast that employment growth will continue in 2018, although not at a sufficient pace to moderate pressure on wages and salaries.

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., 69.2% of men and 56.7% of women participated in the labor force in April 2018 for an overall rate of 62.8%, 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 65.1% in March 2018. 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 3.6% at the end of 2018 while Virginia's unemployment rate is forecast at 3.0%.

We project modest growth in civilian jobs in 2018. U.S. job growth is projected to average 1.2% while Virginia's job growth is forecast to average 1.5%.

Private sector profitability continues to outperform its historical average at the national level. Corporate profits as a percentage of GDP were 8.5% at the end of 2017, well above the historical average of 6.5%. The business tax changes in the Tax Cuts and Jobs Act of 2017 are improving corporate profitability in 2018. Firms are taking advantage of the immediate expensing provisions to increase capital investments and larger firms are repatriating retained earnings from overseas. As these earnings are fungible, our expectation that corporations would increase share buybacks in 2018 has proven to be correct. Increasing profits and buybacks are likely to bolster equities prices throughout 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. The Bipartisan Budget Agreement of 2018 increased discretionary federal spending well above our expectations in January 2018. The additional $300 billion in discretionary spending will undoubtedly positively impact the Commonwealth's economy.

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 2019 and beyond.

First, we project the federal deficit will exceed $800 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. The additional expenditures as the result of the Bipartisan Budget Act of 2018 will also add $300 billion in unfunded additional spending in FY 18 and FY 19. Coupled with other increases due to natural disasters, Congress and the President have increased the 10-year deficit by at least $2 trillion since December 2017. We project a return to $1 trillion deficits in FY 2019 and a rapid increase in interest expenditures on the debt over the next decade.

Second, while the recent increases in equities markets have created over $6 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 in late 2017 exceeded those observed prior to the Great Depression in 1929 and remain above the historical average. The market contraction in early 2018 lowered price-to-earnings ratios but markets appear to be recovering on positive economic news. While price-to-earnings ratios have not yet approached the historical high, equities markets are due for a correction if adverse information becomes available.

Third, given tightening labor market conditions and an improving global economy, input prices will rise in 2018, spurring increases in inflation. We expect the Federal Reserve Bank will increase the federal funds rate by at least 50 more basis points in 2018. If significant inflation does occur due to expansionary fiscal policy, then the Federal Reserve will 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. A significant shock, to include a substantial partial shutdown in the Fall of 2018 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.

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 possibility in 2019, subject to the usual caveats of economic and political shocks.

2017 Forecasts, Actuals, and 2018 Forecast

	2017 Forecast	2017 Actual	January 2018 Forecast	May 2018 Forecast
U.S. Real GDP Growth	2.2%	2.3%	3.0%	3.1%
Civilian Job Growth	1.5%	1.2%	1.1%	1.2%
Unemployment Rate	4.7%	4.1%	3.8%	3.6%
Consumer Price Index	2.8%	2.2%	2.9%	3.0%
Core CPI	2.4%	1.7%	2.2%	2.1%
30-Year Conventional Mortgage	4.3%	4.0%	5.0%	5.0%
Federal Deficit	---	-$655 Billion	$-850 Billion	$-825 Billion
Virginia Real GDP	1.5%	2.0%	2.5%	2.7%
Virginia Job Growth	---	1.4%	1.3%	1.5%

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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.