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## US: Dollar drag

- On the back of weak manufacturing and international trade data, second-half 2015 real GDP growth is poised to rise by less than 2% as current-quarter output is projected to increase just 1.5%. This would result in 2015 growth of 2.0% (Q4/Q4), slightly below the 2.2% average annualized gain in economic output since the economy exited recession more than six years ago. More importantly, we expect 2016 real GDP growth to come in at only 2.2% (Q4/Q4), down 50 basis points from our previous estimate. This is due to a reassessment of the negative effects of the rising dollar and the possibility of further appreciation yet to come.
- Nevertheless, with real potential GDP growth only around 1% due to slowing productivity growth, even a trend-like 2% GDP growth rate would likely be enough to put further downward pressure on the unemployment rate. Consequently, this should keep the Fed on track to raise interest rates, albeit at a very modest pace, as policymakers gain confidence that a tightening labor market will engender faster wage gains and a cyclical firming of inflation toward their 2% long-term goal.
- The US factory sector is bearing the brunt of depressed global demand. The manufacturing ISM survey is in contraction territory, and the industrial production index is down from its cyclical peak in December 2014. Given that changes in the trade-weighted dollar tend to affect net exports with a substantial lag, the economy has yet to experience the full impact of the appreciating dollar. If the trade-weighted dollar remains at its current level or appreciates further, net exports could pose a more significant drag on US economic activity.
- Based on the appreciation to date, we estimate the rise in the dollar is worth roughly 60 basis points of monetary tightening. The fact that the currency is doing some of the Fed's work for it is one reason why we expect the trajectory of interest rates to be mildly shallower than that implied by the FOMC's central-tendency forecasts. The strong dollar will also weigh on import prices, and hence consumer goods inflation. To be sure, there is a risk that the US dollar will rise substantially further because the Fed is the only major central bank that is beginning to remove monetary accommodation. Other central banks, notably the ECB, are further easing monetary policy. Furthermore, the US factory sector is being hamstrung by a mini-inventory cycle that is also depressing output. This destocking will likely end next quarter. In the interim, the consumer looks set to continue to do the heavy lifting with respect to growth, but we expect spending to modestly slow over the course of next year because of the waning impact of the energy tax cut, a substantial portion of which appears to have been saved.
- Additionally, we see only modest scope for non-residential investment to fill the void, as the uncertainty around global growth prospects and the outcome of the US Presidential Election may keep companies in a wait-and-see mode with respect to capital spending plans. While the drag from energy-related capital spending should dissipate in the coming quarters, it is not likely that we will see a meaningful boost to output growth from non-residential investment over the next several quarters.