Business Cycle Update

What It Would Take for U.S. Economy to Grow at 4% Rate

Long-term economic growth likely to remain slower than history; short-term increase possible under certain scenarios

Dirk Hofschire, CFA | Senior Vice President, Asset Allocation Research
Lisa Emsbo-Mattingly | Director of Asset Allocation Research
Irina Tytell, PhD | Senior Research Analyst, Asset Allocation Research
Austin Litvak | Senior Analyst, Asset Allocation Research

Key Takeaways

- The new presidential administration has a stated goal of boosting real (inflation-adjusted) U.S. growth to 4%, a much higher rate than has been experienced in recent decades.
- Achieving 4% growth over the long term appears extremely challenging, given the current U.S. demographic outlook.
- A shorter-term growth acceleration is possible, although it would likely require a healthy dose of fiscal stimulus (and deficit expansion).
- The potential upside from more simulative fiscal policies may be constrained by the maturing—although still healthy—nature of the U.S. business cycle.
- We continue to favor global equities, though smaller asset allocation tilts are warranted due to the advanced stage of the U.S. business cycle, fuller valuations for riskier assets, the potentially wide distribution of policy outcomes, and rising geopolitical risk.

The pace of real (inflation-adjusted) economic growth in the United States has slowed structurally in recent decades, and the new presidential administration has stated a goal of boosting growth to a much higher 4% rate. This article investigates how the secular and cyclical backdrops may affect the ability of the United States to achieve a higher growth rate.

Long-term U.S. growth is likely to be much slower than history

Over long periods of time, the pace of real GDP growth in an economy can be approximated by the sum of two things: labor-force growth (new workers added to the economy) and productivity growth (increased production from those workers). As seen in Exhibit 1, both U.S. labor-force and productivity growth peaked decades ago and have slowed since. Since 1996, the labor force has grown roughly 1% a year, while productivity has increased about 1.5%, resulting in real GDP that has averaged just below 2.5% for the past two decades.

Going forward, our long-term projection is for both labor-force and productivity growth to continue to slow. Much of this is due to the continued aging of the U.S. population. Having fewer young job entrants implies slower labor-force growth, and aging societies

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may also experience lower innovation, risk-taking, and human-capital investments that weigh on productivity growth rates. As a result, we anticipate labor-force growth slowing to a mere 0.5% a year going forward, and productivity growth falling to 1.1%, resulting in real-GDP growth averaging just 1.6% long term. (For more details on our outlook, see Fidelity Leadership Series article "Secular Outlook for Global Growth 2016-2035.")

What would it take to reach 4% real-GDP growth over the long term?

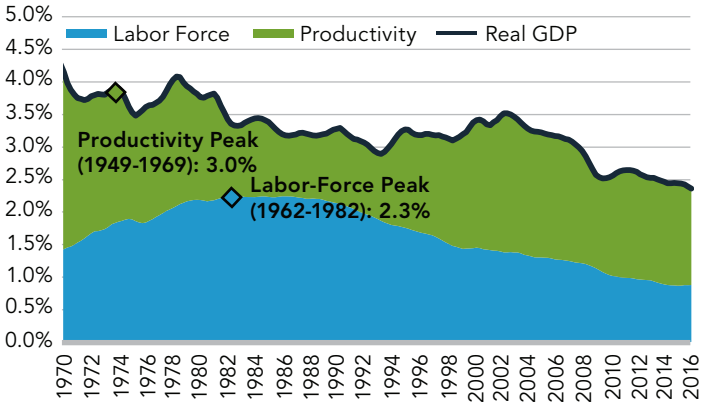
If the demographic outlook for the United States doesn't change materially, achieving 4% real GDP growth on a secular basis would require worker productivity rates reaccelerating back to peak levels of 3% per year. This rate of productivity growth has not been seen in major developed economies for nearly 50 years, and was only sustained in the United States in the aftermath of World War II when the nation converted from a military-industrial-based economy to a consumer-based one.

Even if 3% productivity was reached, the United States would still need to generate higher participation from its working-age population. The participation rate—or the share of people in a working-age population who are actively employed or seeking employment—has experienced a multi-decade decline, dropping to 63% from its peak of 67% in the early 2000s (see chart, Exhibit 2). The fall is due to a rising share of retirees and a structural decline in participation of prime-age men (25-54) and young workers (see table, Exhibit 2). To get just 1% labor-force growth (needed to achieve 4% growth assuming 3% productivity), the overall participation rate would need to rise back to 65%—the equivalent of 25 million workers re-entering the labor force. This dynamic is unlikely, as it would not only require the participation rates of prime-age men and young workers rising back

EXHIBIT 1: Four-percent GDP growth is not likely over the long run.

Real GDP Growth Components

Year-over-Year Growth (20-Year Average)

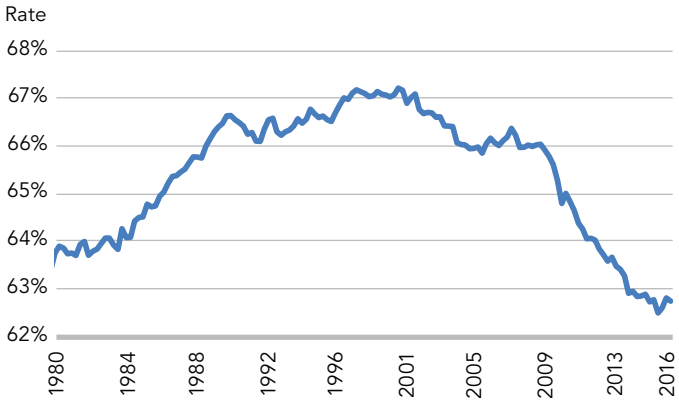


	Scenarios for 4% Growth		20-Year AART Projections
Labor-Force Growth	2.3%	1.0%	0.5%
Labor-Market Productivity	1.7%	3.0%	1.1%
Real GDP Growth	4.0%	4.0%	1.6%

Source: Bureau of Economic Analysis, Bureau of Labor Statistics, Haver Analytics, Fidelity Investments (AART), as of Sep. 30, 2016.

EXHIBIT 2: A reversal of the decline in the participation rate is an extremely challenging proposition.

Labor-Force Participation Rate (16 Years and Older)



Labor force participation rate component	Historical Peak	4Q 2016
Men (25-64)	98%	89%
Young Workers (16-24)	73%	54%

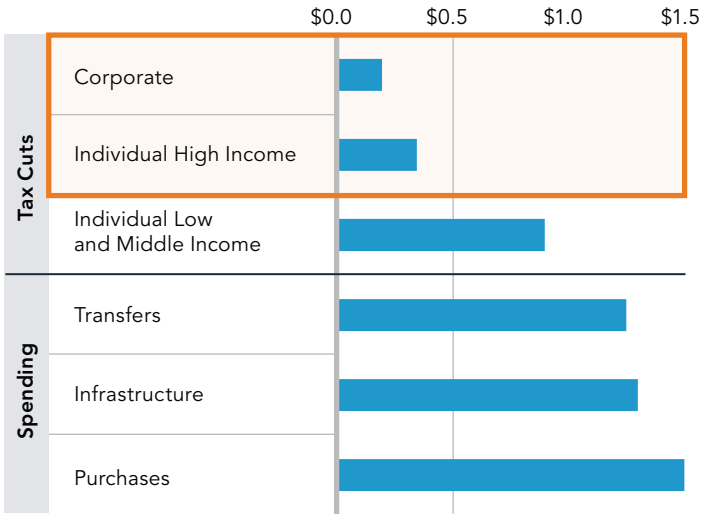
Source: Bureau of Labor Statistics, Haver Analytics, Fidelity Investments (AART), as of Dec. 31, 2016.

to their previous peaks, but also the participation rate of retiree-aged workers to stay at record levels.

Another way U.S. growth could accelerate to a higher rate would be if demographic trends reversed in the United States. This would require an explosion in population growth similar to what was experienced when the baby boomers entered the labor force en masse in the early 1980s, which pushed labor-force growth to a peak of 2.3% per year. Given that the U.S. workers that will enter the labor force over the next two decades have already been born, the only way to achieve this magnitude of reacceleration would be a surge in immigration. Such a policy change to dramatically increase the flow of foreign workers into the U.S. economy seems highly unlikely in the current political environment. Even if it did happen, productivity growth would need to reaccelerate substantially as well. In other words, all of these constraints make a long-term move to a much higher level of real-GDP growth an extremely challenging proposition.

EXHIBIT 3: Historically, corporate tax cuts have provided less economic growth benefit than new spending.

Economic Impact from $1 of Fiscal Stimulus by Policy Category



Source: Congressional Budget Office, Fidelity Investments (AART), as of Feb. 28, 2015.

Any cyclical boost in growth could be tempered by low multipliers

On a cyclical basis, changes in economic policy always have the potential to create sharper, shorter-term swings in growth. The lighter regulatory tone set by the new administration has already boosted small business and corporate sentiment, which has the potential to unleash business investment. However, even if deregulatory action overrides any anti-growth uncertainty about more restrictive trade or immigration policies, a jump from today's roughly 2% growth to a sustained 4% would likely require a healthy dose of fiscal stimulus.

For the new leadership in Washington, stimulative tax-cut and infrastructure spending policies have been part of the early discussion. However, the impact of any fiscal stimulus may be inhibited by potentially low multipliers (i.e., how much growth is generated by easier fiscal policy). First, multipliers tend to be highest (the biggest growth bang for the fiscal buck) when the fiscal mix is more heavily weighted toward new spending, such as infrastructure. Tax cuts, especially for entities such as corporations and high-income individuals that may not spend the money immediately, tend to have lower cyclical multipliers (see Exhibit 3). While the policy outlook is highly uncertain and can change at any time, the early Republican plans have placed a heavier emphasis on corporate tax cuts and appear to give less priority to new spending.

Second, fiscal multipliers tend to be higher when the economy is running below its potential rate of growth and the Federal Reserve does not respond with tighter monetary policy. These conditions are most consistent with an early-cycle dynamic. This implies that fiscal stimulus boosts growth the most when the economy exits

recession, as there is high unemployment and excess capacity, and the Federal Reserve is holding interest rates at a low level. More than seven years since the end of the last recession, the economy does not generally exhibit these early-cycle characteristics, meaning a lower fiscal multiplier might be expected (see Exhibit 4).

U.S. economy is in solid shape, but in the later stages of its business cycle

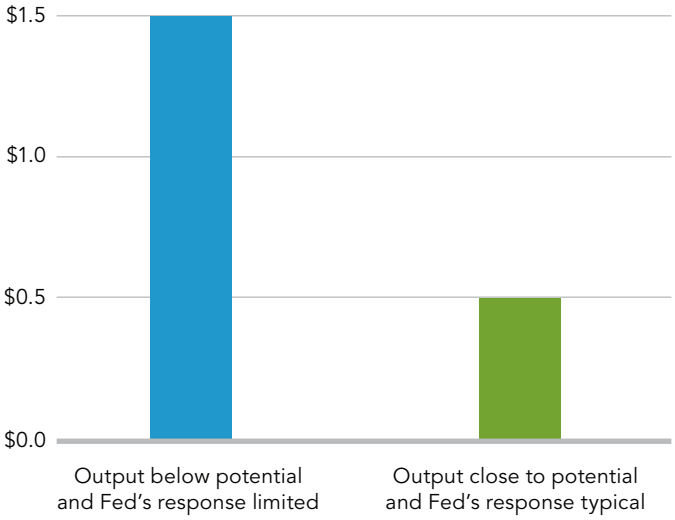
U.S. cyclical trends are defined by two major dynamics. First, the economy is experiencing a healthy expansion on the back of solid labor markets and consumer spending. Second, the economy exhibits elements of a more mature phase (mid to late) of the U.S. business cycle, without the broad-based slack in labor and credit markets that typically drive sharp early-cycle accelerations in growth. As a result, there is near-term upside potential if pro-growth policies are implemented, but a sustained acceleration may be difficult due to the constraints presented by the more mature U.S. business cycle.

Consider the following factors:

- **Labor markets are tight.** The unemployment rate has recovered to pre-recession lows, and wage growth continues to pick up (see Exhibit 5). Payroll growth has remained healthy but decelerated, and all of these trends are consistent with historical late-cycle dynamics. Tighter labor markets provide a solid backdrop for the U.S. consumer and continued overall expansion, but faster GDP growth would likely result in higher wage pressures.
- **Monetary and credit conditions are no longer easing.** Rising inflation—headline inflation heading toward 3% and core inflation (excluding food and energy) remaining firmly above 2%—has firmed market

EXHIBIT 4: Economic benefits from fiscal stimulus tend to be larger when there is more slack in the economy.

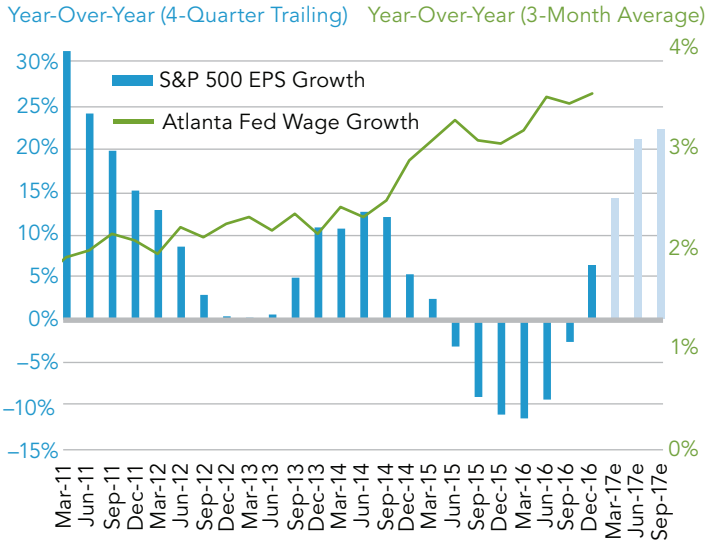
Analysis of the Impact of a $1 Boost from Fiscal Stimulus over Two Years



Source: Congressional Budget Office, Fidelity Investments (AART), as of Feb. 28, 2015.

EXHIBIT 5: Corporate profits have recovered but rising wage costs may cap the upside.

Corporate Earnings vs. Wage Growth



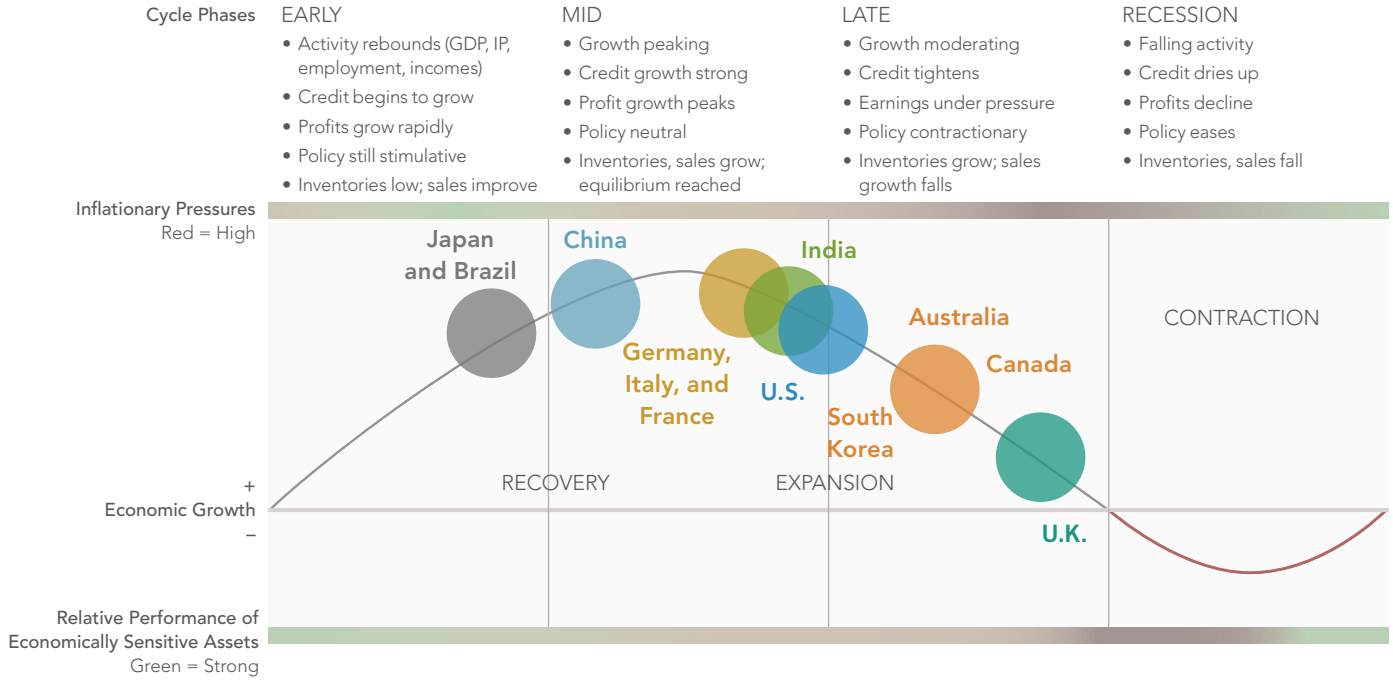
December 2016 earnings captures 407 out of 500 companies. e=estimate. Source: Standard & Poor's, Federal Reserve Bank of Atlanta, Fidelity Investments (AART), as of Feb. 16, 2017.

expectations that the Federal Reserve will hike its policy rate at least two more times in 2017. As is typical during a maturing cycle, the expectation for higher policy rates has tightened credit conditions in several business and consumer categories, including business loans, auto loans, and credit cards. Current credit and monetary conditions support continued expansion, but if growth and inflation accelerate, monetary and credit-standard tightening are likely to act as a counterweight.

- **Business sector experiencing a mix of various trends.** Some U.S. businesses are experiencing a growth revival, with the global economic recovery boosting areas such as manufacturing and supporting a recovery in profit growth (Exhibit 5). However, businesses in the aggregate also face a more mature cycle phase due to rising profit margin pressures from accelerating wages, rising interest expense, and a stronger dollar. The corporate sector is supported by the global industrial recovery and optimism about policy changes, but tightening labor and monetary conditions make an early-cycle-type reacceleration in profits unlikely.

Pro-growth policies could temporarily create some acceleration in U.S. economic growth, but the relatively mature phase of the cycle implies that higher growth and inflation would likely create a faster move toward a full late-cycle phase (see Exhibit 6, Business Cycle Framework).

EXHIBIT 6: The world's largest economies are in expansion, though at various phases of the business cycle.
Business Cycle Framework



Note: The diagram above is a hypothetical illustration of the business cycle. There is not always a chronological, linear progression among the phases of the business cycle, and there have been cycles when the economy has skipped a phase or retraced an earlier one. Please see endnotes for a complete discussion. Source: Fidelity Investments (AART).

A closer look at business cycles around the world

China

The Chinese economy remains in cyclical expansion, but policymakers have begun to rein in monetary and credit stimulus. Industrial activity reaccelerated to multi-year highs, and manufacturing Purchasing Managers' Indexes (PMIs) continue to support the near-term outlook. However, the upside to overall economic growth may be limited, as policymakers have moved away from an easing stance by allowing interbank rates to rise, and reining in their support of the property market. Additionally, inflation has begun to pick up, which may further limit policy accommodation. **Less accommodative policy, in addition to continued excess credit and capacity, will serve to constrain China's cyclical growth upside.**

Europe

The Euro Area remains in a mature mid-cycle phase. Manufacturing PMIs indicate that Europe's industrial sectors are continuing to reaccelerate, benefiting from the recovery in global trade and Asian growth. However, the European political environment poses risks, as uncertainty surrounding upcoming core-country elections could weigh on consumer and corporate sentiment. **There are risks stemming from the European political environment, but overall, Europe's cyclical expansion remains steady.**

Global Summary

After a reacceleration supported by a global industrial recovery, the global economy continues to gain traction and show signs of a synchronized expansion. Seventy percent of countries' leading economic indicators are rising on a six-month basis, compared to just 45% a year ago. Emerging markets as a whole have improved off a low base, with corporate profit growth now rising for the group for the first time since 2014. Export-oriented countries, such as South Korea, Taiwan, and Japan, have showed notable improvement, with inventory-to-shipment ratios in these countries moving toward benign levels, as sales outpace inventory growth. Commodity-exporting countries, such as Canada and Australia, also have improved due to recovering commodity prices, although they are farther along in their cycles. **The global economy is showing signs of synchronized reacceleration and reflation.**

Asset allocation implications

Potential changes in U.S. economic policies continue to be a key focus for the financial markets. Some progress on regulatory relief has helped boost business optimism, but legislative plans for tax reform and other measures continue to lack clarity and may take some time to pan out. In this environment, the synchronized global expansion provides a solid growth backdrop for riskier assets. However, the potential upside from more stimulative U.S. fiscal policies may be constrained by the mature nature of the U.S. business cycle.

From an asset allocation standpoint, we continue to favor global equities. However, smaller asset allocation tilts are warranted due to the advanced stage of the U.S. business cycle, fuller valuations for many riskier assets such as U.S. equities, the wide distribution of potential policy outcomes, and rising geopolitical risk. As the United States proceeds toward the late-cycle phase, exposure to inflation-resistant assets may become even more valuable to provide portfolio diversification.

Authors

Dirk Hofschire, CFA | Senior Vice President, Asset Allocation Research

Lisa Emsbo-Mattingly | Director of Asset Allocation Research

Irina Tytell PhD | Senior Research Analyst, Asset Allocation Research

Austin Litvak | Senior Analyst, Asset Allocation Research

The Asset Allocation Research Team (AART) conducts economic, fundamental, and quantitative research to develop asset allocation recommendations for Fidelity's portfolio managers and investment teams. AART is responsible for analyzing and synthesizing investment perspectives across Fidelity's asset management unit to generate insights on macroeconomic and financial market trends and their implications for asset allocation.

Asset Allocation Research Team (AART) Research Analyst Joshua Wilde, CFA; Senior Analyst Jacob Weinstein, CFA; Research Analyst Jordan Alexiev, CFA, and Analyst Cait Dourney also contributed to this article. Fidelity Thought Leadership Vice President Kevin Lavelle provided editorial direction.

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Fixed-income securities carry inflation, credit, and default risks for both issuers and counterparties.

Although bonds generally present less short-term risk and volatility than stocks, bonds do contain interest rate risk (as interest rates rise, bond prices usually fall, and vice versa) and the risk of default, or the risk that an issuer will be unable to make income or principal payments. Additionally, bonds and short-term investments entail greater inflation risk—or the risk that the return of an investment will not keep up with increases in the prices of goods and services—than stocks. Increases in real interest rates can cause the price of inflation-protected debt securities to decrease.

Stock markets, especially non-U.S. markets, are volatile and can decline significantly in response to adverse issuer, political, regulatory, market, or economic developments. Foreign securities are subject to interest rate, currency exchange rate, economic, and political risks, all of which are magnified in emerging markets.

Investing involves risk, including risk of loss.

Past performance is no guarantee of future results.

Diversification and asset allocation do not ensure a profit or guarantee against loss.

All indices are unmanaged. You cannot invest directly in an index.

Increases in real interest rates can cause the price of inflation-protected debt securities to decrease.

The commodities industries can be significantly affected by commodity prices, world events, import controls, worldwide competition, government regulations, and economic conditions.

The Business Cycle Framework depicts the general pattern of economic cycles throughout history, though each cycle is different; specific commentary on the current stage is provided in the main body of the text. In general, the typical business cycle demonstrates the following:

During the typical early-cycle phase, the economy bottoms out and picks up steam until it exits recession then begins the recovery as activity accelerates. Inflationary pressures are typically low, monetary policy is accommodative, and the yield curve is steep. Economically sensitive asset classes such as stocks tend to experience their best performance of the cycle.

During the typical mid-cycle phase, the economy exits recovery and enters into expansion, characterized by broader and more self-sustaining economic momentum but a more moderate pace of growth. Inflationary pressures typically begin to rise, monetary policy becomes tighter, and the yield curve experiences some flattening. Economically sensitive asset classes tend to continue benefiting from a growing economy, but their relative advantage narrows.

During the typical late-cycle phase, the economic expansion matures, inflationary pressures continue to rise, and the yield curve may eventually become flat or inverted. Eventually, the economy contracts and enters recession, with monetary policy shifting from tightening to easing. Less economically sensitive asset categories tend to hold up better, particularly right before and upon entering recession.

Index definitions

A Purchasing Managers' Index (PMI®) is a survey of purchasing managers in a certain economic sector. A PMI over 50 represents expansion of the sector compared to the previous month, while a reading under 50 represents a contraction, and a reading of 50 indicates no change. The Institute for Supply Management® reports the U.S. manufacturing PMI®. Markit compiles non-U.S. PMIs. The Consumer Price Index (CPI) is a monthly inflation indicator that measures the change in the cost of a fixed basket of products and services, including housing, electricity, food, and transportation. The S&P 500® Index is a market capitalization-weighted index of 500 common stocks chosen for market size, liquidity, and industry group representation to represent U.S. equity performance. S&P 500 is a registered service mark of The McGraw-Hill Companies, Inc., and has been licensed for use by Fidelity Distributors Corporation and its affiliates.

GDP: gross domestic product.

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