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Economic Research

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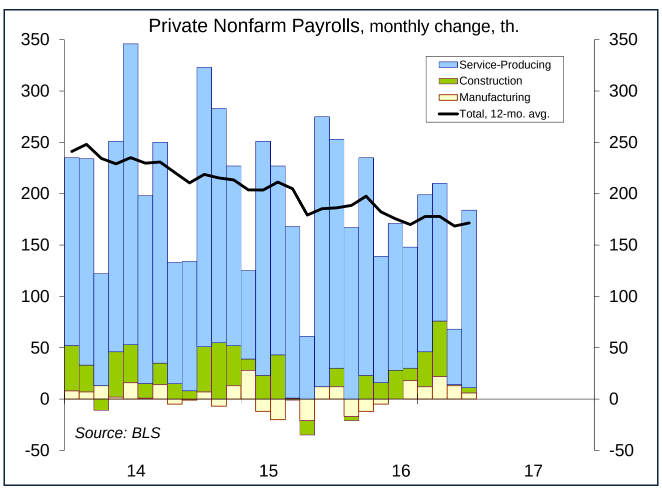
Economic Trends

Renewed Hope, But Will It Be More of the Same?

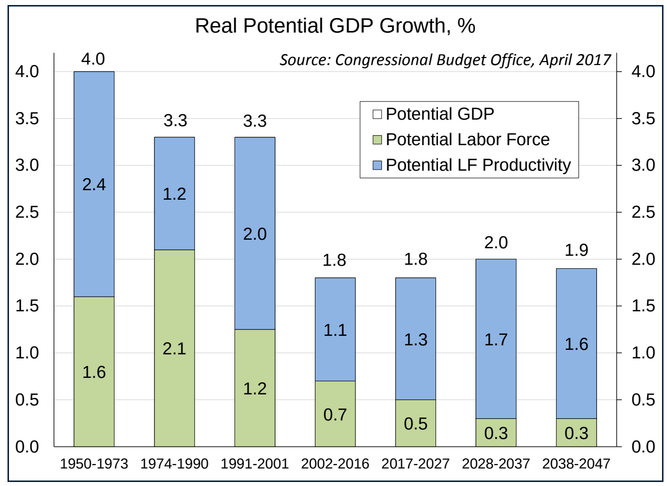
- *Recent economic data have been consistent with moderate growth over the near term (following a soft 1Q17).*
- *The Federal Reserve, focused on the job market and the inflation outlook, is gradually normalizing monetary policy and will likely end the reinvestment policy later this year.*
- *The widely anticipated Trump tax "plan" was a one-page, detail-free repeat of what was proposed six months earlier – and will likely face an uphill battle in Congress. Nevertheless, stock market participants remain enthusiastic.*

Real GDP rose at a 0.7% annual rate in the advance estimate for 1Q17. That figure will be revised, but the story is not expected to change much. Real consumer spending rose at a 0.3% annual rate, following a strong 3.5% pace in 4Q16. Business fixed investment rose at a 9.4% pace, vs. 0.9% in the fourth quarter, reflecting the improved business outlook. Residential homebuilding continued to advance and was likely helped by mild weather. Slower inventory growth subtracted 0.9 percentage point from headline GDP growth and we should see at least a partial rebound in 2Q17.



Job growth was uneven in March and April, consistent with the normal month-to-month noise. Private-sector payrolls averaged a 164,000 monthly gain over the last three months, a bit slower than the 170,000 average for 2016 (vs. +213,000 in 2015 and +239,000 in 2014). Slower job growth is a function of tighter labor market conditions. As the job market tightens further, and remaining slack is taken up, job growth should eventually slow to a more sustainable pace (about 100,000 jobs per month is consistent with population growth). The unemployment rate fell to 4.4% in April, the lowest since March 2007. The broad U-6 measure fell to 8.6%, vs. 8.0% in March and 9.7% a year ago. Average hourly earnings rose 0.3% in April up a moderate 2.5% from a year ago.

With labor force growth certain to remain slower than in previous decades (and likely to be restrained even further if we limit immigration), real GDP growth will also be slower – that is, unless we see a sharp pickup in productivity growth. Technology could be a positive factor in boosting productivity. Capital spending in labor-saving equipment is already happening in a variety of fields – and has been a major force behind factory-sector job losses over the last two decades.

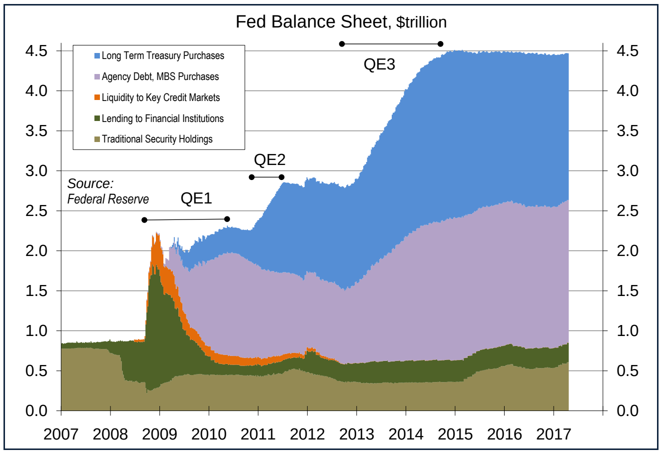


Tighter job markets normally result in faster wage growth, which should lead firms to allocate labor more efficiently (hence, lifting productivity growth). Wage growth has picked up over the last couple of years, but the pace remains moderate. More moderate wage growth (compared to previous periods when the unemployment rate was low) could reflect less bargaining power (much lower union membership than in past decades and a greater concentration of firms).

The labor market is the primary reason that the Fed seeks to normalize monetary policy. The inflation outlook, the other key factor in policy decisions, remains moderate (following some signs of a pickup at the start of the year). Hence, the Fed should be able to continue its gradual pace of rate increases. Of course, policy is not on a predetermined path. The Fed could move a little faster or slower depending on the data. At this point, a June 14 rate increase appears more likely than not.

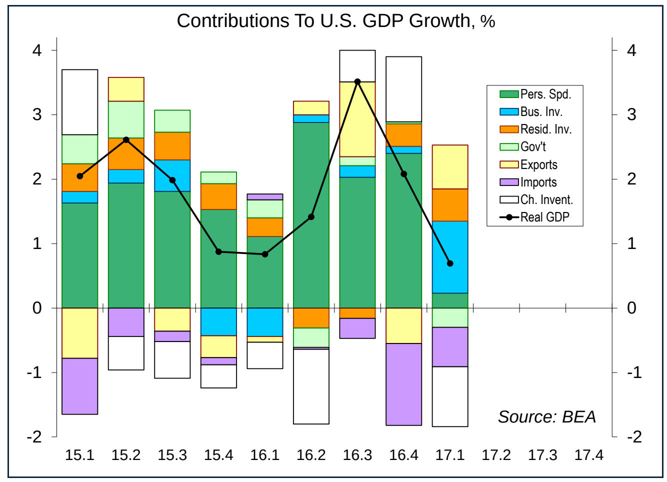
During its Large-Scale Asset Purchase programs (QE1, QE2, QE3), the Federal Reserve increased the size of its balance sheet by about $3.6 trillion. Even before starting its asset purchases, the Fed was working out how it would unwind them. Officials have been considering when to start that unwinding. The Fed has been reinvesting proceeds from maturing securities in its portfolio. This keeps the size of the balance sheet steady. When the Fed ends this reinvestment policy, the size of the balance sheet will decrease naturally over time, a process that will likely take 10 years or more.

There are some technical issues for the Fed in ending the reinvestment policy. The Fed is not planning to sell its holdings of long-term Treasuries and mortgage-backed securities outright. However, to maintain a steady mix of maturities in its portfolio, the Fed is expected to buy and sell securities as it unwinds. None of this should be unsettling for the financial markets, although, all else equal, long-term interest rates should trend gradually higher.



Developments in Washington may have some impact on the markets in the months ahead. Lawmakers reached an agreement that authorizes spending through September, the end of the current fiscal year. Congress did not vote to raise the federal debt ceiling, although Treasury has a workaround that should keep the government funded until autumn (but the debt ceiling will have to be raised at some point). Broad-based tax reform, a priority of Congress and the White House, depends on the repeal and replacement of the Affordable Care Act. While the House has passed its version, the Senate is expected to take its time and will write its own healthcare bill. Broad tax reform, including a reduction in business tax rates and an elimination of most tax deductions, looks doubtful. Note that tax expenditures (the various deductions built into the tax code) totaled about $1.5 trillion in 2016, compared to total tax receipts of $3.3 trillion. Hence, reducing those deductions is seen as a key offset to lowering tax rates. The problem is that various interests will vigorously defend their deductions. That is what makes tax reform so difficult. Note that tax rates could still be cut later this year, but on a much smaller scale than many had hoped for at the start of this year.

The global economy faces some challenges, but the overall outlook has improved. President Trump has sent mixed signals on trade disputes. The rhetoric on China and Mexico has been toned down considerably. However, the administration has since picked a fight with Canada over softwood lumber and apparently came very close to pulling out of NAFTA.



Real GDP growth is likely to rebound in 2Q17, but the underlying trend is expected to remain moderate, reflecting the limitations imposed by a tighter job market. Of course, there are likely to be a number of surprises along the way.

	2Q16	3Q16	4Q16	1Q17	*2Q17*	*3Q17*	*4Q17*	*1Q18*	*2Q18*	*3Q18*	2016	*2017*	*2018*
GDP (↓ *contributions*)	1.4	3.5	2.1	0.7	***3.3***	***2.2***	***2.0***	***2.0***	***2.0***	***2.0***	1.6	***2.1***	***2.1***
consumer durables	0.7	0.8	0.8	-0.2	***0.2***	***0.2***	***0.2***	***0.2***	***0.2***	***0.2***	0.4	***0.3***	***0.2***
nondurables & services	2.2	1.2	1.6	0.4	***1.6***	***1.3***	***1.3***	***1.3***	***1.3***	***1.2***	1.6	***1.2***	***1.3***
bus. fixed investment	0.1	0.2	0.1	1.1	***0.4***	***0.3***	***0.3***	***0.3***	***0.3***	***0.3***	-0.1	***0.5***	***0.3***
residential investment	-0.3	-0.2	0.4	0.5	***0.3***	***0.2***	***0.2***	***0.2***	***0.2***	***0.2***	0.2	***0.3***	***0.2***
Priv Dom Final Purchases	3.2	2.4	3.4	2.2	***3.0***	***2.4***	***2.4***	***2.3***	***2.3***	***2.2***	2.3	***2.7***	***2.3***
government	-0.3	0.1	0.0	-0.3	***0.0***	***0.1***	***0.1***	***0.1***	***0.1***	***0.1***	0.1	***-0.1***	***0.1***
exports	0.2	1.2	-0.6	0.7	***0.4***	***0.4***	***0.4***	***0.4***	***0.4***	***0.4***	0.0	***0.4***	***0.4***
imports	0.0	-0.3	-1.3	-0.6	***-0.5***	***-0.5***	***-0.5***	***-0.5***	***-0.4***	***-0.4***	-0.2	***-0.6***	***-0.5***
Final Sales	2.6	3.0	1.1	1.6	***2.5***	***2.0***	***2.0***	***2.0***	***2.0***	***2.0***	2.0	***2.0***	***2.0***
ch. in bus. inventories	-1.2	0.5	0.0	-0.9	***0.8***	***0.2***	***0.0***	***0.0***	***0.0***	***0.0***	-0.4	***0.1***	***0.1***
Unemployment, %	4.9	4.9	4.7	4.7	***4.5***	***4.4***	***4.3***	***4.3***	***4.3***	***4.4***	4.9	***4.5***	***4.3***
NF Payrolls, monthly, th.	164	239	148	155	***165***	***155***	***145***	***140***	***135***	***130***	187	***160***	***133***
Cons. Price Index (q/q)	2.3	1.8	3.0	3.1	***0.9***	***2.2***	***2.2***	***2.2***	***2.2***	***2.2***	1.3	***2.3***	***2.1***
excl. food & energy	2.1	2.1	2.0	2.5	***1.2***	***2.0***	***2.0***	***2.1***	***2.1***	***2.1***	2.2	***2.0***	***2.0***
PCE Price Index (q/q)	2.0	1.5	2.0	2.4	***1.0***	***2.0***	***2.1***	***2.1***	***2.1***	***2.1***	1.1	***1.8***	***2.0***
excl. food & energy	1.8	1.7	1.3	2.0	***1.1***	***1.9***	***2.0***	***2.0***	***2.0***	***2.0***	1.7	***1.6***	***1.9***
Fed Funds Rate, %	0.37	0.40	0.45	0.70	***0.94***	***1.16***	***1.21***	***1.46***	***1.66***	***1.69***	0.39	***1.00***	***1.68***
3-month T-Bill, (bond-eq.)	0.3	0.3	0.4	0.6	***0.9***	***1.1***	***1.3***	***1.5***	***1.6***	***1.8***	0.3	***1.0***	***1.7***
2-year Treasury Note	0.8	0.7	1.0	1.2	***1.4***	***1.6***	***1.8***	***1.9***	***2.0***	***2.1***	0.8	***1.5***	***2.0***
10-year Treasury Note	1.8	1.6	2.1	2.5	***2.4***	***2.7***	***2.9***	***3.1***	***3.2***	***3.3***	1.8	***2.6***	***3.2***