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Monthly Economic Outlook

The 2018 Economic Outlook

- *The economy appears to be closing out 2017 in good shape. The tax cut bill is likely to add a little to growth in the near term, but is not expected to add much over 10 years.*
- *Corporate tax cuts will boost after-tax earnings, helping to support share prices, but how much is already factored in? The tax bill will also add to the federal budget deficit.*
- *With short-term interest rates close to neutral, personnel changes will add to monetary policy uncertainty in 2018, but the market focus will likely be on the roll back in regulations.*

The U.S. has needed to revamp its tax system for a long time. Over the years, there has been widespread agreement that tax reform should be bipartisan, deficit-neutral, and fair (meaning that people with similar amounts of income should pay about the same amount of taxes). It should simplify the tax code and reduce the distortions that the tax system causes. The Tax Cut and Jobs Act (TCJA) does none of that.

The centerpiece of the bill is a massive cut in the corporate taxes, with the main rate going from 35% to 21%. If a firm is paying that top rate, the reduction will result in a 21.5% increase in after-tax profits (all else equal). Hence, share prices will be higher accordingly. Stocks have rallied significantly over the last year in anticipation of lower corporate tax rates and market sentiment is likely to remain positive in early 2018.

Will the tax bill boost GDP growth? Yes, but the question is by how much. Main stream economic models, such as the Penn-Wharton Budget Model and the model used by the Joint Committee on Taxation expect real GDP growth to be 0.6% to 1.1% higher at the end of 2017. In other words, the bill will add about 0.1 percentage point to GDP growth per year on average. That's not a lot. However, the final bill includes some measures, such as a reduction in marginal tax rates at the upper end of the income scale, that were not included in either the House or Senate versions. Hence, what little stimulus there is in the bill will be frontloaded, adding up to 0.5 percentage point to real GDP growth in 2018.

Proponents of the tax bill suggest that the drop in the corporate tax rate will provide a considerable boost to capital spending. However, there's been nothing preventing business investment in recent years. Borrowing costs have been low. Corporations are sitting on about $2.3 trillion in cash now and a repatriation tax holiday on profits currently held overseas may add another $1 trillion or more. In the past, there has been little correlation between corporate tax rates and business fixed investment. Cuts in corporate taxes tend to show up as share buybacks or dividend increases. Still, capital spending has picked up, in the U.S. and abroad, over the last year.

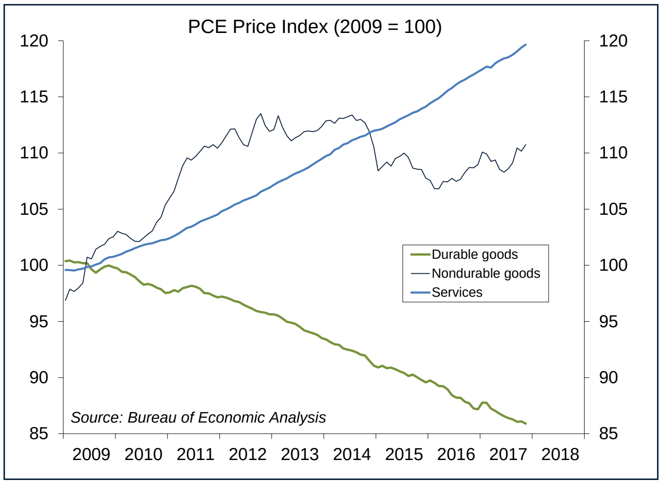
The tax bill is projected to add $1.5 trillion or more to the national debt over the next ten years. As a percentage of nominal GDP, the annual budget deficit has already been trending higher, and is projected to increase more as the baby-boom generation retires and spending on Social Security and Medicare rise. The tax bill ought to add some upward pressure on long-term interest rates, but it's unclear how much (some portion of the increase in corporate cash is likely to find its way to the bond market, preventing yields from rising too rapidly).

With the economy at or near full employment, it's unclear whether the Federal Reserve will work to counter any near-term fiscal stimulus. The transition to new leadership (Jerome "Jay" Powell will take over as chair on February 3) should be smooth. Powell is a lawyer, not an economist, but he has considerable experience in the financial sector and will have good support from the Fed staff. Nevertheless, it's expect that there will be some push to bring in monetary policy expertise among Fed governor appointments (there will be three vacancies after Yellen leaves). While all of the Fed governors and 12 district bank presidents participate at the Federal Open Market Committee meetings, only the governors, the New York Fed president, and four of the other district bank presidents vote on policy. Two district bank presidents formally dissented in favor of keeping rates steady at the December 12-13 FOMC meeting, but they will rotate off the committee in 2018. New York Fed President Dudley has indicated that he will retire around the middle of the year. The change in personnel adds uncertainty to the monetary policy outlook, but the FOMC is expected to be somewhat more hawkish in 2018 – that is, officials will be a bit more likely to raise short-term rates. It's critical that monetary policy decisions be independent and free from politics, but there may be some concern that incoming Fed officials will be beholden to who put them there (in which case, they might be more inclined to keep rates steady).

Chair Yellen's task of normalizing the federal funds target rate is nearly complete. That is, the current target range (1.25% to 1.50%) is not far from neutral. However, as Yellen has noted, the neutral federal funds rate is expected to rise as the economy improves. Hence, while the Fed may be close to neutral now, it can be expected to continue raising short-term interest rates over time. We can be certain that future moves will be gradual and that decisions will be data-dependent.

The increase in monetary uncertainty comes just as the risks of a policy error are rising. The Fed may raise too rapidly or it may not tighten soon enough (risking a potential destabilizing correction later on). Soft landings are hard. The base case scenario (and apparent market consensus) is for two rate hikes in 2018, but it could be anywhere from zero to four.

The PCE Price Index has continued to trend below the Fed's 2% target. As Chair Yellen noted, there have been a number of factors keeping inflation low in recent years, including labor market slack, a strong dollar, and weak commodity prices. These factors are now behind us, but core inflation has continued to trend low, suggesting that something more may be going on. Inflation components have diverged. There is mild deflation in consumer goods, especially durable goods, and moderate inflation in services, dominated by rents (or rental equivalents) and healthcare costs.



In her final year as Fed chair, Janet Yellen removed a major market uncertainty by setting in motion the unwinding of the Fed's balance sheet. The balance sheet run-off will pick up over the course of 2018, but as it hits its full stride later in the year, the pace will be moderate. Long-term interest rates can be expected to drift higher, but gradually. Fed officials have described the balance sheet unwinding as "background" and "not active policy." The federal funds target rate will remain the central bank's main policy tool.

While monetary policy will be important, deregulation will be a key issue for the markets. Principals (note the spelling) matter in Washington and the various financial regulatory agencies (including the Fed) will all have new leadership.

The economy is expected to face increased constrains from the labor market. Labor force growth is projected to be a fraction of what it was a few decades ago (when the baby-boom entered and female labor force participation was on the rise). Tighter immigration isn't going to help. There could be more slack in the labor market than is currently seen. The pace of growth in private-sector nonfarm payrolls in 2017 was the same as it was in 2016, but that was due to a further decline in the unemployment rate (which is expected to edge lower into early 2018). The tighter job market has not generated significant wage pressures, but Fed officials will be watching for signs of that and could tighten accordingly.

Consumer spending growth was uneven in 2017, with weather-related softness in 1Q and 3Q, and rebounds in 2Q and 4Q. Spending appears to have closed out 2017 on a strong note, but has outpaced income growth to some extent (expect more unevenness over the course of 2018). Business sentiment remains strong, which should help support fixed investment. In 3Q17, hurricanes led to a pickup in inventory growth and a narrower trade deficit (inventories and net exports added 1.2 percentage point to 3Q17 GDP growth). These should reverse in 4Q17.

All else equal, the increase in the federal budget deficit will mean an increase in the trade deficit as well, which will subtract from headline GDP growth.

Beyond April, the economic expansion will be the second longest on record. There are few signs of the kind of excesses that would threaten a recession, but as my old man used to say, "Rome wasn't burnt in a day."

	1Q17	2Q17	3Q17	***4Q17***	***1Q18***	***2Q18***	***3Q18***	***4Q18***	***1Q19***	***2Q19***	2016	**2017**	**2018**
GDP (↓ *contributions*)	1.2	3.1	3.2	***2.4***	***2.4***	***2.3***	***1.9***	***1.9***	***1.9***	***1.9***	1.5	***2.2***	***2.4***
consumer durables	0.0	0.6	0.6	***0.3***	***0.3***	***0.3***	***0.3***	***0.3***	***0.3***	***0.2***	0.4	***0.5***	***0.4***
nondurables & services	1.3	1.7	0.9	***1.5***	***1.4***	***1.3***	***1.2***	***1.2***	***1.2***	***1.2***	1.5	***1.4***	***1.3***
bus. fixed investment	0.9	0.8	0.6	***0.7***	***0.6***	***0.5***	***0.4***	***0.4***	***0.4***	***0.4***	-0.1	***0.6***	***0.6***
residential investment	0.4	-0.3	-0.2	***0.4***	***0.2***	***0.2***	***0.1***	***0.1***	***0.1***	***0.1***	0.2	***0.1***	***0.2***
Priv Dom Final Purchases	3.1	3.3	2.2	***3.5***	***3.0***	***2.7***	***2.3***	***2.2***	***2.2***	***2.2***	2.3	***2.9***	***2.8***
government	-0.1	0.0	0.1	***0.1***	***0.1***	***0.1***	***0.1***	***0.1***	***0.1***	***0.1***	0.1	***0.0***	***0.1***
exports	0.9	0.4	0.3	***0.2***	***0.2***	***0.2***	***0.3***	***0.3***	***0.3***	***0.3***	0.0	***0.4***	***0.2***
imports	-0.6	-0.2	0.1	***-0.6***	***-0.6***	***-0.5***	***-0.6***	***-0.5***	***-0.4***	***-0.4***	-0.2	***-0.5***	***-0.5***
Final Sales	2.7	3.0	2.4	***2.7***	***2.2***	***2.1***	***1.8***	***1.8***	***1.9***	***1.9***	1.9	***2.3***	***2.3***
ch. in bus. inventories	-1.5	0.1	0.8	***-0.3***	***0.1***	***0.2***	***0.1***	***0.0***	***0.0***	***0.0***	-0.4	***-0.1***	***0.1***
Unemployment, %	4.7	4.4	4.3	***4.1***	***3.9***	***3.8***	***3.8***	***3.8***	***3.9***	***4.0***	4.9	***4.4***	***3.8***
NF Payrolls, monthly, th.	166	187	121	***210***	***150***	***140***	***135***	***130***	***125***	***121***	187	***171***	***139***
Cons. Price Index (q/q)	3.1	-0.3	2.0	***3.7***	***2.4***	***2.0***	***2.0***	***2.0***	***2.0***	***2.0***	1.3	***2.1***	***2.3***
excl. food & energy	2.5	0.6	1.7	***2.1***	***1.9***	***1.9***	***1.9***	***2.0***	***2.0***	***2.0***	2.2	***1.8***	***1.9***
PCE Price Index (q/q)	2.2	0.3	1.5	***2.8***	***2.0***	***1.9***	***1.9***	***1.9***	***1.9***	***1.9***	1.2	***1.7***	***1.9***
excl. food & energy	1.8	0.9	1.3	***1.8***	***1.8***	***1.8***	***1.8***	***1.8***	***1.8***	***1.8***	1.8	***1.5***	***1.8***
Fed Funds Rate, %	0.70	0.94	1.16	***1.21***	***1.41***	***1.44***	***1.66***	***1.71***	***1.91***	***1.92***	0.39	***1.01***	***1.56***
3-month T-Bill, (bond-eq.)	0.6	0.9	1.0	***1.3***	***1.4***	***1.5***	***1.6***	***1.7***	***1.9***	***1.9***	0.3	***1.0***	***1.6***
2-year Treasury Note	1.2	1.3	1.5	***1.7***	***1.9***	***2.0***	***2.1***	***2.1***	***2.1***	***2.1***	0.8	***1.4***	***2.0***
10-year Treasury Note	2.5	2.3	2.2	***2.4***	***2.6***	***2.7***	***2.8***	***2.9***	***3.0***	***3.0***	1.8	***2.3***	***2.7***