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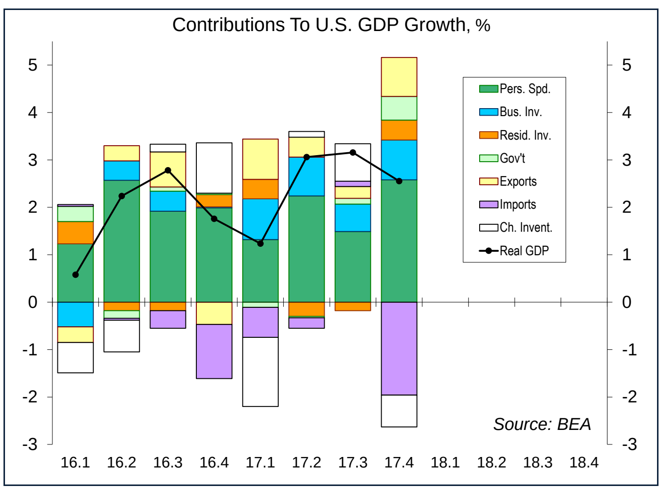
Scott J. Brown, Ph.D., (727) 567-2603, Scott.J.Brown@RaymondJames.com **January 30, 2018**

Monthly Economic Outlook

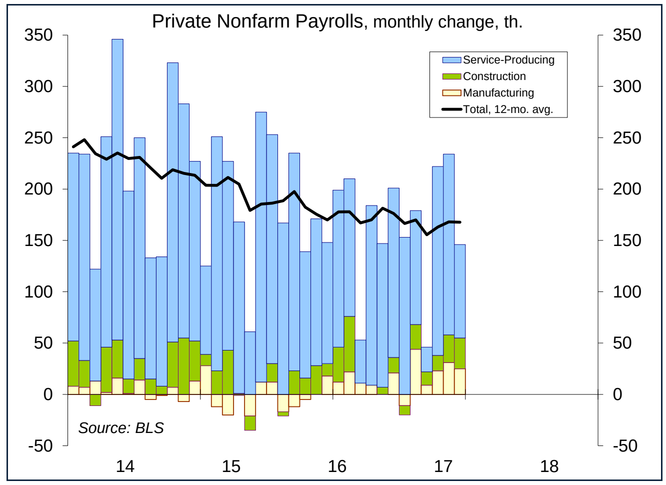
An Increasingly Uncertain Outlook

- *While the economy appears to have good momentum in the near term, it is increasingly unclear how tax cuts, a tighter job market, and a more hawkish Fed will balance out.*
- *The tight labor market should force a slowing in job growth, unless we get a sharper decline in the unemployment rate, which would put Fed policymakers behind the curve.*
- *The Fed is expected to be more hawkish in 2018. Long-term interest rates should drift a bit higher, and the slope of the yield curve should remain consistent with moderate growth.*

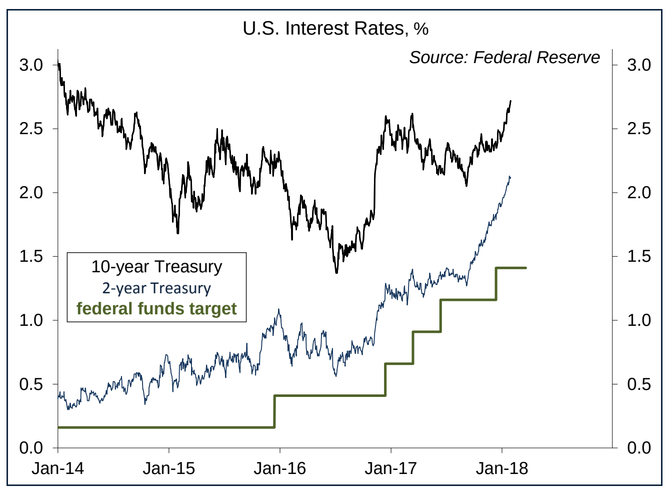
Real GDP rose at a 2.6% annual rate in the advance estimate for 4Q17, but the economy was a lot stronger than the headline growth figure would seem to suggest. A slower pace of inventory accumulation and a wider trade deficit subtracted 1.8 percentage points from overall GDP growth. Focusing on the "meat and potatoes" of the economy, Private Domestic Final Purchases (PDFP = consumer spending, business fixed investment, and residential fixed investment) rose at a 4.6% annual rate. Part of that strength reflected a rebound from the third quarter's hurricanes (PDFP rose at a 2.2% pace in 3Q17), but averaging the two quarters indicates strong growth in domestic demand over the last several quarters (PDFP rose 3.3% 4Q17/4Q16). The fourth quarter GDP data are subject to revision (the second estimate is due February 28), but the underlying story shouldn't change much.



Relatively strong growth was achieved in 2017 through a further decline in the unemployment rate (which fell from 4.7% to 4.1% over the course of the year). Growth in private-sector payrolls averaged about 170,000 per month, the same as in 2016 (less than 100,000 is consistent with the growth in the working-age population). There may currently be more slack in the labor market than is currently believed, but job growth is expected to slow as the job market continues to tighten.



Despite the tighter job market, wage pressures have remained moderate, but eighteen states raised their minimum wages in January. Many firms give annual cost-of-living increases at the start of the year (the Consumer Price Index rose 2.1% over the 12 months ending in December). The labor market is the widest channel for inflation pressure. Personnel changes add some uncertainty to the monetary policy outlook and decisions will remain data dependent, but the financial markets are now factoring in a March 21 Fed rate hike.



The 10-year Treasury note yield has recently broken through to a four-year high. The key question is why? Long-term interest rates normally rise as the economy improves. Inflation is still expected to remain relatively low, but a wider federal budget deficit, expectations of tighter monetary policy, and higher interest rates abroad are putting upward pressure on U.S. bond yields. In turn, higher long-term interest rates, unless matched by higher earnings growth, can be expected to dampen share prices to some extent. Given the uncertainty, we can expect increased market volatility over the near term.

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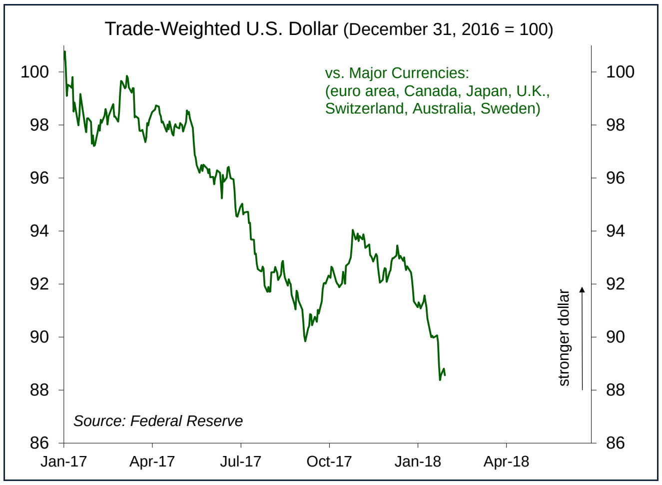
Normally, a strong economy, robust stock market, and tighter monetary policy would all be dollar positive. However, the greenback has declined about 12% against the major currencies over the last year. Much of that weakness likely reflects the improvement in global growth. The International Monetary Fund recently noted that the world economy was stronger than expected and well balanced in 2017. The IMF upped its global growth projections for 2018 and 2019.



Recall that for most of the global economy recovery, the U.S. was seen as the best game in town. The Fed was much more active than other central banks in its efforts to boost growth. Austerity dampened the pace of recovery, but the U.S. government tightened its belt less than other countries. We are now at a point where the global economy is fully in gear, while the U.S. economy is late-cycle, at or near full employment. It's not a question of global investors souring on the U.S. Rather, the rest of the world is looking relatively more attractive. All else equal, that implies a softer dollar. A softer dollar would normally boost U.S. exports, but trade policy is uncertain.

As usual, U.S. economic data will be subject to seasonal noise at the start of the year. However, there are a number of questions that will have to be answered in coming months.

Through December, the Fed's interest rate increases were about getting monetary policy closer to neutral. Having taken the foot off the gas pedal, is it now time to hit the brakes? The Tax Cut and Jobs Act of 2017 is not expected to add much to growth over the next ten years, but there is some stimulus in the first year. As noted, the economy appears to be at or near full employment, so that stimulus arrives at an unusual time. Wage pressures could heat up a lot more, leading the Fed to raise short-term interest rates sooner and faster than they would otherwise. The belief among Fed policymakers is that by waiting too long, they would have to raise rates more aggressively later on, risking a recession in late 2018 or in 2019. The risks of a monetary policy error are rising.

Adjusting for inflation, consumer spending (68% of GDP) rose at a 3.8% annual rate in the initial estimate for 4Q17. Much of that strength reflected a rebound from a soft 3Q17 (which saw a hurricane-restrained pace of 2.2%). Taking the two quarters together, spending rose at a 3.0% annual rate in the second half. However, inflation-adjusted disposable income rose at a 0.8% annual rate. Aggregate private-sector wages and salaries rose at a 2.1% pace – better, but still well short of spending growth. Wage data are often revised, but at face value these figures suggest that spending has been fueled partly by higher debt, which raises the possibility of a slowdown for the consumer sector at some point.

This year's chief themes on the economy are near-term strength, followed by increased uncertainty in the outlook for the second half of the year. Wage growth and business investment may be stronger than expected. Geopolitical developments and an over-aggressive Fed are downside risks.

	1Q17	2Q17	3Q17	4Q17	1Q18	2Q18	3Q18	4Q18	1Q19	2Q19	2016	2017	2018
GDP (↓ *contributions*)	1.2	3.1	3.2	2.6	***3.5***	***2.4***	***1.9***	***1.9***	***1.9***	***1.9***	1.5	***2.3***	***2.7***
consumer durables	0.0	0.6	0.6	1.0	***0.3***	***0.3***	***0.3***	***0.3***	***0.3***	***0.2***	0.4	***0.5***	***0.5***
nondurables & services	1.3	1.7	0.9	1.6	***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	0.8	***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	4.6	***3.0***	***2.7***	***2.3***	***2.2***	***2.2***	***2.2***	2.3	***3.0***	***3.0***
government	-0.1	0.0	0.1	0.5	***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	0.8	***0.3***	***0.3***	***0.3***	***0.3***	***0.3***	***0.3***	0.0	***0.4***	***0.4***
imports	-0.6	-0.2	0.1	-2.0	***0.2***	***-0.5***	***-0.6***	***-0.5***	***-0.4***	***-0.4***	-0.2	***-0.6***	***-0.5***
Final Sales	2.7	3.0	2.4	3.2	***3.2***	***2.2***	***1.8***	***1.8***	***1.9***	***1.9***	1.9	***2.4***	***2.6***
ch. in bus. inventories	-1.5	0.1	0.8	-0.7	***0.3***	***0.2***	***0.1***	***0.0***	***0.0***	***0.0***	-0.4	***-0.1***	***0.1***
Unemployment, %	4.6	4.3	4.3	4.1	***3.9***	***3.8***	***3.7***	***3.7***	***3.7***	***3.8***	4.9	***4.4***	***3.8***
NF Payrolls, monthly, th.	166	187	128	204	***150***	***140***	***135***	***130***	***125***	***121***	187	***171***	***139***
Cons. Price Index (q/q)	3.1	-0.3	2.0	3.7	***3.4***	***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	2.3	***2.5***	***1.9***	***1.9***	***2.0***	***2.0***	***2.0***	2.2	***1.8***	***2.0***
PCE Price Index (q/q)	2.2	0.3	1.5	2.8	***2.5***	***1.9***	***1.9***	***1.9***	***1.9***	***1.9***	1.2	***1.7***	***2.1***
excl. food & energy	1.8	0.9	1.3	1.9	***2.0***	***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	1.20	***1.46***	***1.69***	***1.91***	***1.96***	***2.16***	***2.17***	0.39	***1.00***	***1.76***
3-month T-Bill, (bond-eq.)	0.6	0.9	1.0	1.2	***1.5***	***1.7***	***1.9***	***2.0***	***2.2***	***2.2***	0.3	***1.0***	***1.8***
2-year Treasury Note	1.2	1.3	1.5	1.7	***2.2***	***2.4***	***2.4***	***2.5***	***2.5***	***2.6***	0.8	***1.4***	***2.4***
10-year Treasury Note	2.5	2.3	2.2	2.4	***2.8***	***2.9***	***3.0***	***3.1***	***3.2***	***3.2***	1.8	***2.3***	***2.9***

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