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Economic Research

Published by Raymond James & Associates

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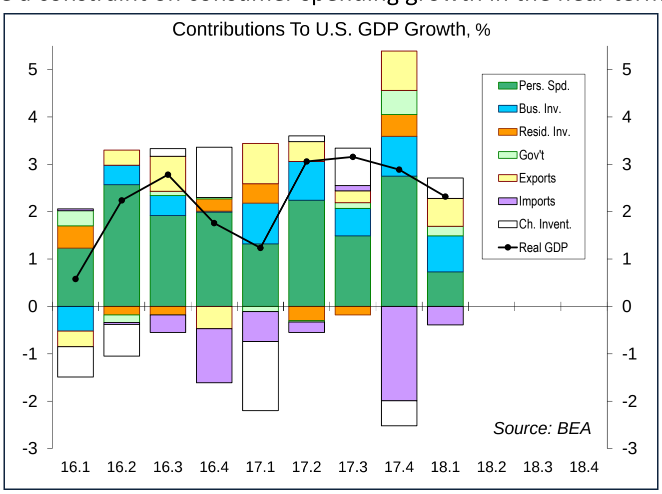
May 9, 2018

Economic Trends

As Good As It Gets?

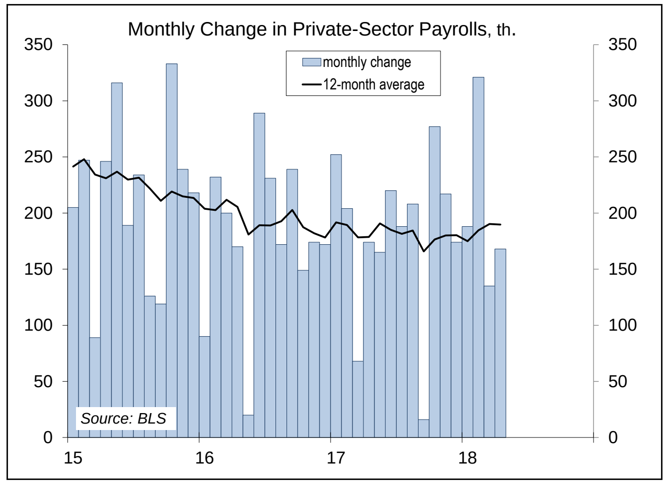
- *Economic growth moderated in the first quarter, driven largely by a lackluster pace in consumer spending, but growth is expected to pick up in 2Q18. Beyond that, labor market constraints are likely to become more binding.*
- *Inflation has moved closer to the Federal Reserve's 2% goal, but that's mostly a quirk. Pipeline pressures have picked up, but consumer price inflation is unlikely to rise sharply.*
- *Federal Reserve policymakers are expected to continue raising short-term interest rates gradually until the economy shows more definitive signs of achieving a long-term sustainable pace or if we experience a major external shock.*

Real GDP rose at a 2.3% annual rate in the advance estimate for 1Q18 (up 2.9% y/y). Consumer spending rose at a lackluster 1.1% annual rate (+2.6% y/y), following a blistering 4.0% pace in 4Q18 (which itself reflected a rebound from hurricane effects in 3Q18). Real disposable income was weak in the second half of 2017 (a 0.9% annual rate), but the pace picked up in the first quarter (+3.4%). The Tax Cut and Jobs Act included some relief for workers. Tax withholding fell in February, leaving workers with a little extra cash but not a lot, and few seemed to notice. Higher gasoline prices are likely to be a constraint on consumer spending growth in the near term.

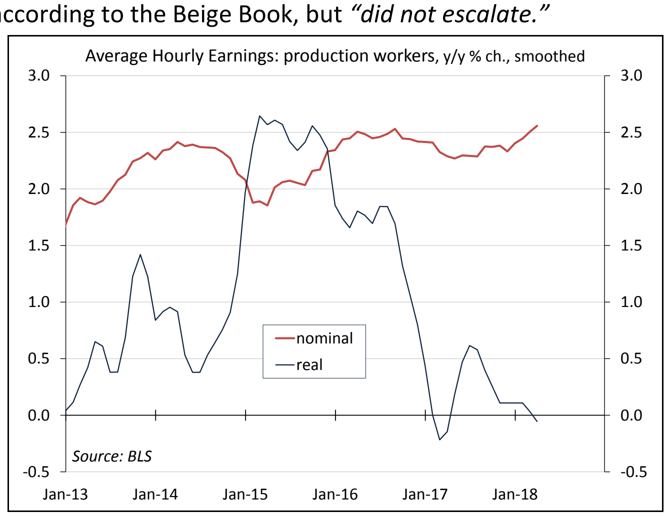


Business fixed investment remained at a relatively brisk pace in the first quarter, buoyed by strong business sentiment and supported partly by the continued recovery in energy exploration (which is capital intensive). Shipments of nondefense capital goods slowed somewhat in 1Q18, but new orders stalled. A strong global economy has been a positive factor for business investment, but trade policy uncertainty has been a clear negative. April surveys showed that supply managers were mostly optimistic, but rising input costs and supply constraints were increasingly cited as concerns.

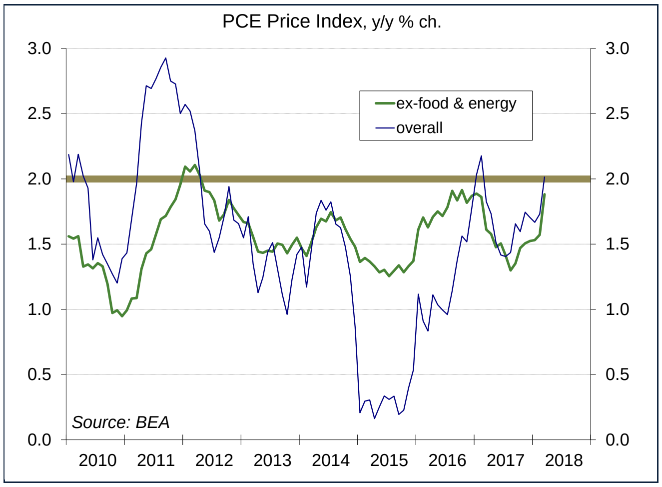
Residential fixed investment was flat in the first quarter. That followed a strong 4Q18, but weather was likely a factor (the first few months of the year are not a good reflection of the shape of the housing sector). Housing demand has strengthened, but rising building costs and a lack of skilled labor remain key constraints for builders. Job growth remains supportive. Mortgage rates have risen but not a lot. However, rising prices of homes have worsened affordability issues.



Job growth was uneven in the first quarter (February's mild weather likely pulled forward seasonal gains from March and April), but the overall pace remained strong. Labor market conditions remain tight across the country, restraining job gains in some regions. The Fed's most recent Beige Book noted that contacts reported *"difficulty finding qualified candidates across a broad array of industries and skill levels."* Firms experienced labor shortages for a number of high-skilled positions, including engineering, information technology, healthcare, construction, and transportation. *"Upward wage pressure persisted,"* according to the Beige Book, but *"did not escalate."*



The March PCE Price Index reflected higher year-over-year inflation, but that was not a surprise. Prices in wireless telecom services fell sharply in March 2017. That drop fell out of the 12-month inflation calculation, lifting the year-over-year increase. Fed officials were well aware of this situation (a year ago, Fed Chair Janet Yellen had cited the decline in wireless telecom services as a "transitory" factor keeping inflation low).



Federal Reserve officials are more interested in future inflation. Wage pressures are building but not excessively. That likely reflects a variety of issues, including labor's limited bargaining power and low productivity growth. Firms have responding to the tight job market by offering more perks (to attract new workers), increasing overtime, and accelerating automation. Prices of raw materials have risen, adding to pipeline inflation pressures, but firms still seem limited in their ability to pass higher costs along. The White House's trade policy has contributed to higher input cost inflation. The decision to pull out of the Iran agreement has lifted oil prices. Truck driver shortages have added to transportation costs.

Trade agreements are notoriously complex. The North American Free Trade Agreement took years to complete. A major re-adjustment cannot be done in just a few months. Recent reports suggest that negotiations with Canada and Mexico may have reached an impasse. The Trump administration's trade delegation trip to China resulted in no concessions. Investors have generally been sanguine, believing that (as with the renegotiation of trade with South Korea) some minor changes would be made to existing trade agreements and a major trade war would be avoidable. However, the risks of a broader trade war are increasing. U.S. tariffs invite retaliatory tariffs against U.S. exports, raise input costs, disrupt supply chains, and increase uncertainty for global investment – and, most importantly, do nothing to save American jobs. Recently, more than 1,100 economists, including 15 Nobel laureates, sent a letter to President Trump cautioning against protectionist policies. This echoes a similar letter, signed by 1,028 economists in 1930, urging Congress to reject the Smoot-Hawley Tariff Act. Congress passed protectionist measures, which made the Great Depression worse. The lesson of history is that nobody learns from history.

Meanwhile, the dollar has found a floor recently. Tighter Fed policy is dollar positive, but the stronger dollar likely has more to do with what's happening elsewhere. The dollar had been on a downtrend since late 2016, not because the U.S. economy was weak – rather, the rest of the world was looking more attractive. More recently, the luster may be off of the European economy, and trade policy disruptions are likely to be more troublesome to emerging economies than to the U.S.

Recessions are associated with two things: tighter monetary policy and higher oil prices. Neither is at a point that would lead to a downturn in economic activity anytime soon. U.S. growth is expected to remain moderate. However, the risks ought to be monitored closely in the months ahead.

	1Q17	2Q17	3Q17	4Q17	1Q18	2Q18	3Q18	4Q18	1Q19	2Q19	2017	2018	2019
GDP (↓ *contributions*)	1.2	3.1	3.2	2.9	2.3	***2.6***	***2.0***	***1.9***	***1.9***	***1.9***	2.3	***2.6***	***1.9***
consumer durables	0.0	0.6	0.6	1.0	-0.3	***0.3***	***0.3***	***0.3***	***0.3***	***0.2***	0.5	***0.3***	***0.3***
nondurables & services	1.3	1.7	0.9	1.8	1.0	***1.5***	***1.3***	***1.3***	***1.2***	***1.2***	1.4	***1.3***	***1.2***
bus. fixed investment	0.9	0.8	0.6	0.8	0.8	***0.5***	***0.4***	***0.4***	***0.4***	***0.4***	0.6	***0.6***	***0.4***
residential investment	0.4	-0.3	-0.2	0.5	0.0	***0.3***	***0.1***	***0.1***	***0.1***	***0.1***	0.1	***0.1***	***0.1***
Priv Dom Final Purchases	3.1	3.3	2.2	4.8	1.7	***2.9***	***2.4***	***2.3***	***2.2***	***2.2***	3.0	***2.8***	***2.3***
government	-0.1	0.0	0.1	0.5	0.2	***0.1***	***0.1***	***0.1***	***0.1***	***0.1***	0.0	***0.2***	***0.1***
exports	0.9	0.4	0.3	0.8	0.6	***0.3***	***0.3***	***0.3***	***0.3***	***0.3***	0.4	***0.5***	***0.3***
imports	-0.6	-0.2	0.1	-2.0	-0.4	***-0.5***	***-0.6***	***-0.5***	***-0.4***	***-0.4***	-0.6	***-0.7***	***-0.5***
Final Sales	2.7	3.0	2.4	3.4	1.9	***2.5***	***1.9***	***1.9***	***1.9***	***1.9***	2.4	***2.4***	***1.9***
ch. in bus. inventories	-1.5	0.1	0.8	-0.5	0.4	***0.2***	***0.1***	***0.0***	***0.0***	***0.0***	-0.1	***0.2***	***0.0***
Unemployment, %	4.6	4.3	4.3	4.1	3.9	***3.8***	***3.7***	***3.7***	***3.7***	***3.8***	4.4	***3.8***	***3.8***
NF Payrolls, monthly, th.	166	187	128	221	202	***155***	***140***	***135***	***125***	***121***	182	***158***	***120***
Cons. Price Index (q/q)	3.0	0.1	2.1	3.3	3.5	***2.0***	***2.1***	***2.0***	***2.1***	***2.1***	2.1	***2.5***	***2.1***
excl. food & energy	2.2	0.8	1.8	2.2	3.0	***2.0***	***1.9***	***2.0***	***2.0***	***2.0***	1.8	***2.2***	***2.0***
PCE Price Index (q/q)	2.2	0.3	1.5	2.7	2.7	***1.7***	***1.9***	***2.0***	***2.0***	***2.0***	1.7	***2.1***	***2.0***
excl. food & energy	1.8	0.9	1.3	1.9	2.5	***1.9***	***1.8***	***1.9***	***1.9***	***1.9***	1.5	***1.9***	***1.9***
Fed Funds Rate, %	0.70	0.94	1.16	1.20	1.45	***1.71***	***1.94***	***2.16***	***2.19***	***2.41***	1.00	***1.81***	***2.43***
3-month T-Bill, (bond-eq.)	0.6	0.9	1.0	1.2	1.6	***1.9***	***2.1***	***2.2***	***2.3***	***2.4***	1.0	***2.0***	***2.5***
2-year Treasury Note	1.2	1.3	1.5	1.7	2.3	***2.3***	***2.5***	***2.5***	***2.6***	***2.6***	1.4	***2.4***	***2.6***
10-year Treasury Note	2.5	2.3	2.2	2.4	2.9	***3.1***	***3.2***	***3.3***	***3.3***	***3.4***	2.3	***3.1***	***3.4***