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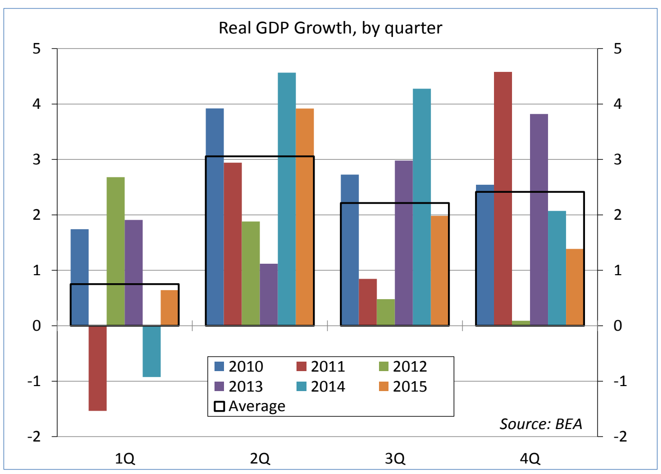
Economic Trends

Back in the Sweet Spot?

- *Recent economic data reports have been generally soft, suggesting relatively weak GDP growth in the first quarter. However, the data are also consistent with moderate growth in the near term – not strong, but not terribly weak either.*
- *Following signs of a pickup in core inflation in January and February, March inflation figures were more benign. Combined with the moderate growth outlook, the Fed's gradual path of policy normalization should be even more gradual.*
- *Much of the fear that was rampant at the start of the year (China, Fed tightening, a too-strong dollar, a possibility of "recession") has subsided. As in the last few years, the economic expansion is expected to continue, but not so fast that the Fed rushes to take away the punch bowl.*

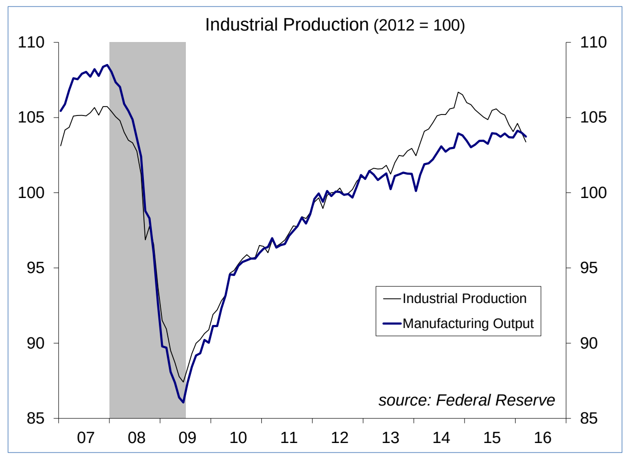
The advance estimate of 1Q16 GDP growth will arrive on April 28. Based on current data, the economy likely expanded at a relatively modest pace, with a slower pace of consumer spending and a continued downtrend in business fixed investment (largely reflecting the contraction in energy exploration). The first quarter picture of foreign trade and inventories is far from complete, but both are expected to be moderate drags on overall growth. Remember, this will be the advance estimate – figures will be revised, and revised again.



Seasonal adjustment is a regular issue with the economic data. Following the holiday shopping season, activity slows in the first couple of months of the year and then picks up again in the spring. However, it's hard to get the adjustment right, especially if there's a major floating holiday, such as Easter. Take any one month's worth of data with a grain of salt. Seasonal patterns may have been permanently altered following the Great Recession. We can't tell for sure due to the small sample size (just six years), but the methodology will pick up a changed seasonal pattern over time. First quarter figures for the last few years may eventually be revised higher.

Retail sales rose modestly in the first quarter. Unit auto sales declined. However, the early Easter may have been a factor in March. Vehicle sales depend critically on the final weekend of the month, when dealers are motivated to meet sales targets and clear lots; this year, that was Easter weekend. Ex-autos, March retail sales rose modestly, but that was partly due to higher gasoline prices. Core sales, which exclude autos, building materials, and gasoline, were flat, but the figure for February was revised higher. Consumer fundamentals, especially the job market, remain supportive, but data for April and May will be critical in cementing the consumer outlook.

Residential construction rose at a more moderate pace in 1Q16, despite the fact that the weather was favorable. Multi-family activity has slowed following unusual strength in 2015. Single-family permits were up 15.2% from 1Q15.



The ISM Manufacturing Index moved above 50 in March for the first time in six months, consistent with modest improvement in factory sector activity. Growth in new orders picked up, production expanded, but factory employment continued to edge lower. The Federal Reserve released annual benchmark revisions at the beginning of April. Normally, these revisions are relatively minor, but this one showed a much slower pace of manufacturing growth in recent years than was reported earlier (still positive, but pulling down 2013-15 growth from 5.4% to 2.4%). Industrial production peaked in late 2014. The decline is the only major recession indicator in retreat (nonfarm payrolls, personal income, and real business sales are still trending higher). The drop in industrial production mostly reflects the contraction in energy exploration. The Fed reports that oil and gas drilling fell further in 1Q16 and has declined by 72% since the end of 2014. In addition, winter temperatures have generally been warmer than usual, resulting in a lower output from utilities. Manufacturing output remained mixed, but appears to be on a relatively sluggish trend, reflecting an impact from the stronger dollar.

The dollar went on a sharp tear in mid-2014, driven by divergent monetary policy expectations (Fed moving toward tightening, other central banks easing further) and concerns about growth in the rest of world. However, the magnitude of the dollar's rise was hard to justify on relative differentials in monetary policy and economic growth or on the dollar's role as a safe-haven currency. It's well known that currency markets can overshoot and the expansion of the global financial system means that conditions can be inherently unstable in the short run. Very large amounts can move around the world quickly.

The dollar has begun to reverse, partly on expectations of a more gradual Fed policy path. U.S. exporters have faced softer global growth, declining export prices, and a reduced dollar-value of earnings from abroad. The decline in the dollar is providing some relief, but not a lot. The effects of a strong dollar will take some time to work through the system. The U.S. is now running a trade surplus with OPEC, which means that we'll see fewer dollars flowing back to the U.S. and potential sales of U.S. assets held abroad (not a big problem).

The Chinese currency was a major question mark in this year's outlook and poised a significant risk to global economic growth. We began the year with large capital outflows and a major effort by the People's Bank of China, the country's central bank, to stem the tide. Expectations of a renminbi devaluation created incentive for Chinese investors to place money outside the country, which put more downward pressure on the currency. In November, December, and January, the PBOC was depleting currency reserves by about $100 billion per month to defend the currency; having burned through $800 billion since May 2014 (it had started with $4 trillion). The depletion of reserves slowed to $28 billion in February and reserves rose by $10 billion in March. The PBOC appears to have had some success in stabilizing the currency, but we'll have to see if that continues.

China's economic transition is expected to be bumpy, but fears of an outright collapse (due to a bursting of a credit bubble) appear to have been overdone. The economies of Latin America are in sorry shape, with Brazil beset by political turmoil and Venezuela hammered by the low price of oil. Europe is slugging along, but the U.K.'s June 23 vote on whether to remain in the European Union is a negative (for both the U.S. and the E.U.). It's expected that the U.K will vote to stay, but the uncertainty leading up to the vote is likely to restrain business fixed investment. Weakness in capital spending is already a major concern worldwide, and may result in a softer trend in global growth for some time.

Meanwhile, the U.S. economy is still mostly self-contained. The consumer outlook remains promising. Business fixed investment should pick up. The recovery in housing should continue. And yet, the overall pace of economic growth may be a little more moderate than was expected at the start of the year. The Fed remains in tightening mode, but should be in no hurry to raise rates in the months ahead.

	1Q15	2Q15	3Q15	4Q15	1Q16	2Q16	3Q16	4Q16	1Q17	2Q17	2015	2016	2017
GDP (↓ *contributions*)	0.6	3.9	2.0	1.4	0.5	2.0	2.2	2.3	2.3	2.3	2.4	1.7	2.3
consumer durables	0.1	0.6	0.5	0.3	-0.1	0.3	0.2	0.2	0.2	0.2	0.4	0.2	0.2
nondurables & services	1.0	1.9	1.6	1.4	1.2	1.5	1.5	1.4	1.4	1.4	1.7	1.6	1.4
bus. fixed investment	0.2	0.5	0.3	-0.3	-0.1	0.3	0.3	0.3	0.3	0.3	0.4	0.1	0.3
residential investment	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.2	0.2	0.2	0.3	0.3	0.2
Priv Dom Final Purchases	2.0	3.9	3.2	2.0	1.4	2.9	2.7	2.6	2.6	2.5	3.3	2.4	2.6
government	0.0	0.5	0.3	0.0	0.2	0.2	0.3	0.2	0.2	0.2	0.1	0.2	0.2
exports	-0.8	0.6	0.1	-0.3	-0.4	-0.2	0.2	0.2	0.2	0.2	0.2	-0.1	0.2
imports	-1.1	-0.5	-0.4	0.1	-0.1	-0.3	-0.4	-0.4	-0.4	-0.3	-0.8	-0.2	-0.3
Final Sales	-0.2	3.9	2.7	1.6	0.9	2.2	2.3	2.3	2.3	2.3	2.3	2.0	2.3
ch. in bus. inventories	0.9	0.0	-0.7	-0.2	-0.5	-0.2	-0.1	0.0	0.0	0.0	0.2	-0.3	0.0
Unemployment, %	5.5	5.4	5.1	5.0	4.9	4.8	4.7	4.7	4.7	4.8	5.3	4.8	4.8
NF Payrolls, monthly, th.	190	251	192	282	209	185	180	175	170	165	229	187	163
Cons. Price Index (q/q)	-2.9	2.4	1.4	0.8	-0.3	1.9	1.9	2.0	2.1	2.1	0.1	1.1	2.0
excl. food & energy	1.7	2.3	1.8	2.2	2.7	1.8	1.8	1.9	1.9	1.9	1.8	2.1	1.9
PCE Price Index (q/q)	-1.9	2.2	1.3	0.3	0.3	1.5	1.8	1.9	2.0	1.9	0.3	1.1	1.9
excl. food & energy	1.0	1.9	1.4	1.3	2.0	1.6	1.7	1.7	1.7	1.7	1.3	1.7	1.7
Fed Funds Rate, %	0.11	0.13	0.14	0.16	0.36	0.38	0.42	0.68	0.92	1.15	0.13	0.46	1.29
3-month T-Bill, (bond-eq.)	0.0	0.0	0.0	0.1	0.2	0.3	0.5	0.7	0.8	1.1	0.1	0.4	1.3
2-year Treasury Note	0.6	0.6	0.7	0.8	0.8	0.8	1.1	1.3	1.5	1.8	0.7	1.0	2.0
10-year Treasury Note	2.0	2.2	2.2	2.2	1.9	1.9	2.3	2.6	3.0	3.1	2.1	2.2	3.2