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Economic Research
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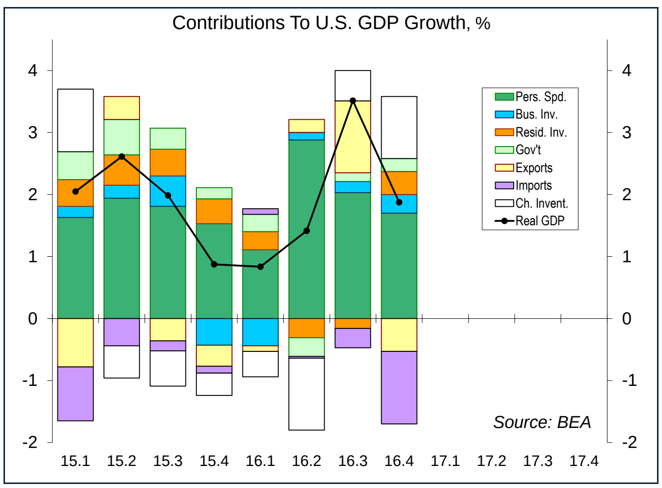
Economic Trends

Cautious Optimism

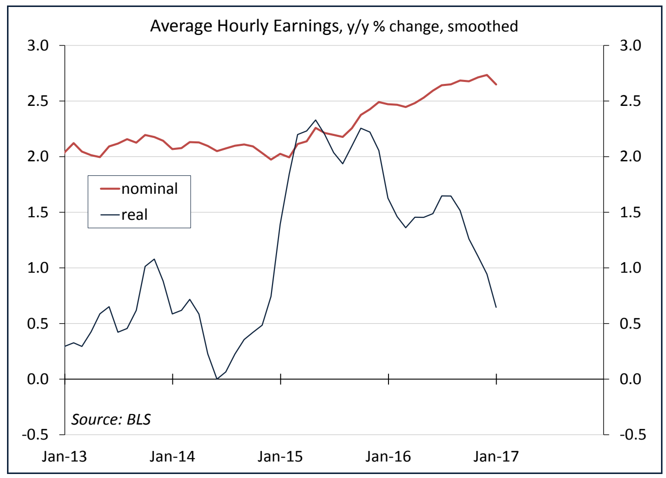
- *Economic data have been subject to seasonal distortions, but recent figures have remained consistent with positive momentum in consumer spending and business investment.*
- *Optimism about the economy has increased since the November election, but a tight labor market and difficulties in getting President Trump's agenda through Congress are likely to be constraints. Global trade disruptions are the greatest risk.*
- *Monetary policy remains data-dependent, but the Federal Reserve is expected to raise short-term interest rates gradually.*

Real GDP rose at a 1.9% annual rate in the advance estimate for 4Q16, but that figure understates the economy's strength. A faster pace of inventory growth added a full percentage point to headline growth, while a wider trade deficit subtracted 1.7 percentage points. Private Domestic Final Purchases (consumer spending, business fixed investment, and residential investment) rose at a 2.8% annual rate (+2.4% y/y).

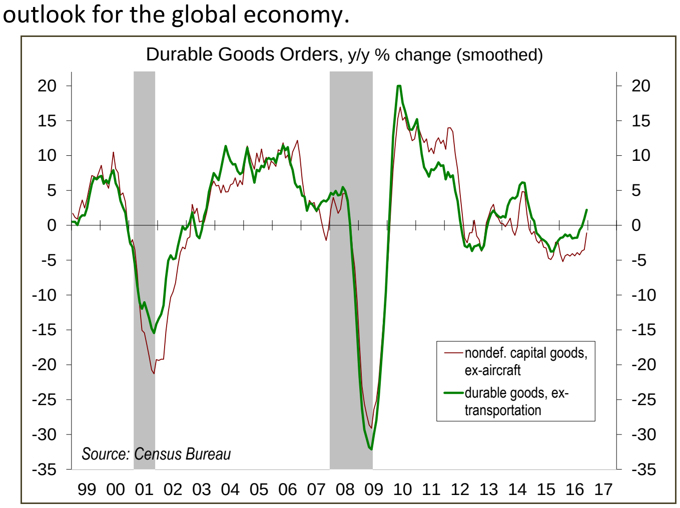


It's often said that net exports are a drag on GDP growth. That's true in an arithmetic sense. However, increased imports are a sign of strength in the domestic economy. We spend more on domestic goods; we spend more on imported goods, which have a negative sign in the GDP calculation. Some of the pop in fourth quarter imports may have reflected an impact from a stronger dollar, but these figures tend to be uneven across quarters (that is, they sometimes bunch up). Exports fell, reflecting a rollback in agricultural exports, which had surged in 3Q16 (mostly soybeans to China and Mexico).

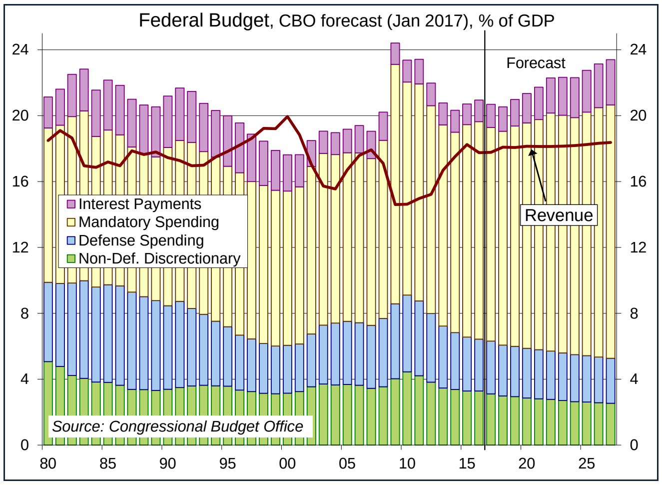
Nonfarm payrolls were reported to have risen by 227,000 in January, but that is after seasonal adjustment. Unadjusted payrolls fell by nearly three million, reflecting the end of the holiday shopping season and some school year effects. Claims for unemployment benefits are trending at their lowest level since 1973. The seasonal spike in unadjusted claims at the start of this year was more muted, consistent with a further tightening of labor market conditions (the key factor in the Fed's monetary policy outlook). The unemployment rate ticked up to 4.8% in January, reflecting a pickup in labor force participation, but seasonal adjustment makes that a bit suspect. Average hourly earnings rose just 0.1% in January (+2.5% y/y), but appeared distorted. Average hourly earnings in finance fell 1.0%, likely reflecting a shift in income into 1Q17 (to take advantage of what is expected to be a lower tax rate). While nominal wage growth has been trending higher, real wage growth has slowed, as gasoline prices have bottomed. Job gains should continue to support consumer spending growth, but purchasing power is becoming somewhat constrained. Rising rents and healthcare costs aren't helping the typical middle-class consumer.



After a lengthy soft patch, orders for capital goods started to pick up in the second half of last year and, with the rise of business optimism, have risen further since the election. The rise in orders has also been helped by a somewhat brighter outlook for the global economy.



The Congressional Budget Office is projecting, based on current law, that the federal budget deficit will hit $1 trillion in six years. That reflects a rise in Medicare and Social Security expenditures as the baby-boom generation retires, as well as an anticipated normalization of interest rates. Republicans want to increase defense spending. Reducing nondefense discretionary spending won't be enough to balance the budget. The House leadership wants to "reform" Medicare, but it's unclear how inflation in healthcare costs will be reined in.



While the new administration wants to do a lot all at once, Congress doesn't work that way. Repealing and replacing (or now perhaps simply "repairing") the Affordable Care Act has taken precedence over tax cuts. Getting a revenue-neutral tax reform bill through Congress is likely to be difficult. Nobody wants to give up their tax breaks. Business tax cuts are expected to be a greater priority than individual tax cuts, and a key focus will be on changing how foreign earnings of U.S. firms are taxed. Here, things get very complicated, very quickly. There are huge downside risks of getting it wrong.

Donald Trump campaigned as a nationalist. Renegotiating the North American Free Trade Agreement will be a priority. This is odd because most studies indicate that while factory jobs were lost to Mexico (and also to Canada), net employment was little changed by NAFTA (job gains roughly balanced job losses). The U.S. trade deficit has expanded with Mexico, but much of that is due to a weaker peso. Factory job losses are more closely associated with technology changes and trade with China. The White House has indicated it will focus on bilateral trade agreements rather than multilateral agreements (Nobel Laurate Robert Solow famously noted that he had a chronic trade deficit with his barber).

While the general public views foreign trade as a zero-sum game (someone loses, someone wins), the net benefits from trade are clear. That's not to downplay the personal and social costs of factory job losses, especially for small and medium-sized towns. Compensating the losers is important. The protectionist view runs counter to the nature of modern manufacturing activity. Raw materials and parts come from all over the world and are shipped and assembled across borders at various stages of the production process. Raising tariffs risks a trade war (counter tariffs) and interrupting supply chains – and that means damaging U.S. manufacturing activity and increasing costs for consumers and businesses.

The U.S. needs to reform how it taxes the foreign earnings of U.S. firms, but getting it wrong could lead to unintended consequences, such as large currency swings. Note that foreign exchange volumes in the U.S. dollar average more than $4 trillion per day, according to the Bank of International Settlements. Global financial adjustments can be fast and very large – and could become unsettled in a trade dispute.

The economy has good momentum. Investors are optimistic, but some degree of caution may be warranted.

	1Q16	2Q16	3Q16	4Q16	***1Q17***	***2Q17***	***3Q17***	***4Q17***	***1Q18***	***2Q18***	2016	**2017**	**2018**
GDP (↓ *contributions*)	0.8	1.4	3.5	1.9	***2.3***	***2.1***	***2.0***	***2.0***	***2.0***	***2.0***	1.6	***2.2***	***2.0***
consumer durables	-0.1	0.7	0.8	0.8	***0.1***	***0.2***	***0.2***	***0.2***	***0.2***	***0.2***	0.4	***0.4***	***0.2***
nondurables & services	1.2	2.2	1.2	0.9	***1.2***	***1.2***	***1.2***	***1.2***	***1.2***	***1.2***	1.6	***1.2***	***1.2***
bus. fixed investment	-0.4	0.1	0.2	0.3	***0.4***	***0.4***	***0.3***	***0.3***	***0.3***	***0.3***	-0.1	***0.3***	***0.3***
residential investment	0.3	-0.3	-0.2	0.4	***0.1***	***0.2***	***0.1***	***0.1***	***0.1***	***0.1***	0.2	***0.1***	***0.1***
Priv Dom Final Purchases	1.1	3.2	2.4	2.8	***2.3***	***2.3***	***2.2***	***2.1***	***2.1***	***2.0***	2.3	***2.4***	***2.1***
government	0.3	-0.3	0.1	0.2	***0.2***	***0.2***	***0.2***	***0.2***	***0.2***	***0.2***	0.2	***0.2***	***0.2***
exports	-0.1	0.2	1.2	-0.5	***0.2***	***0.2***	***0.2***	***0.2***	***0.2***	***0.2***	0.0	***0.2***	***0.2***
imports	0.1	0.0	-0.3	-1.2	***-0.2***	***-0.3***	***-0.3***	***-0.2***	***-0.2***	***-0.2***	-0.2	***-0.4***	***-0.2***
Final Sales	1.2	2.6	3.0	0.9	***2.2***	***2.1***	***2.0***	***2.0***	***2.0***	***1.9***	2.0	***2.0***	***2.0***
ch. in bus. inventories	-0.4	-1.2	0.5	1.0	***0.1***	***0.0***	***0.0***	***0.0***	***0.0***	***0.0***	-0.4	***0.2***	***0.0***
Unemployment, %	5.0	4.9	4.9	4.7	***4.7***	***4.6***	***4.6***	***4.6***	***4.5***	***4.5***	4.9	***4.6***	***4.5***
NF Payrolls, monthly, th.	196	164	239	148	***155***	***150***	***145***	***140***	***135***	***130***	187	***148***	***128***
Cons. Price Index (q/q)	-0.3	2.5	1.6	3.4	***2.5***	***2.2***	***2.2***	***2.2***	***2.2***	***2.2***	1.3	***2.4***	***2.2***
excl. food & energy	2.7	2.1	1.9	2.0	***2.1***	***1.9***	***2.0***	***2.0***	***2.1***	***2.1***	2.2	***2.0***	***2.0***
PCE Price Index (q/q)	0.3	2.0	1.5	2.2	***1.9***	***2.0***	***2.0***	***2.1***	***2.1***	***2.1***	1.1	***1.9***	***2.1***
excl. food & energy	2.1	1.8	1.7	1.3	***1.5***	***1.8***	***1.9***	***2.0***	***2.0***	***2.0***	1.7	***1.6***	***2.0***
Fed Funds Rate, %	0.36	0.37	0.40	0.45	***0.66***	***0.68***	***0.91***	***0.96***	***1.16***	***1.19***	0.39	***0.80***	***1.30***
3-month T-Bill, (bond-eq.)	0.2	0.3	0.3	0.4	***0.6***	***0.6***	***0.9***	***0.9***	***1.1***	***1.2***	0.3	***0.8***	***1.3***
2-year Treasury Note	0.8	0.8	0.7	1.0	***1.2***	***1.4***	***1.5***	***1.6***	***1.7***	***1.9***	0.8	***1.4***	***1.9***
10-year Treasury Note	1.9	1.8	1.6	2.1	***2.5***	***2.7***	***2.9***	***3.2***	***3.3***	***3.4***	1.8	***2.8***	***3.5***