

Economic Trends

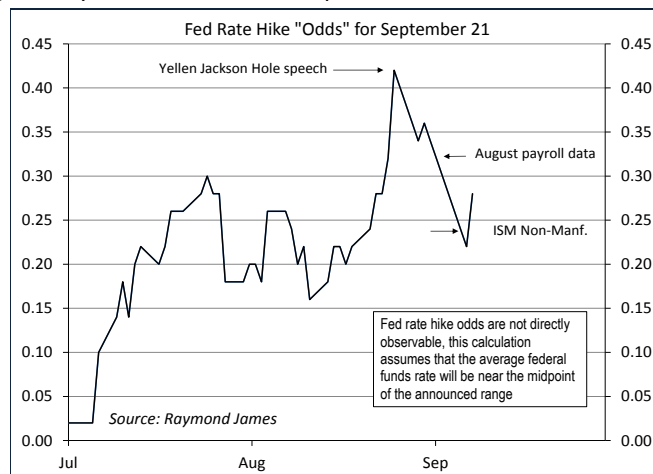
In a Fed Spin

- Economic data have been mixed, but generally consistent with moderate economic growth in the near term.
- Federal Reserve officials, including Chair Yellen, have signaled a possible September 21 rate hike. However, while short-term hawkish, officials also appear long-term dovish.
- Financial market participants doubt the central bank's resolve. However, a 25-basis-point increase in the federal funds target rate should not have a major impact.

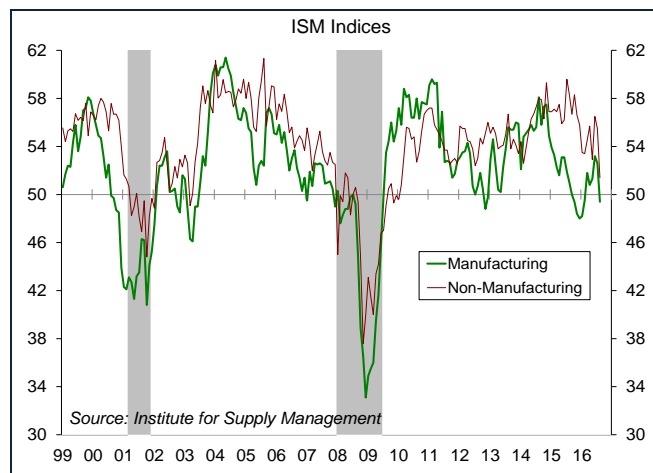
In its July 27 policy statement, the Federal Open Market Committee added a key phrase, "near-term risks to the economic outlook have diminished," paving the way for a possible interest rate hike in September. Just before the FOMC meeting, the Fed's Board of Governors met to consider requests from the district banks to increase the discount rate (the rate the Fed charges banks for short-term borrowing), currently 1.00%. Recall that changes to the discount rate (also called the primary credit rate) have to be requested by one or more of the district banks and be approved by the governors. In late July, eight of the 12 district banks had requested a 25-basis-point increase in the discount rate (but, obviously, the governors did not approve). The presidents of four of those district banks have a vote on the FOMC this year. Hence, there has been growing sentiment for higher short-term interest rates. Almost always, the Fed's Board of Governors will approve a change in the discount rate when the FOMC changes the federal funds rate target (the federal funds rate, the market rate that banks charge each other to borrow excess reserves overnight, averaged 0.40% in August, a bit above the mid-point of the 0.25-0.50% target range).

In her Jackson Hole speech (August 29), Fed Chair Janet Yellen was expected to restrict her remarks to a general discussion of monetary policy tools (the theme of the Kansas City Fed's annual monetary policy symposium this year) and not say much about the current situation. Instead, she went out of her way to preface her comments with "a few remarks on the near-term outlook for the U.S. economy and the potential implications for monetary policy." Fed policymakers expect "moderate growth, additional strengthening in the labor market, and inflation rising to 2% over the next few years," she noted, adding that "in light of the continued solid performance of the labor market and our outlook for economic activity and inflation, I believe the case for an increase in the federal funds rate has strengthened in recent months." This was a clear signal that a rate increase was likely to come sooner rather than later, but she also left herself an out: "of course, our decisions always depend on the degree to which incoming data continue to confirm the Committee's outlook."

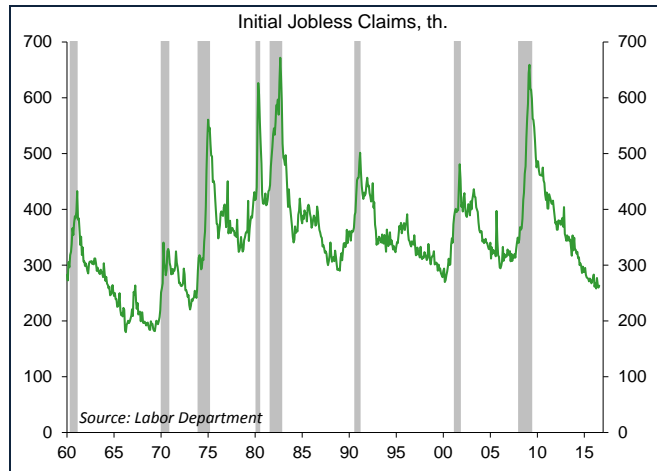
While the federal funds futures market priced in a greater chance of a September move following Yellen's Jackson Hole speech, the odds never went above 50%. The Fed may have simply cried wolf too many times, or perhaps market participants believe that the incoming economic data would be weak enough to keep monetary policy on hold. The economic data that arrived after Yellen's speech have been mixed, but generally on the soft side of expectations.



The estimate of real GDP growth for 2Q16 GDP growth was revised lower (to a 1.1% annual rate), but consumer spending was stronger than initially reported and the trend in personal income was revised sharply higher, suggesting a much better backdrop for spending growth in the near term. Inventories have become leaner in recent quarters, which usually bodes well for future production (reflecting an inventory rebuild). Yet, most indicators suggest a mixed, but generally lackluster, manufacturing sector. Residential housing has sputtered a bit, reflecting supply constraints and affordability issues. On balance, recent economic figures have remained consistent with modest to moderate growth in the near term.



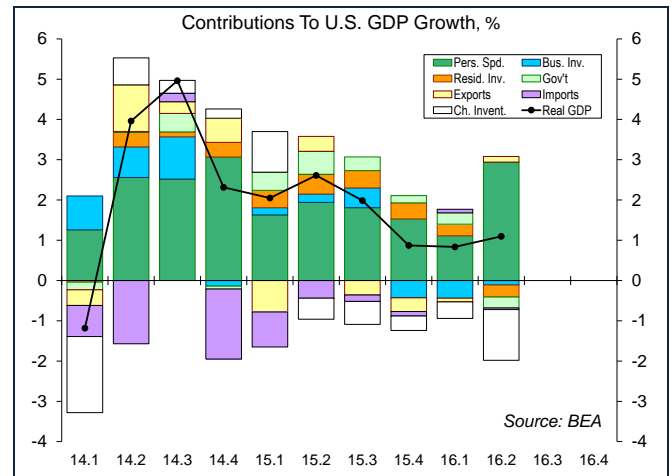
The focus for Federal Reserve policy has been on the labor market. The monthly change in nonfarm payrolls (+151,000 in August) is a fairly noisy statistic. The underlying trend in job growth appears to have slowed over the last several months (relative to the very strong pace of 2014-15), but that's at least partly due to a tighter job market. The unemployment rate has flattened (at 4.9% in August, vs. 5.1% a year ago). Labor force participation and the employment/population ratio have improved only modestly over the last year. The Fed's Beige Book, the summary of anecdotal economic assessments from around the country, noted that labor market conditions "remain tight." Wage pressures, while "moderate on balance," had "increased further." Average hourly earnings rose 2.4% over the 12 months ending in August, mixed across industries.



Quarterly figures on labor productivity are choppy, but the trend through the second quarter remained weak. Unit labor costs, the labor expense per unit of output, have risen at a faster pace. This will show up either as higher inflation (if firms can pass those higher costs along) or will eat into corporate profit margins (if they can't).

	3Q15	4Q15	1Q16	2Q16	3Q16	4Q16	1Q17	2Q17	3Q17	4Q17	2015	2016	2017
GDP (↓ contributions)	2.0	0.9	0.8	1.1	2.8	2.7	2.2	2.2	2.2	2.1	2.6	1.5	2.3
consumer durables	0.5	0.3	-0.1	0.7	0.2	0.2	0.2	0.2	0.2	0.2	0.5	0.3	0.3
nondurables & services	1.4	1.2	1.2	2.2	1.4	1.3	1.3	1.3	1.2	1.2	1.6	1.6	1.3
bus. fixed investment	0.5	-0.4	-0.4	-0.1	0.2	0.2	0.2	0.2	0.3	0.3	0.3	-0.1	0.2
residential investment	0.4	0.4	0.3	-0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.4	0.2	0.2
Priv Dom Final Purchases	3.3	1.8	1.1	3.0	2.3	2.3	2.3	2.2	2.2	2.1	3.3	2.2	2.3
government	0.3	0.2	0.3	-0.3	0.3	0.2	0.2	0.2	0.2	0.2	0.3	0.2	0.2
exports	-0.4	-0.3	-0.1	0.1	0.4	0.2	0.2	0.2	0.3	0.3	0.0	0.0	0.3
imports	-0.2	-0.1	0.1	0.0	-0.2	-0.3	-0.2	-0.2	-0.2	-0.2	-0.7	-0.1	-0.2
Final Sales	2.6	1.2	1.2	2.4	2.5	2.2	2.2	2.2	2.1	2.1	2.4	2.0	2.2
ch. in bus. inventories	-0.6	-0.4	-0.4	-1.3	0.3	0.5	0.0	0.0	0.0	0.0	0.2	-0.4	0.1
Unemployment, %	5.1	5.0	4.9	4.9	4.9	4.8	4.8	4.8	4.7	4.7	5.3	4.9	4.8
NF Payrolls, monthly, th.	192	282	196	146	188	150	135	140	135	130	229	170	135
Cons. Price Index (q/q)	1.4	0.8	-0.3	2.5	1.4	2.0	2.1	2.1	2.0	1.9	0.1	1.2	2.0
excl. food & energy	1.8	2.2	2.7	2.1	1.7	1.9	1.9	1.9	1.9	1.9	1.8	2.2	1.9
PCE Price Index (q/q)	1.3	0.3	0.2	2.0	1.9	1.9	2.0	1.9	1.9	1.8	0.3	1.0	1.8
excl. food & energy	1.4	1.3	2.0	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.4	1.6	1.7
Fed Funds Rate, %	0.14	0.16	0.36	0.37	0.40	0.63	0.67	0.88	0.90	1.13	0.13	0.44	0.89
3-month T-Bill, (bond-eq.)	0.0	0.1	0.2	0.3	0.3	0.5	0.7	0.9	0.9	1.1	0.1	0.3	0.9
2-year Treasury Note	0.7	0.8	0.8	0.8	0.8	1.1	1.3	1.4	1.5	1.6	0.7	0.9	1.4
10-year Treasury Note	2.2	2.2	1.9	1.8	1.6	1.9	2.2	2.3	2.6	2.7	2.1	1.8	2.5

For the most part, the economic outlook appears to be essentially "more of the same." That is, household sector fundamentals are sound, which should support solid growth in consumer spending (which accounts for about 70% of GDP). Business fixed investment is likely to remain soft, but the contraction in energy exploration (which is capital-intensive) appears to be behind us (hence, will no longer be a drag on overall business investment). Housing is likely to improve, but may not be especially strong in the near term. Global growth, while spotty, is likely to improve in the quarters ahead.



The recent backdrop (moderate growth, low inflation) has been supportive for the stock market. The economy has been improving, but not so fast that the Fed will rush to take the punch bowl away. In a low interest rate environment, price/earnings ratios should be higher. However, important questions lie ahead. Population demographics imply slower labor input in the U.S. and around the world. The trajectory for potential economic growth would be further limited by slow productivity growth, but that may prove to be temporary.