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INVESTMENT MANAGEMENT

Economic Perspectives

CONFIDENCE DESPITE POLICY UNCERTAINTY

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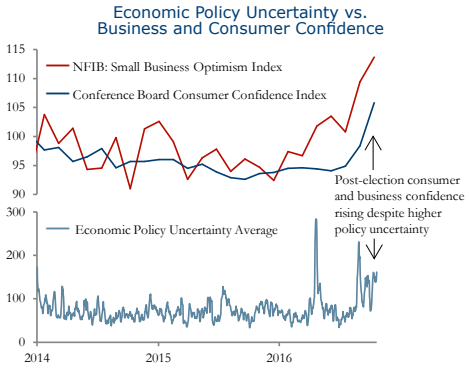
IN THIS ISSUE

- Fed appears to be moving toward a more hawkish position
- Positive news continues to roll in from the labor market
- Inflation appears on track to surpass the Fed's target rate
- Economic growth decelerated in the fourth quarter due to a massive reversal in trade

Figure 1

CLICK TO ENLARGE



Source: NFIB, Conference Board, Economic Policy Uncertainty
January 2017

Donald Trump's presidential election victory generated a wave of optimism that lower taxes, increased infrastructure spending, and a rollback in regulation will help spur a sluggish U.S. economy to better growth. Not only has the stock market risen to record highs, but consumers, small business owners, homebuilders, and manufacturers alike are all feeling more optimistic (*Figure 1*). Most economists, though, have been more skeptical, only modestly raising their GDP forecasts for the year ahead. At the center are differing views of how much stimulus we may get and how effective it will be at this stage of the business cycle.

We believe enthusiasm over near-term economic growth prospects may be warranted to a degree, so long as the new president does not follow through on his more extreme anti-globalization and anti-immigration campaign rhetoric. After a decade of sub-3% gains in GDP, the U.S. economy would undoubtedly benefit from tax reform as well as from policies designed to lift its productivity and potential growth rate. But how much and how soon remain open questions. Budget realities may limit the scope of stimulus while the interplay of political dealing and the legislative process means policy implementation almost always involves long lags before evidence of real economic impacts materializes. Therefore, any fiscal boost will likely turn out to be a storyline of 2018, rather than 2017.

Research also shows that the powers of fiscal multipliers are significantly smaller during economic expansions than they are during downturns. When the economy is already operating at or near capacity, as is the case today, policy stimulus is as likely to fuel inflation and trigger increases in long-term interest rates, undercutting potential gains in real growth. Indeed, while the exact nature and size of fiscal change ahead remains uncertain, tighter financial conditions have already begun to bite. Increases in bond yields since the election have been swiftly passed through to mortgage rates, while corporations are now confronted with higher borrowing costs and export-oriented firms are contending with a stronger dollar.

The new president has certainly been dealt a favorable hand. Much has been made about the Trump rally in the stock market, but its roots lie earlier in an upturn in economic and corporate profit growth that began in the third quarter of last year. Changes in policy notwithstanding, we have long been expecting the U.S. economy to regain some momentum in 2017 as headwinds on the nation's industrial sector begin to fade. With survey indicators of manufacturing at their highest level in two years, and the modest recovery underway in mining output and investment, these key drags on economic growth over the past few years are now behind us.

Nonetheless, we are somewhat cautious about building too much optimism into our forecast. With Trump's presidency comes quite a bit of opportunity, but also a

fair amount of uncertainty and potential economic risk. Any analysis of the new administration's economic impact needs to include his stance on trade and his more nationalist or isolationist view of global events. The more recent White House focus, for instance, on stricter trade agreements and the possibility of large tariffs or taxes on exports could potentially offset gains from other areas of tax and regulatory relief.

More than anything, the outlook for 2017 may hang on one factor that can be tough to measure: what many call "animal spirits," a term coined by John Maynard Keynes to describe the human emotion that drives consumer confidence. If the recent spike in optimism among business and consumers translates into increased risk-taking, then the economy may be able to shift up to a stronger growth path. But sentiment is also prone to swings that are hard to predict. This is particularly true when uncertainty is high and policy priorities are hard to determine. Whether or not an awakening of "animal spirits" will be enough to breathe new life into the economy will likely depend on more clarity making its way out of Washington in coming months.

The Fed seems to be moving toward a more hawkish position in recent months.

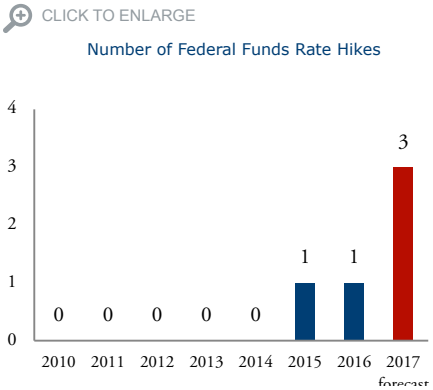
THE FED

The Fed seems to be moving toward a more hawkish position in recent months. As recently as this past October, Fed Chair Janet Yellen had suggested that she would allow the economy to run "hot." This is when inflation could move above the target of 2.0% and the unemployment rate could move below the natural rate. Doing so would allow "slack" in the labor force to be reduced. But in a recent speech, she stated that such a move would be "risky and unwise."

Now, the general view is that waiting too long to raise interest rates will drive inflation expectations higher, something the Fed does not want to do after so many decades of pushing them downward. Furthermore, the very low federal funds rate could potentially create leverage, which can lead to a bubble. And the final issue is that it would put the Fed behind the curve, forcing them to raise the federal funds rate at a pace faster than they planned. That in turn runs the risk of causing disruption in the markets.

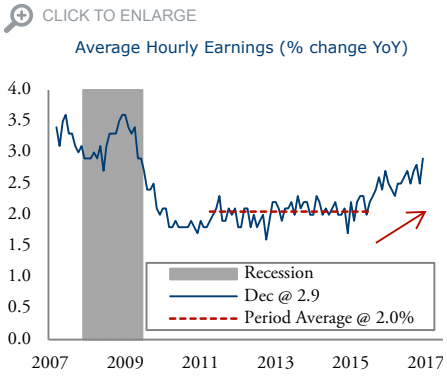
The Fed's forecast is for three rate increases this year (*Figure 2*).

Figure 2



Source: Federal Reserve Bank
January 27, 2017

Figure 3



Source: Bureau of Labor Statistics
December 31, 2016

The pace of job growth has slowed of late—a natural movement as the economy approaches full employment.

LABOR

Positive news continues to roll in for the labor market. Non-farm payrolls have moved up 156,000 and have increased for 75 consecutive months, extending the all-time record. The unemployment rate, which is at 4.7%, has been at or below 5.0% since September 2015. The most exciting news of late has been the increase in average hourly earnings. This past month, the yearly change jumped to 2.9%, a cycle high. It had been hovering around 2.0% for several years of this expansion (*Figure 3*). This trend is expected to continue. It will get a boost in the January labor report since 19 states enacted a boost to the minimum wage effective on January 1 of this year.

The pace of job growth has slowed of late (2015 average monthly gain of 229,000 vs. the 2016 average monthly gain of 180,000). This is a natural movement as the economy approaches full employment. It also helps explain the increase in wages, as businesses are having trouble finding qualified workers and are being forced to "pay up."

INFLATION

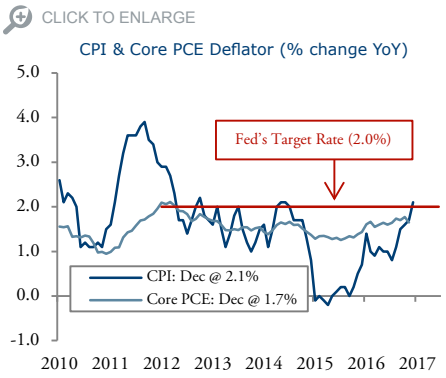
After several years of below target price increases, it appears that inflation will surpass and stay above the Fed's target rate (*Figure 4*). In December, the yearly change in the consumer price index (CPI) poked above the 2.0% target level for the first time since 2014 (the rout in oil prices during 2014-2016 had been keeping it low). Over the past year, improving oil and other commodity prices have been the main causes of upward pressure inflation.

Inflation appears on track to surpass and stay above the Fed's target rate.

The other important proxy for inflation is the core consumer price expenditure price index (Core-PCE)—the Fed's favored measurement. Since this index does not include food and energy prices, it is far less volatile than CPI. It is currently at 1.7% and has been below the 2.0% target rate since 2012.

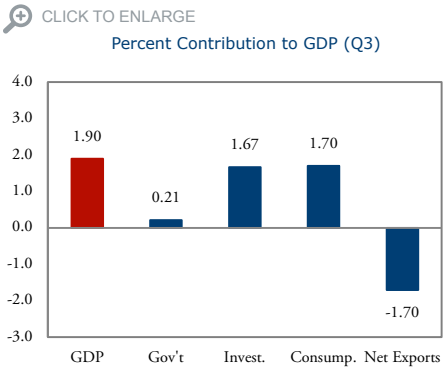
It is important to note that this growth rate of inflation is happening at a moderate pace and is consistent with the Fed's plan to raise the federal funds rate three times this year. Trying to keep inflation at 2.0% is like walking on a razor's edge. Below that rate discourages investment since there is little pricing power. Growth above that rate forces action in monetary policy and the bond market. Fed Chair Yellen recently stated that the Fed will act quickly if inflation moves significantly above the target rate.

Figure 4



Source: Bureau of Labor Statistics, Bureau of Economic Analysis
January 27, 2017

Figure 5



Source: Bloomberg, Chicago Board of Trade
January 27, 2017

GDP

Economic growth decelerated in the fourth quarter due to a massive reversal in trade.

The economy decelerated from the third quarter growth rate of 3.5% to 1.9% in the fourth quarter. It grew at 1.6% for all of 2016, the slowest yearly pace since 2011. The weakness was in the first half of the year following the collapse in oil prices. The annual pace is consistent with the 2.1% average growth rate we have experienced since the end of the recession.

The slower rate of quarterly growth was due to a massive reversal in trade. In Q3, an enormous quantity of soybeans was exported to China. That did not reoccur in Q4, and the trade component took 1.7% away from the GDP report (*Figure 5*). Offsetting that was continued growth in consumption and investment. Consumption, which makes up about two-thirds of GDP, got a boost from auto sales and rose 2.5%, contributing 1.7% to the GDP number. Looking forward, consumption should be supported by solid job growth, increased household wealth, higher confidence, and improving compensation.

The investment component of GDP had a good showing, adding 1.67% to the GDP number. Gains in business investment and intellectual capital spending, along with residential investment (housing), rose sharply (10.2%) following two quarters of declines.

The Government sector added just 0.2% to GDP. Although defense spending fell, it was more than offset by a sharp 2.6% increase in state and local spending.

Index Definitions

The small business optimism index is compiled from a survey that is conducted each month by the National Federation of Independent Business (NFIB) of its members. The index is a composite of 10 seasonally adjusted components based on the following questions: plans to increase employment, plans to make capital outlays, plans to increase inventories, expect economy to improve, expect real sales higher, current inventory, current job openings, expected credit conditions, now a good time to expand, and earnings trend.

The U.S. consumer confidence index (CCI) is an indicator designed to measure consumer confidence, which is defined as the degree of optimism on the state of the economy that consumers are expressing through their activities of savings and spending.

The Economic Policy Uncertainty Index is constructed from three underlying components. One component quantifies newspaper coverage of policy-related economic uncertainty. A second component reflects the number of federal tax code provisions set to expire in future years. The third component uses disagreement among economic forecasters as a proxy for uncertainty.

The Consumer Price Index (CPI) is a measure that examines the weighted average of prices of a basket of consumer goods and services, including transportation, food, and medical care. The CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living.

The Core Personal Consumption Expenditures Price Index (Core PCE) measures the prices paid by consumers for goods and services without the volatility caused by movements in food and energy prices to reveal underlying inflation trends.

Important Disclosures