October 2018 U.S. Economic Outlook
Is the Fed Behind the Curve?

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Key Economic Themes

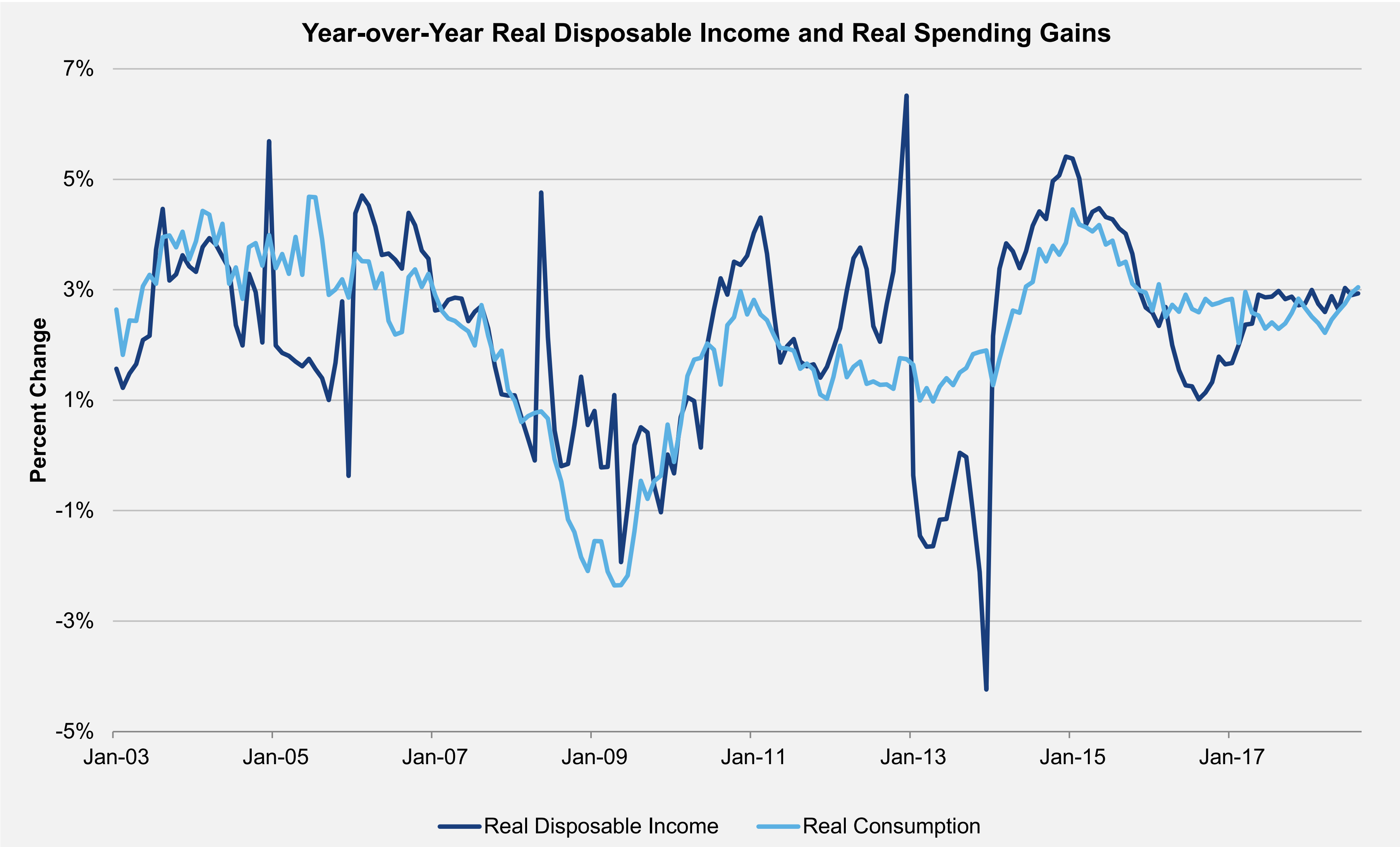
- **Economic growth is running well ahead of potential.** With productivity running at ½% from 2011-2016, potential growth was 1½% at most. Thus, actual growth of 2% was well above trend, allowing for the absorption of a massive amount of slack. More recently, growth appears to have sped up to 3% or better while productivity growth picked up to around 1% or better, both due in part to a friendlier policy backdrop. 2018 could be the best year of the expansion.
- **Business investment has been tepid for years** due in significant part to a hostile policy environment. Capital spending perked up somewhat in 2017, helped along by a revival in domestic energy production. **With tax reform in hand, we are seeing a pickup in pent-up investment demand in 2018.**
- **The household sector has led the way for economic growth.** While business investment appears poised to take the baton, household spending should remain robust. Firming labor markets have yielded solid income growth and therefore spending gains, and a looming tax cut should further boost outlays, though spending growth in the first half of the year was actually slower than in 2016 and 2017.
- **Labor markets have gotten very tight**. There is no longer much debate: labor markets are tight. The unemployment rate has dropped below 4%, and other margins of slack have also dwindled. Hiring has held up surprisingly well, despite a lack of qualified candidates. Wages may finally be beginning to accelerate significantly.
- A puzzling string of soft core inflation readings in 2017 proved to be an anomaly**. Inflation, both headline and core, accelerated early this year and have been steady in recent months**. Year-over-year core PCE deflator readings have been 1.9% or 2.0% since March.
- The Fed finally followed through on its dot projections in 2017, hiking rates 3 times. This earned the markets' grudging respect, as fed funds futures are finally open to 4 hikes for 2018 and 2 more in 2019. However, **I believe that the Fed will have to continue its gradual rate hikes much longer than markets currently expect.**

6 Years Running of Poor Productivity Gains Fundamentally Changed the Landscape; Are We Re-Accelerating?

Q4/Q4 Nonfarm Business Productivity % Chg		
2007	2.4%	02-07 avg: +2.6%
2008	-0.3%	
2009	5.4%	08-09 avg: +2.6%
2010	1.8%	
2011	0.0%	
2012	0.1%	
2013	1.5%	
2014	0.4%	
2015	0.7%	
2016	0.9%	11-16 avg: +0.6%
2017	1.2%	
2018 1st Half	1.6%	

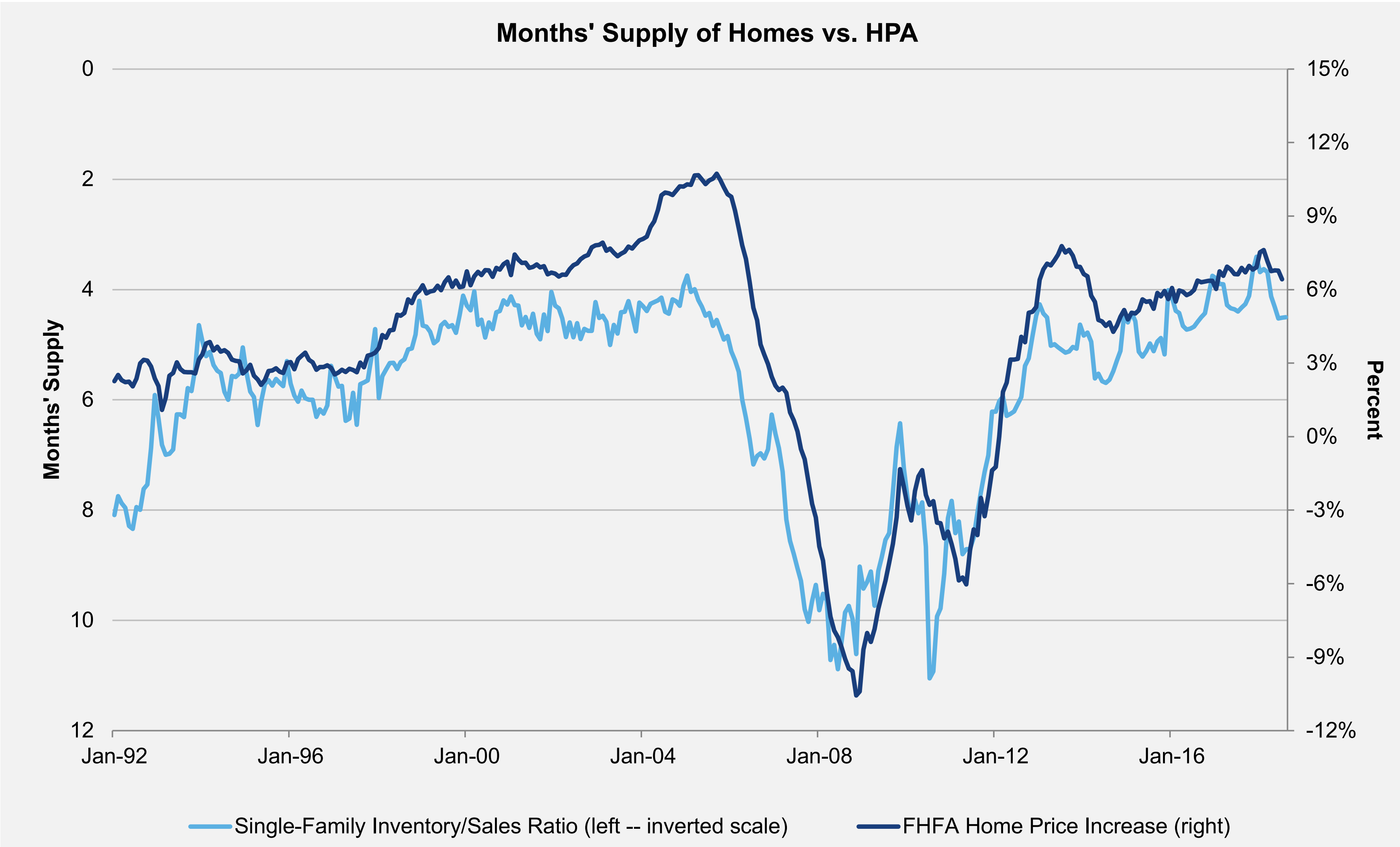
Source: BLS.

Growth in Real Household Income and Spending Have Moved in Tandem (Except for Tax Distortions)



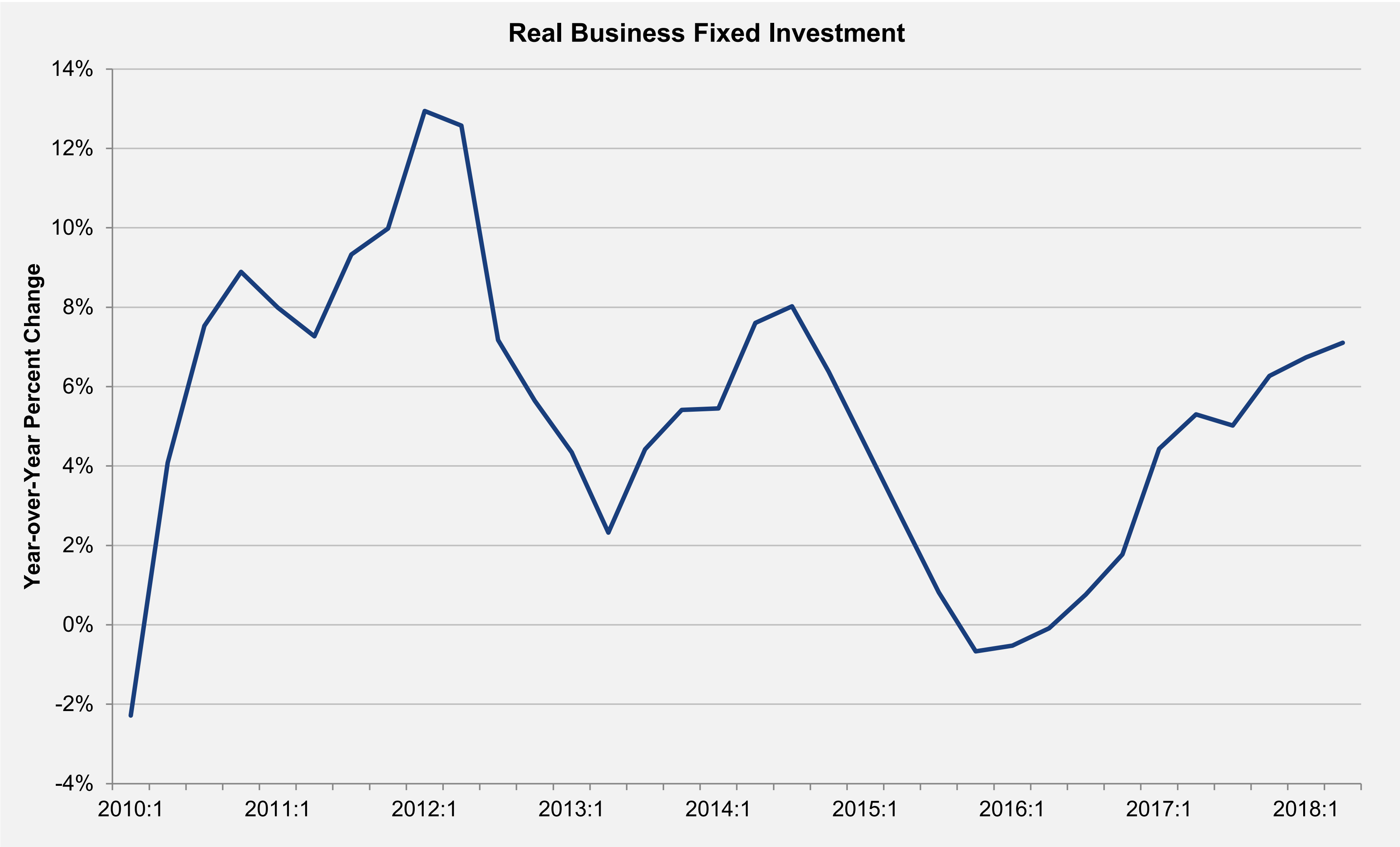
Source: BEA

HOUSING SECTOR: DEMAND > SUPPLY; ARE WE NEAR AN INFLECTION POINT?



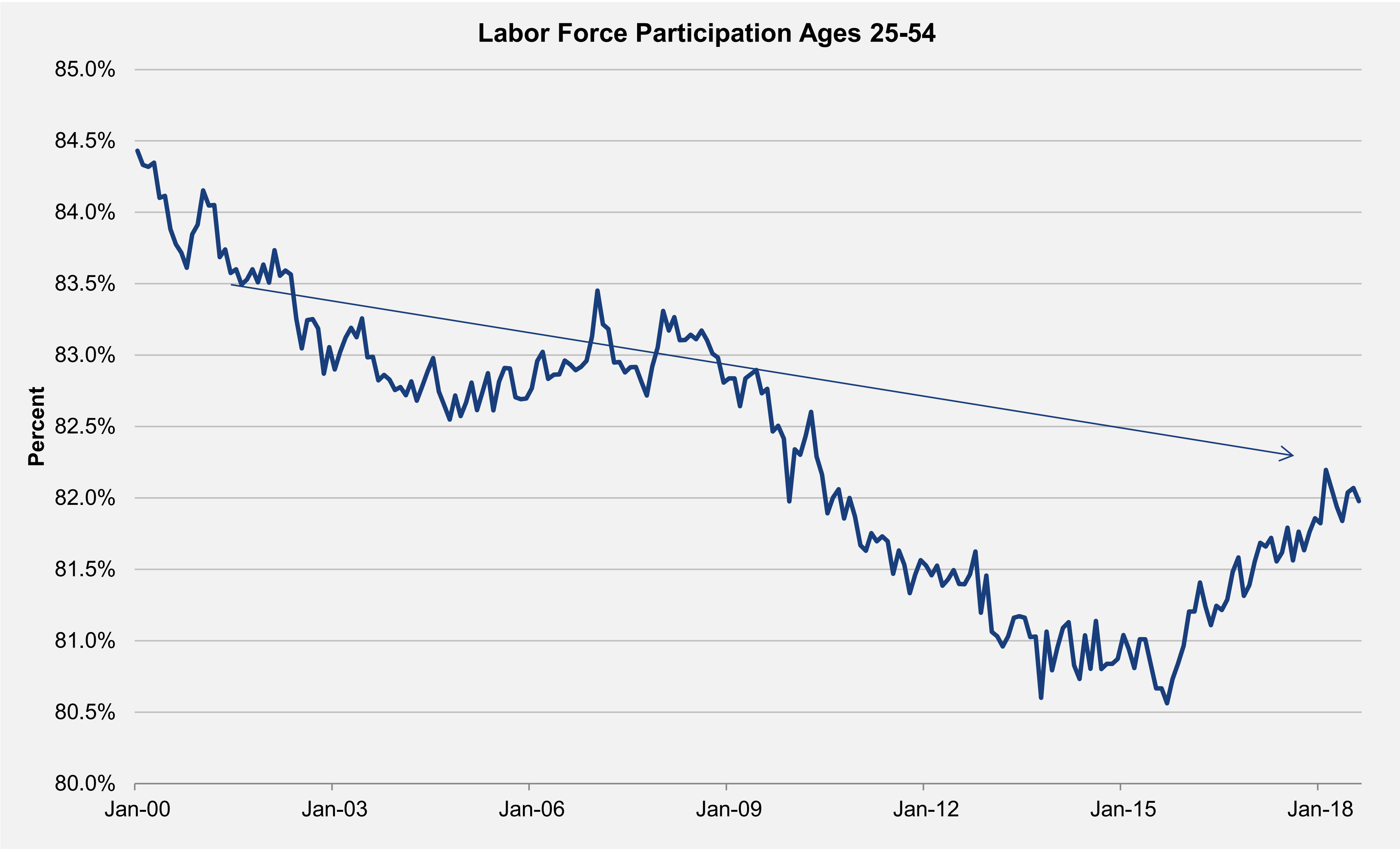
Source: FHFA, NAR, Census Bureau.

Business Investment Spending Had Been Weak for a Long Time But Perked Up in 2017. Pickup Continuing in 2018



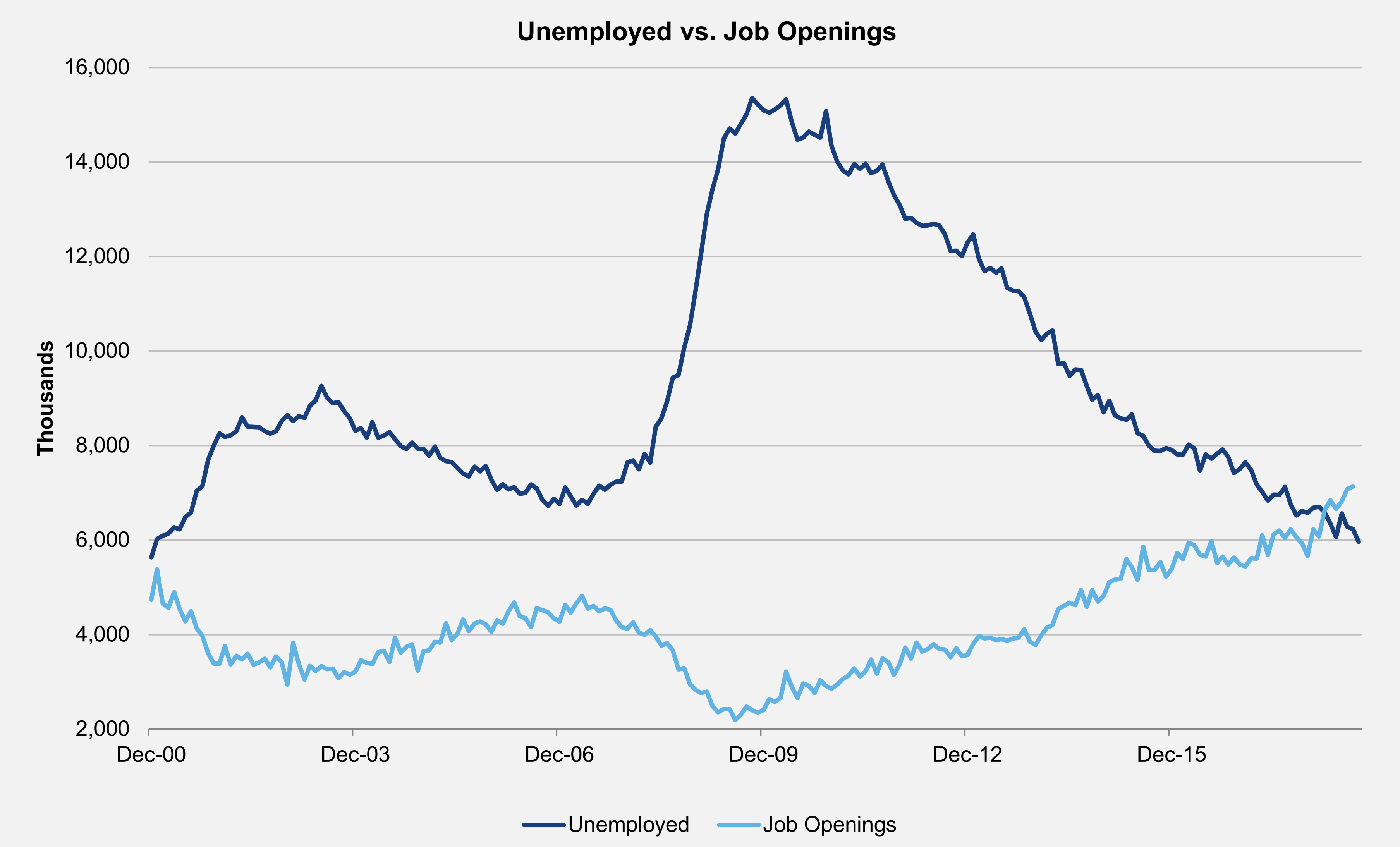
Source: BEA.

Prime-Age Labor Force Participation Recovering; How Much Room To Run?



Source: BLS, AP Sec calculations.

Labor Market Tightening Rapidly in 2018



Source: BLS,.

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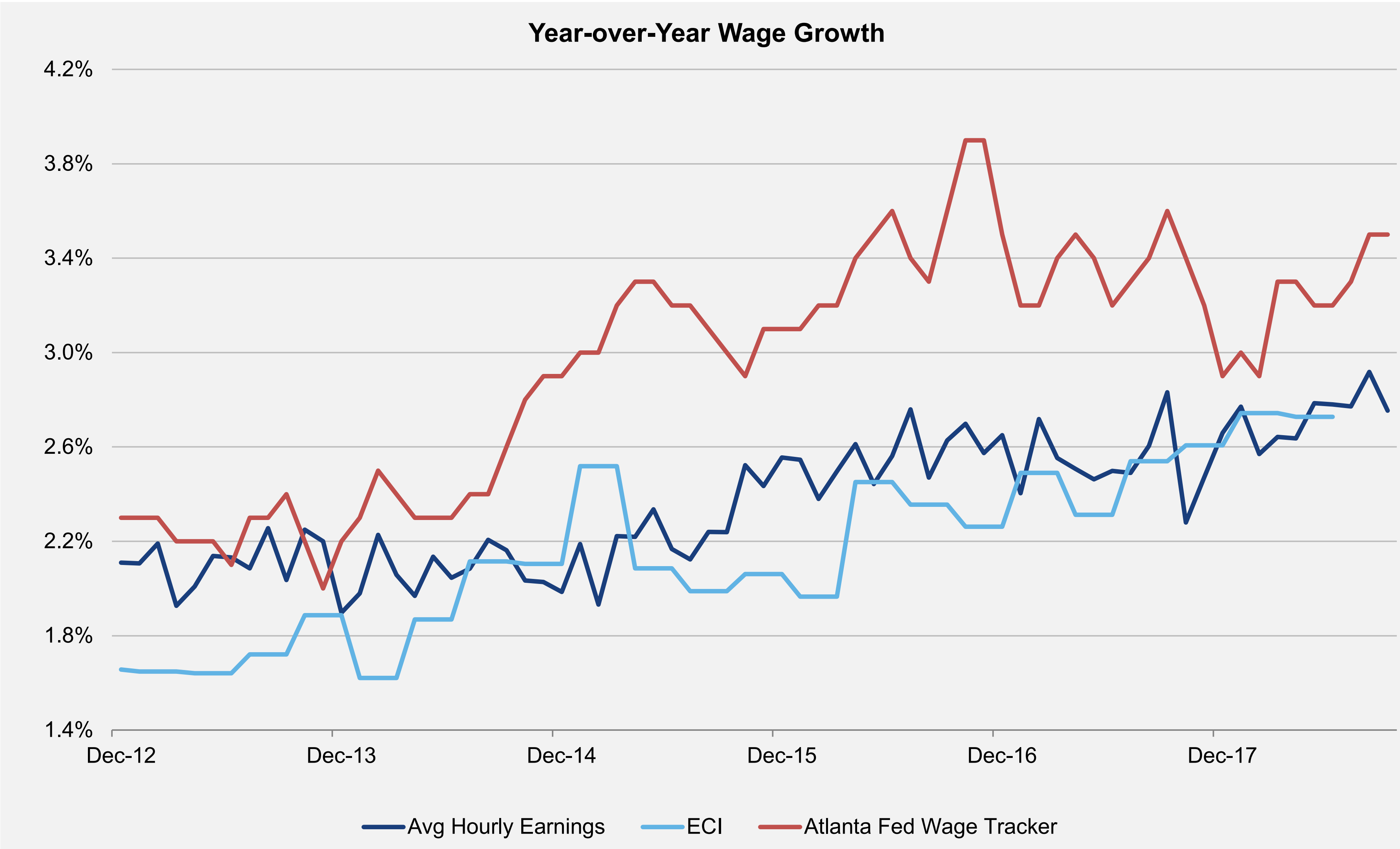
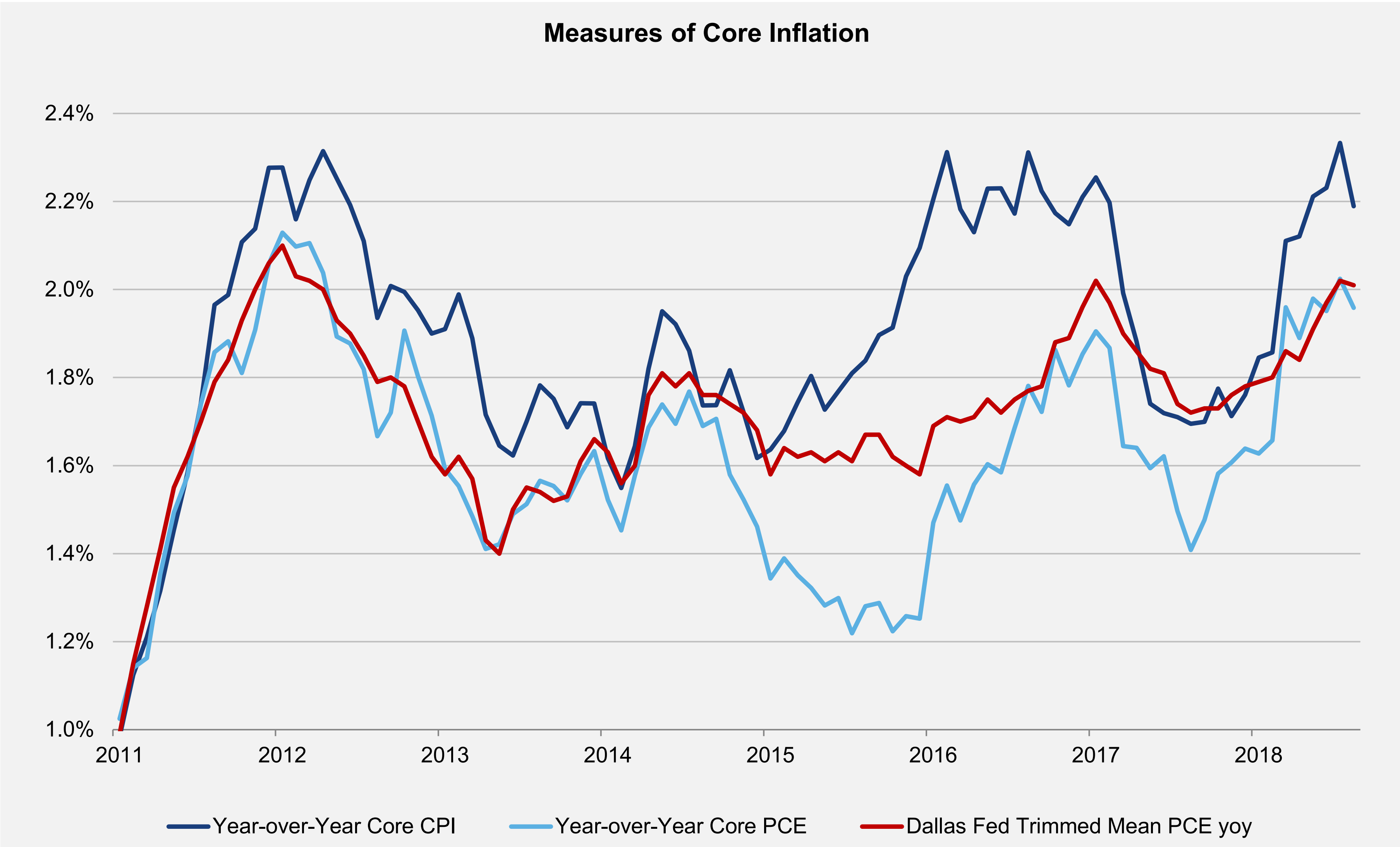
WAGE GROWTH GRADUALLY ACCELERATING



Source: BLS, Atlanta Fed.

Core Inflation Finally Reached 2%

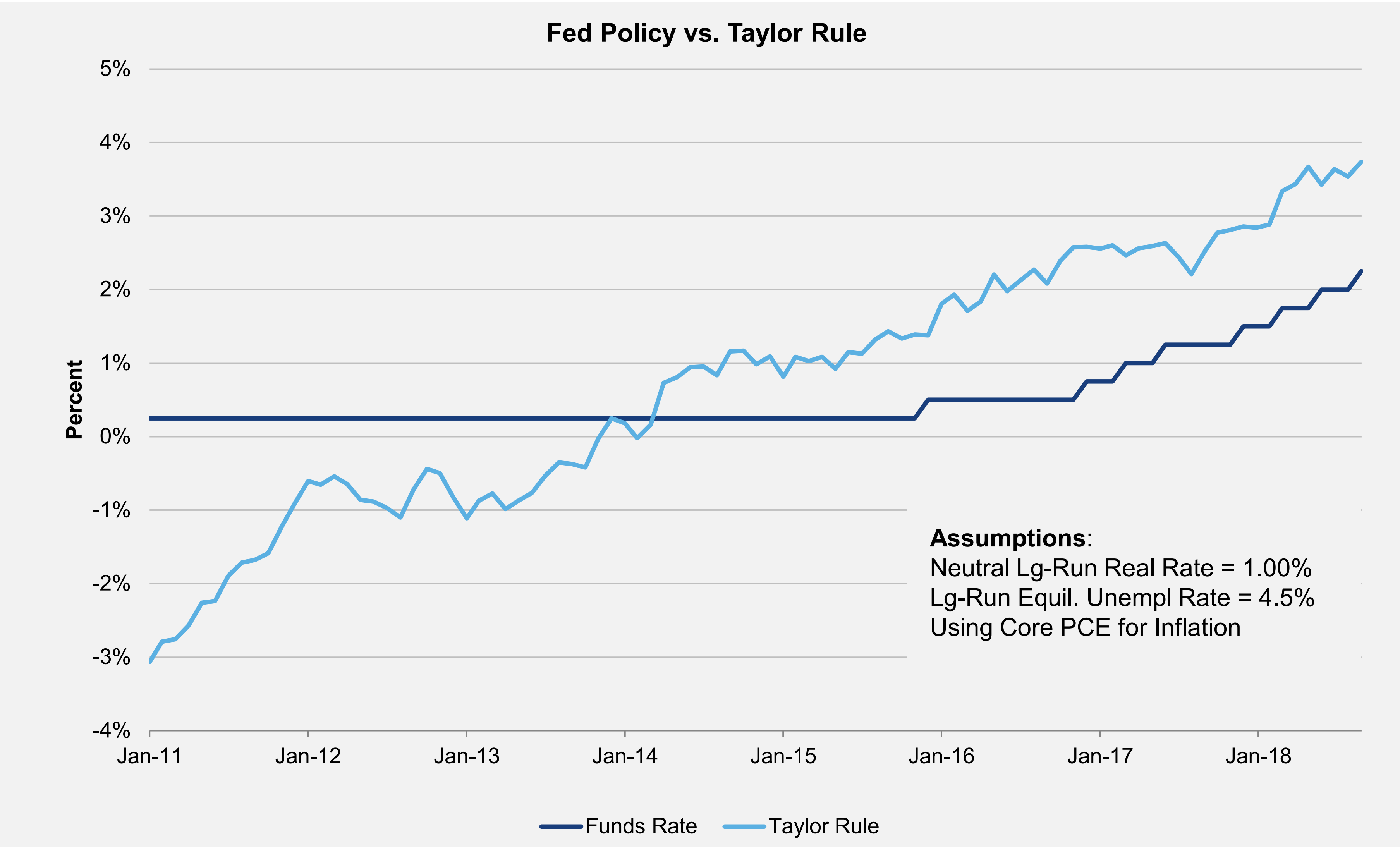


Source: BEA, BLS, Dallas Fed.

Fed Policy

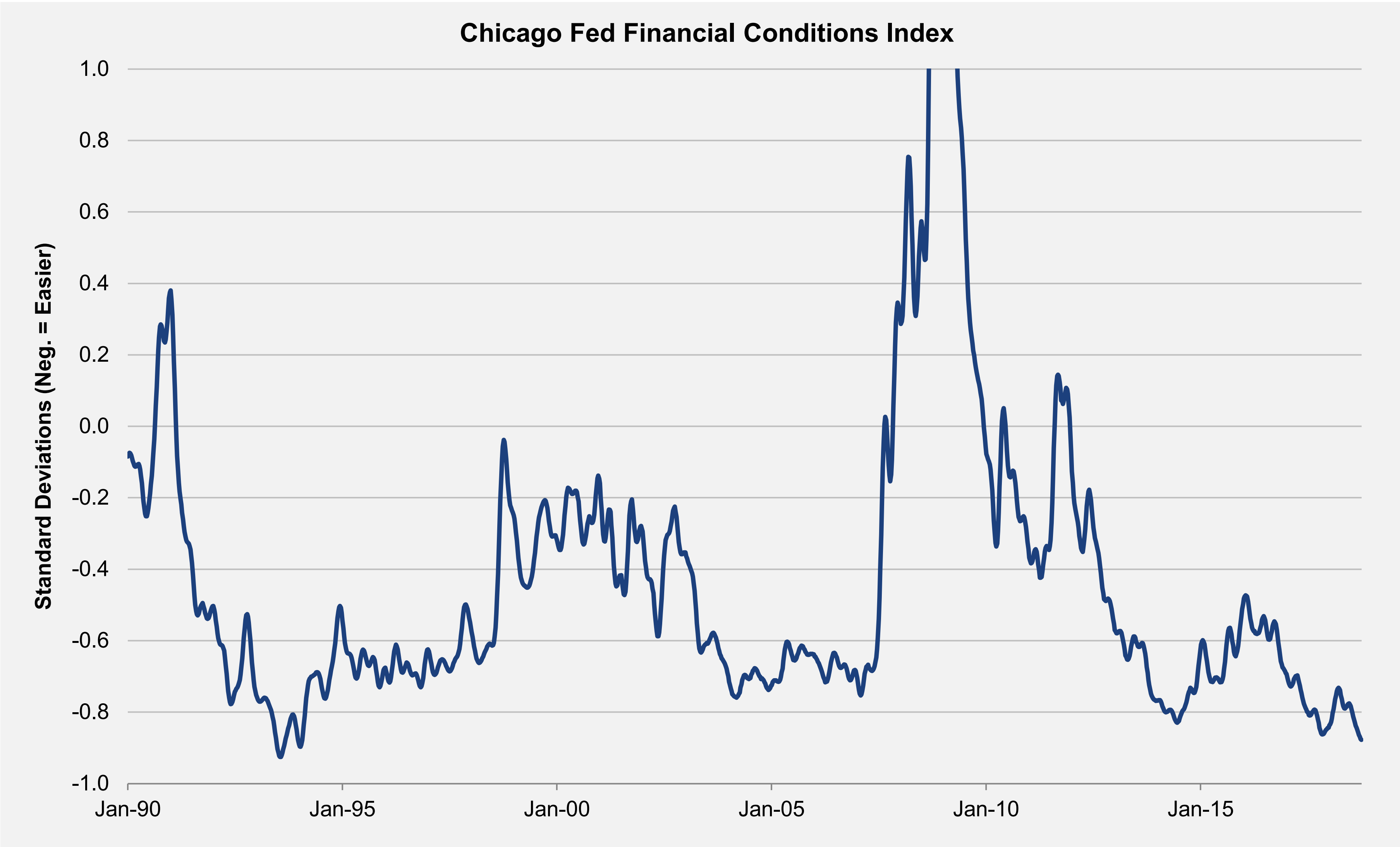
- **Fed has been very patient.** The original Taylor Rule has been at or above 2% (even assuming a lower neutral rate) for over 2 years and at least a percentage point above the actual fed funds rate for almost 3 years – and that does not account for QE!
- With inflation benign, the FOMC has had the luxury to choose their timing. The Fed chose to be “patient” (arguably behind the curve). Officials also elected to be “gradual.” Trying both risks a major error.
- With inflation rebounding and the unemployment rate dropping, the Fed has fallen further behind the curve. The funds rate is further below the Taylor Rule prescription today than it was just before the first rate hike.
- Market pricing for 2018 is finally pretty much in line with the dots.
- **However, market pricing is somewhat more dovish than the dots in 2019 and beyond.** Fed funds futures have about 50 BPs of hikes priced in for 2019 and peak around 2.95% in 2020.

The Fed is Still Playing Catchup



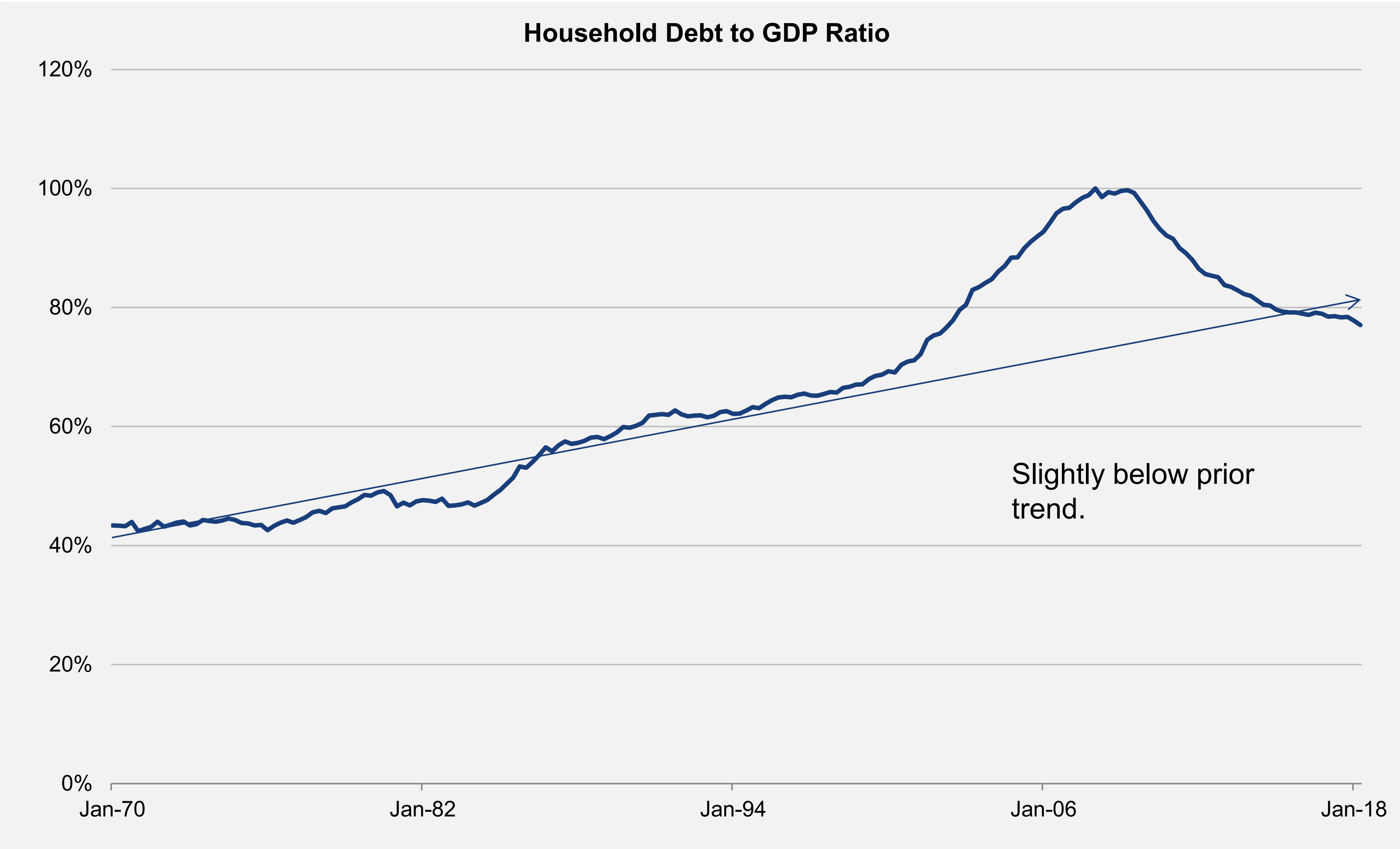
Source: Bloomberg.

At What Point Do Financial Conditions Matter for the Fed?



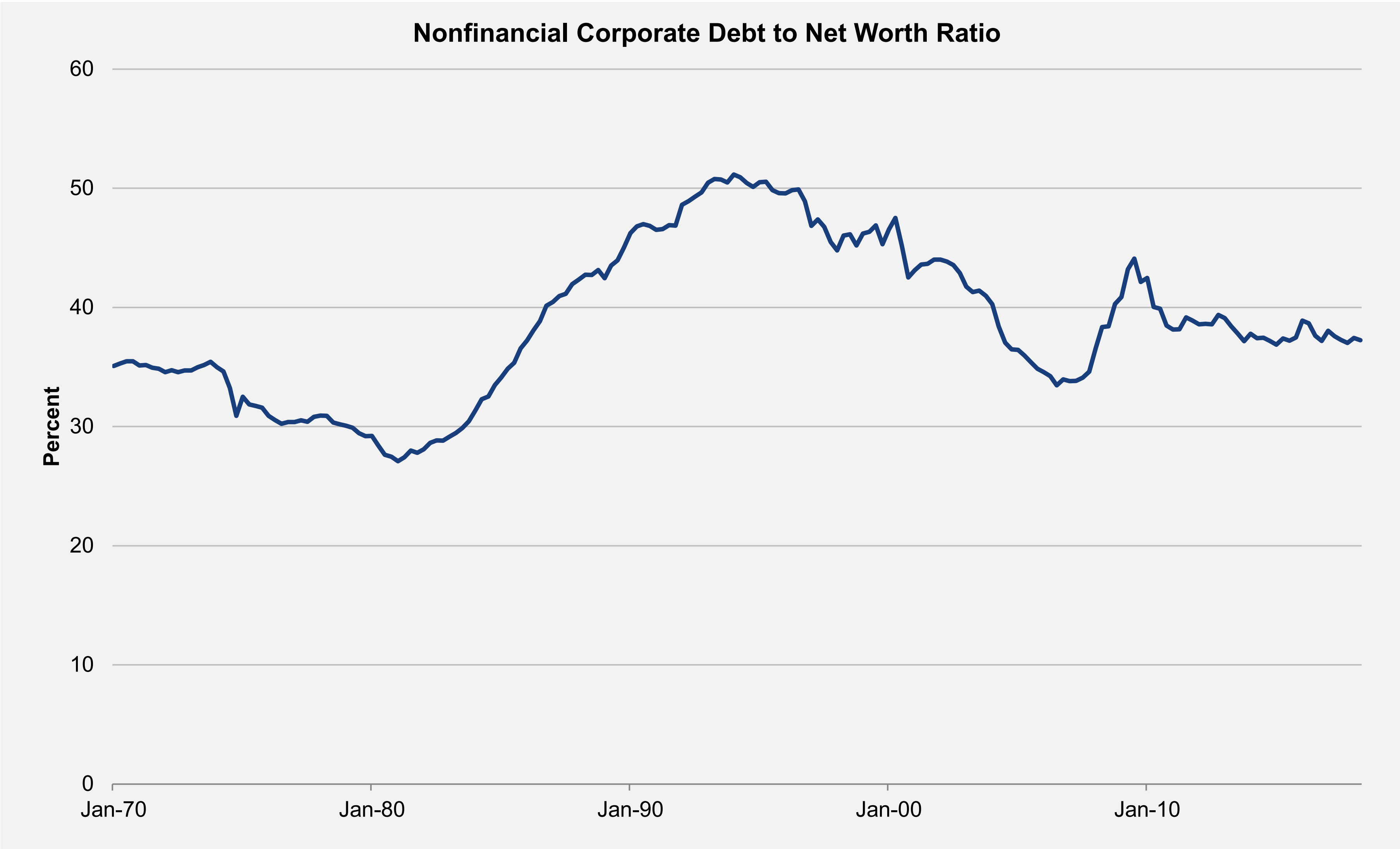
Source: Chicago Fed.

Consumer Balance Sheet in Great Shape



Source: BEA, Federal Reserve.

Business Sector Balance Sheet Not as Good but Still Solid



Source: Federal Reserve.

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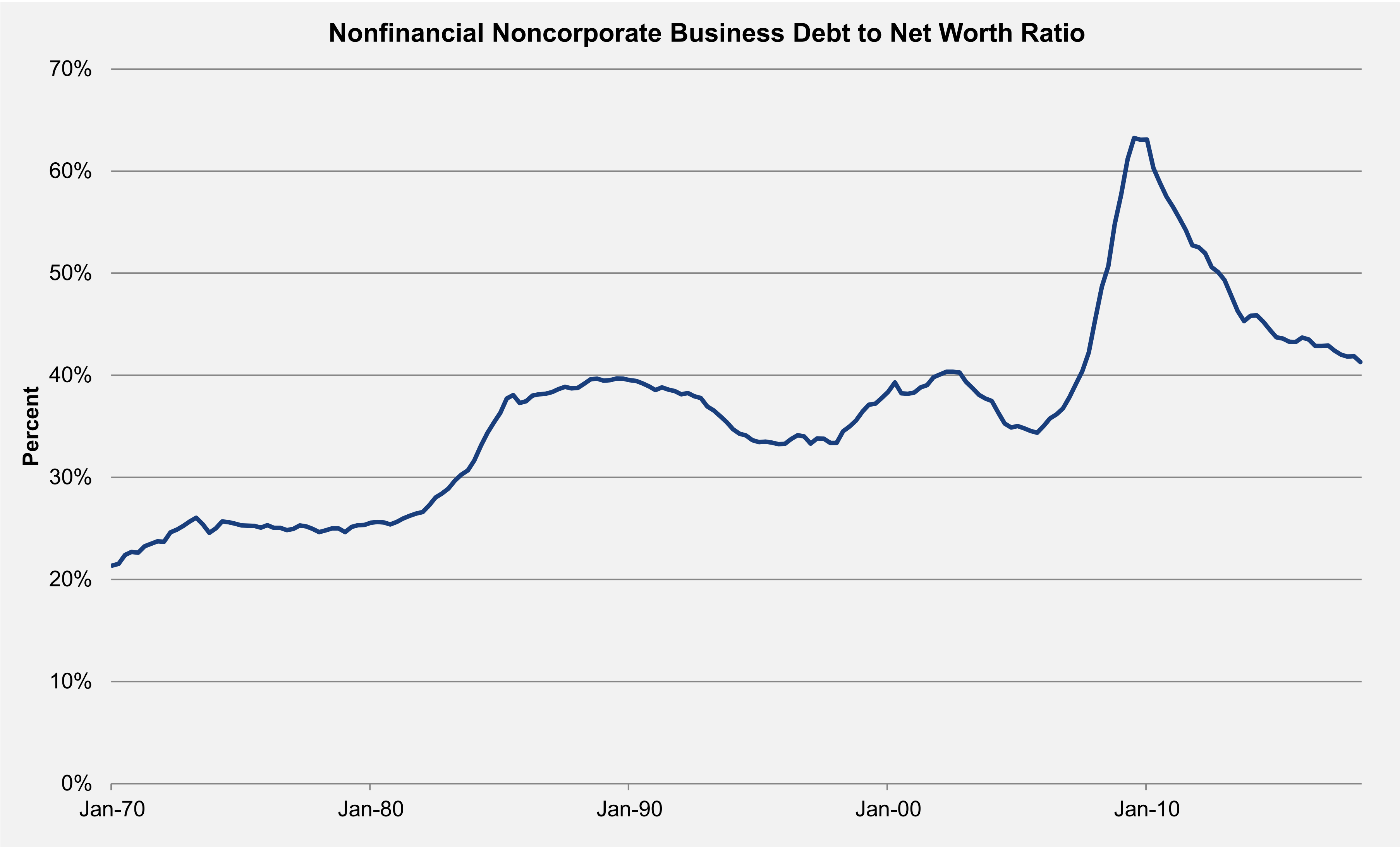

Source: Federal Reserve.

Amherst Pierpont Economic Forecasts

Economic Forecasts – 10/19/2018

	Seasonally Adjusted at an Annualized Rate										
	2017		2018				2019		2017	2018	2019
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q4/Q4*	Q4/Q4*	Q4/Q4*
Real GDP	**2.8**	**2.3**	**2.2**	**4.2**	***2.8***	***3.9***	***2.9***	***3.3***	**2.5**	***3.3***	***3.0***
Personal Consumption Expenditures	2.2	3.9	0.5	3.8	*3.6*	*3.2*	*2.6*	*2.9*	2.7	*2.8*	*2.8*
Nonresidential Investment	3.4	4.8	11.5	8.7	*3.9*	*6.8*	*5.5*	*5.5*	6.3	*7.7*	*5.2*
Equipment and Software	9.8	9.9	8.5	4.6	*3.2*	*8.0*	*6.0*	*6.0*	9.6	*6.1*	*5.8*
Structures	-5.7	1.3	13.9	14.5	*-0.5*	*3.8*	*3.6*	*3.5*	3.1	*7.9*	*3.5*
Residential Investment	-0.5	11.1	-3.4	-1.3	*-1.5*	*6.0*	*4.0*	*6.0*	4.1	*-0.1*	*5.0*
Chg in Business Inventories ($ billions)	$64.4	$16.1	$30.3	-$36.8	*38.0*	*45.0*	*50.0*	*60.0*	-22.9	*19.1*	*62.5*
Net Exports ($ billions)	-$845.9	-$899.2	-$902.4	-$841.0	*-928.0*	*-923.4*	*-928.9*	*-936.1*	-858.7	*-898.7*	*-939.5*
Government Spending	-1.0	2.4	1.5	2.5	*0.6*	*1.1*	*1.0*	*1.1*	0.2	*1.4*	*1.1*
Real Final Sales (of Domestic Product)	1.8	3.2	1.9	5.4	*1.2*	*3.7*	*2.8*	*3.1*	2.6	*3.1*	*2.9*
Real Final Sales to Domestic Purchasers	1.7	4.0	1.9	4.0	*3.0*	*3.5*	*2.8*	*3.1*	2.7	*3.1*	*2.9*
Nominal GDP	4.8	5.1	4.3	7.6	*4.4*	*6.5*	*5.5*	*5.9*	4.5	*5.7*	*5.7*
GDP Chain-Weighted Price Index	2.2	2.5	2.0	3.0	*1.5*	*2.5*	*2.5*	*2.5*	2.0	*2.2*	*2.6*
Core PCE Deflator	**1.4**	**2.1**	**2.2**	**2.1**	***1.5***	***1.9***	***2.6***	***2.6***	**1.6**	***1.9***	***2.7***
Consumer Price Index	2.1	3.3	3.5	1.7	*2.0*	*2.5*	*3.0*	*3.0*	2.1	*2.4*	*3.1*
Core Consumer Price Index	1.8	2.2	3.0	1.8	*2.0*	*2.5*	*2.8*	*2.8*	1.8	*2.3*	*2.9*
Unemployment Rate (quarter average)	4.3	4.1	4.1	3.9	*3.8*	*3.7*	*3.6*	*3.5*	4.4	*3.9*	*3.4*
Fed Funds Target Rate (end of period)	**1.00-1.25**	**1.25-1.50**	**1.50-1.75**	**1.75-2.00**	***2.00-2.25***	***2.25-2.50***	***2.50-2.75***	***2.75-3.00***	**1.25-1.50**	***2.25-2.50***	***3.00-3.25***
2-Year Treasury Yield (end of period)	1.47	1.89	2.27	2.52	2.81	*3.00*	*3.18*	*3.35*	1.89	*3.00*	*3.65*
10-Year Treasury Yield (end of period)	2.33	2.40	2.74	2.85	3.05	*3.35*	*3.55*	*3.75*	2.40	*3.35*	*4.00*

* Annual figures for the change in business inventories represent the Q4/Q4 changes in the pace of inventory accumulation. Annual data shown for the unemployment rate and the interest rates are average and end-of-period figures, respectively.

Note: Forecasts shown in italics.

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