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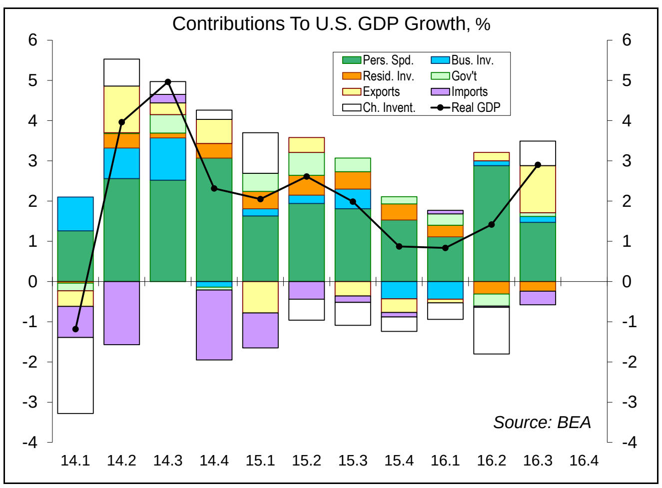
Economic Trends

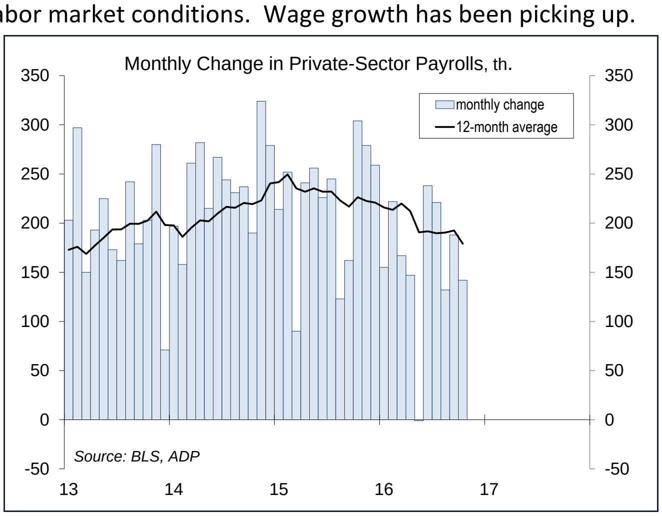
The Post-Election Outlook

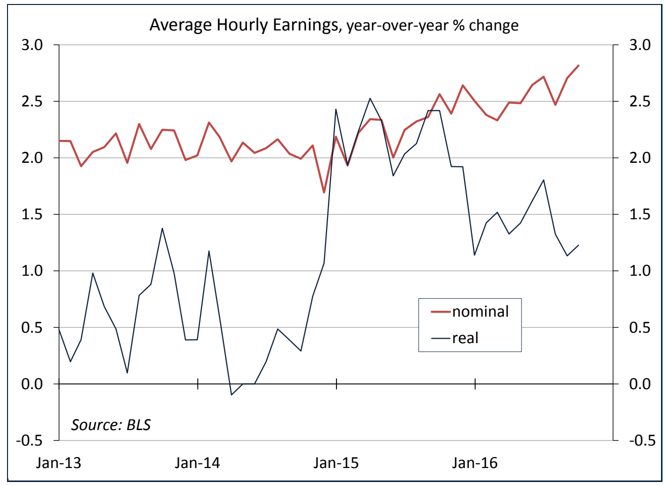
- *The unexpected result of the presidential election has generated optimism that reduced regulations, added infrastructure spending, and lower taxes will spur growth.*
- *However, the economy appears to be relatively close to full employment. If so, fiscal stimulus would be more likely to add to inflation or fuel asset bubbles. Expectations of increased government borrowing have lifted long-term interest rates.*
- *It's unclear what policies we'll get out of Washington in 2017. A trade war remains a significant risk.*

Real GDP rose at a 2.9% annual rate in the advance estimate for 3Q16, boosted by a rise in inventory growth and by a surge in soybean exports (which ought to unwind in 4Q16). Excluding inventories and foreign trade, growth would have been 1.6%. Monthly retail sales figures suggest relatively strong consumer spending growth into the fourth quarter.



Job growth has slowed this year, largely due to tighter labor market conditions. Wage growth has been picking up.





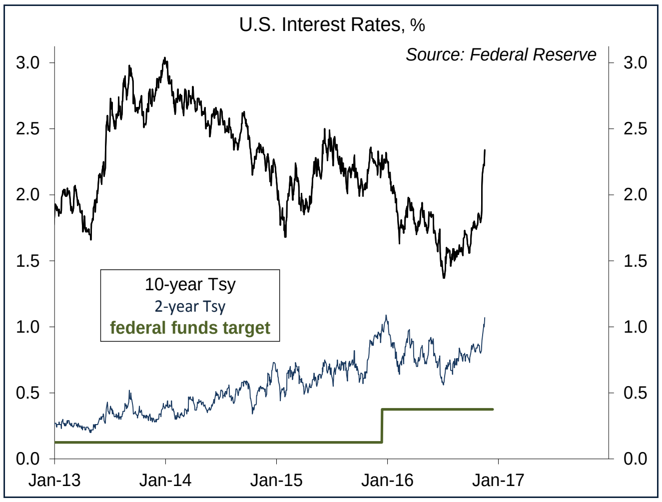
Heading into the election, Hillary Clinton was leading in the polls in the key battleground states, while Democrats were projected to regain control of the Senate. Instead, Donald Trump is president-elect and Republicans will remain in charge of both chambers of Congress. The surprise result has lifted share prices, but bond yields are significantly higher.

A rollback of regulations will reduce business costs and have a significant impact on some industries. A large infrastructure package could add to growth, but that depends on how it is financed. Some Republicans are likely to resist increased spending. The House no longer has earmarks, which means that it's difficult to get additional spending through. Trump's tax proposals from the campaign would reduce revenues by trillions of dollars, but they are almost certain to be scaled back. A reduced tax rate of foreign earnings could send more capital back to U.S. firms, but companies are generally cash rich and borrowing costs have been low, so it's unclear why repatriation would boost business investment.

The main concern about fiscal stimulus, which can be effective in shoring up the economy during a downturn, is that the labor market appears to be close to full employment. Slack remains in the job market. There are many on the sidelines, not officially counted as "unemployed," who would take a good job if offered. Underemployment has been an issue in the recovery, but there have been clear signs of improvement. Involuntary part-time employment has been trending lower. We should see faster wage growth in a tight job market – and growth in average hourly earnings has been trending higher.

Given the aging of the population, trend GDP growth should be a lot slower than in previous decades. Growth can exceed that trend as slack is taken up, but unless we allow a lot more immigration or get an unexpected sharp pickup in productivity growth, demographic constraints will be binding.

Federal Reserve policymakers are set to raise short-term interest rates on December 14. Internal pressures have been building for some time. Ahead of the September 20-21 FOMC meeting, 9 of the 12 district banks had requested that the Fed's Board of Governors raise the discount rate by 25 basis points (the BOG did not approve that request). Fed Chair Yellen said that the Federal Open Market Committee judged, at the policy meeting in early November, that a rate increase *"could well become appropriate relatively soon"* if the incoming data reflected further progress toward the Fed's goals.



U.S. Interest Rates, %

The election results have not changed the Fed's policy outlook, according to Chair Yellen, but the central bank will respond to changes in the economic outlook following the passage of a new fiscal plan. Yellen cautioned, *"Markets are already anticipating that Congress will ultimately choose a fiscal package that involves a net expansionary stance, and in a context of an economy that is operating reasonably close to maximum employment, such a package could have inflationary consequences that the Fed would have to take into account."*

The yield on the 10-year Treasury note has risen about 50 basis points since the election. Long-term interest rates in the U.S. are expected to be held back to some extent by low rates abroad. Conversely, long-term interest rates abroad may be pressured somewhat by higher rates in the U.S. The dollar has strengthened since the election.

The Fed is still expected to raise short-term interest rates gradually over time, but could hike more rapidly if inflation picks up more than expected. Currently, we are seeing very little pressure on the goods side. Gasoline prices have ticked up recently and those increases have been magnified by the seasonal adjustment. Inflation in food prices has continued to diverge, with food at home down 2.3% y/y and food away from home up 2.4% y/y. On average, there is mild deflationary pressure in imports and in raw materials. However, goods account for only about 36% of the Consumer Price Index. Pressure in services has been concentrated in shelter, which appears poised to continue amid a relatively strong job market and rising mortgage rates. Healthcare costs have long outpaced overall consumer price inflation. That's likely to continue even if the Affordable Care Act is repealed. The labor market is the widest channel for inflation pressures.

Trade policy remains a key uncertainty – and a signficant risk – to the economic outlook. It's unclear whether the heated rhetoric of the campaign will translate into actual policy changes, but the president does have the authority to pull the U.S. out of trade agreements. He doesn't need congressional approval to nullify the North American Free Trade Agreement, which has been in place since the 1994. Ironically, the Mexican peso has fallen sharply against the dollar, creating more incentive for U.S. firms to locate production there. There are greater concerns beyond NAFTA. A trade war with China would have destabilizing effects on global trade at a time when global trade activity has already slowed significantly (largely reflecting the ageing of populations worldwide).

	4Q15	1Q16	2Q16	3Q16	***4Q16***	***1Q17***	***2Q17***	***3Q17***	***4Q17***	2015	**2016**	**2017**	**2018**
GDP (↓ *contributions*)	0.9	0.8	1.4	2.9	1.9	2.1	2.0	1.9	1.9	2.6	1.5	2.1	1.9
consumer durables	0.3	-0.1	0.7	0.7	0.3	0.2	0.2	0.2	0.2	0.5	0.4	0.3	0.2
nondurables & services	1.2	1.2	2.2	0.8	1.1	1.1	1.2	1.2	1.2	1.6	1.6	1.2	1.2
bus. fixed investment	-0.4	-0.4	0.1	0.2	0.2	0.3	0.3	0.2	0.2	0.3	-0.1	0.2	0.2
residential investment	0.4	0.3	-0.3	-0.2	0.2	0.2	0.2	0.1	0.1	0.4	0.2	0.1	0.1
Priv Dom Final Purchases	1.8	1.1	3.2	1.6	2.1	2.1	2.1	2.0	2.0	3.3	2.2	2.1	1.9
government	0.2	0.3	-0.3	0.1	0.2	0.2	0.2	0.2	0.2	0.3	0.2	0.2	0.2
exports	-0.3	-0.1	0.2	1.2	-0.6	0.2	0.2	0.2	0.2	0.0	0.0	0.2	0.2
imports	-0.1	0.1	0.0	-0.3	-0.1	-0.2	-0.2	-0.2	-0.2	-0.7	-0.1	-0.2	-0.2
Final Sales	1.2	1.2	2.6	2.3	1.4	2.0	1.9	1.9	1.9	2.4	1.9	1.9	1.9
ch. in bus. inventories	-0.4	-0.4	-1.2	0.6	0.6	0.1	0.0	0.0	0.0	0.2	-0.4	0.1	0.0
Unemployment, %	5.0	4.9	4.9	4.9	4.9	4.8	4.8	4.8	4.8	5.3	4.9	4.8	4.9
NF Payrolls, monthly, th.	282	196	146	206	160	150	145	140	135	229	177	138	118
Cons. Price Index (q/q)	0.8	-0.3	2.5	1.6	3.4	2.2	2.2	2.2	2.2	0.1	1.3	2.4	2.2
excl. food & energy	2.2	2.7	2.1	1.9	1.9	1.9	1.9	2.0	2.0	1.8	2.2	1.9	2.0
PCE Price Index (q/q)	0.3	0.2	2.0	1.4	2.7	2.1	2.0	2.0	2.1	0.3	1.1	2.1	1.9
excl. food & energy	1.3	2.0	1.8	1.7	1.7	1.8	1.8	1.9	2.0	1.4	1.7	1.8	1.8
Fed Funds Rate, %	0.16	0.36	0.37	0.40	0.44	0.63	0.65	0.88	0.92	0.13	0.39	0.77	1.27
3-month T-Bill, (bond-eq.)	0.1	0.2	0.3	0.3	0.4	0.6	0.7	0.9	0.9	0.1	0.3	0.8	1.3
2-year Treasury Note	0.8	0.8	0.8	0.7	1.0	1.2	1.4	1.5	1.6	0.7	0.8	1.4	1.9
10-year Treasury Note	2.2	1.9	1.8	1.6	2.2	2.6	2.7	3.0	3.1	2.1	1.9	2.9	3.5