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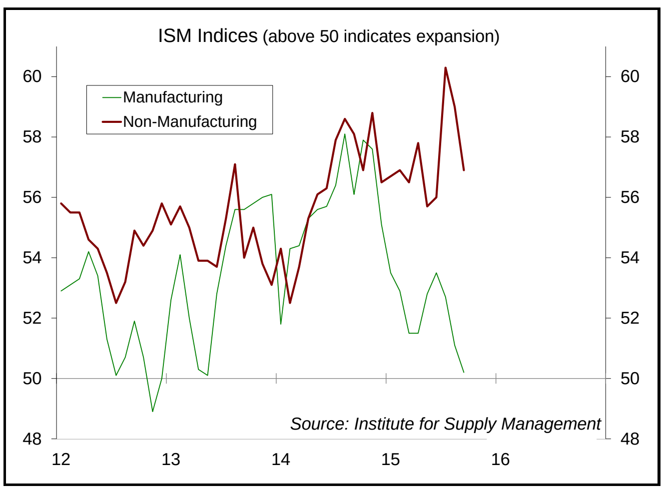
Monthly Economic Outlook

Mixed

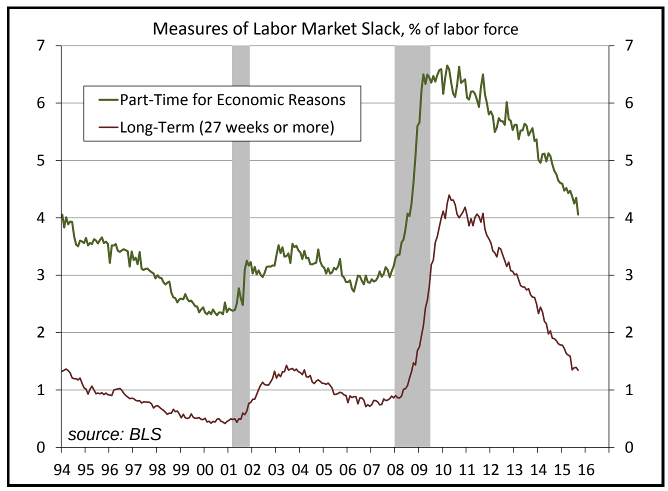
- *The slowdown in global growth and the stronger dollar have restrained U.S. exports. A wider trade deficit and an inventory correction are expected to subtract from GDP growth.*
- *In contrast, consumer spending growth appears to have remained brisk, factory shipments of capital goods have improved, and the housing sector continues to recover.*
- *Since postponing the initial increase in short-term rates in mid-September, most Fed officials (including Chair Yellen) have indicated that a rate hike is likely to be warranted by the end of the year. The markets believe the Fed will wait until 2016.*

Recent economic data present a mixed picture of the U.S. economy. Exports have been restrained by a stronger dollar and slower growth abroad. The September ISM manufacturing survey suggested that factory sector activity is about flat. That likely reflects a combination of overseas weakness and domestic strength. Inventory growth was strong in the first half of the year, most likely unintentionally. Hence, we ought to see some moderation in inventory growth in the second half of the year (subtracting from GDP growth). None of these drags will be large enough to push the economy into recession.



Unit auto sales continued to advance in the third quarter, and combined with the August personal income and spending numbers, point to an annual rate of 3.5-4.0% for inflation-adjusted consumer spending (70% of GDP) in 3Q15. Factory orders declined in the first half of the year, but appear to have picked up somewhat into 3Q15. The contraction in energy exploration has had a tiny impact on national employment, but a drop in related structures subtracted significantly from business fixed investment. The drag on capital spending appears to be largely behind us. Home sales and construction activity have continued to improve. Bank credit to consumers and businesses is still fairly tight, but is gradually getting easier.

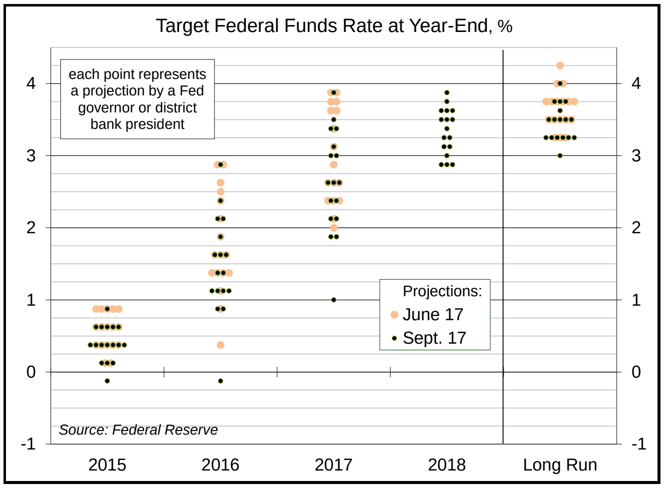
Job growth slowed in the third quarter. The financial press described September's gain in nonfarm payrolls (+142,000) as "dismal," "weak," "grim," or "poor." However, the pace was still well above what is consistent with the growth in the working-age population. Seasonal adjustment issues (the start of the school year and the end of the summer travel season) make the numbers suspect. However, the ADP estimate of private-sector payrolls showed slower hiring at small and medium-sized firms in the last few months. Recall that increased hiring at smaller firms led to a pickup in job growth in 2014 and the first half of 2015. It's possible that these firms were spooked by the negative headlines (China, stock market) over the last couple of months and the slowing may prove to be transitory. In the near term, the net result is that incoming economic data reports have become much more important.



As the labor market continues to tighten, the pace of growth in nonfarm payrolls should slow. However, it's unclear exactly how much slack remains. The unemployment rate is approaching 5%, which is generally considered close to "full employment." However, labor force participation is low. Much of that is demographics (the aging of the population), but it's likely that there are a lot of potential workers on the sidelines. Wage growth has remained lackluster, suggesting that the job market is still far from "tight." Long-term unemployment and the percentage of people working part-time for economic reasons are trending lower, but are still far from normal.

The assessment of labor market slack is a key issue for monetary policymakers and Federal Reserve officials differ in their views. The Fed has to set policy with an eye to where the economy will be 12 to 18 months from now, and there should be a lot less slack over time. Hence, officials anticipate a gradual path of policy normalization. The financial markets remain overly focused on the timing of the initial move.

At the September 16-17 monetary policy meeting, Fed officials revised their projections of growth, unemployment, and inflation, as well as the "appropriate" level of the federal funds rate at the end of each of the next few years. Once again, the dots in the dot plot generally drifted a bit lower. Most Fed officials believe that economic conditions will warrant at least one rate increase by the end of the year. In recent public speeches, officials have repeated this sentiment. Fed Chair Janet Yellen presented a lengthy analysis of the inflation dynamics as justification for normalization. Views continued to vary widely on the path of rates in 2016 and 2017.



Target Federal Funds Rate at Year-End, %

While there appears to be a Fed consensus around the initial timing, the financial markets are doubtful. The federal funds futures are signaling less than even odds of a move this year. Something is going to have to give. Either the Fed will shift its expectations to a later initial move or the markets will have to adjust. Notably, Fed officials have to consider financial market stability and possible reactions as they decide on policy.

In its decisions to delay the initial move (September 17) the Fed is citing the possible impact on the U.S. economy of global economic and financial developments. That is, officials are not reacting specifically to what's going on in the rest of the world, but to the potential impacts that the rest of the world may have on the U.S. As Vice Chair Stanley Fischer noted in August, "in maintaining a stable and strong macroeconomic environment at home, we will be best serving the global economy as well." The strong dollar and soft global economy have put downward pressure on inflation, but Fed officials believe that this impact will be transitory.

Note that China's holdings of U.S. Treasuries are concentrated at the short-end of the yield curve. Sales of Treasuries (to keep the Chinese currency from weakening) should not have a big impact on U.S. bond yields.

House Speaker John Boehner resigned from his position as Speaker of the House effective October 30. That apparently was the price of working with the Democrats to fashion a continuing resolution to fund the government (to December 11). Treasury has indicated that November 5 will be the drop-dead date for raising the debt ceiling (about a month earlier than many had anticipated). The new speaker is expected to be less willing to compromise. However, Boehner is still speaker and there ought to be some haste to work out a deal on a full budget and an increase in the debt ceiling by the end of the month. If that works out, that will be a major hurdle cleared for the financial markets. If not, we would likely see a government shutdown and some risk of a U.S. default.

Looking ahead, growth in real GDP is expected to be moderate in the near term, reflecting ongoing strength in the domestic economy and some restraint in net exports and inventories. Inflation should move gradually higher as commodity prices and the dollar stabilize.

	4Q14	1Q15	2Q15	3Q15	**4Q15**	**1Q16**	**2Q16**	**3Q16**	**4Q16**	2014	**2015**	**2016**	**2017**
GDP (↓ *contributions*)	2.1	0.6	3.9	***2.0***	***2.3***	***2.6***	***2.7***	***2.7***	***2.6***	2.4	***2.5***	***2.6***	***2.5***
consumer durables	0.4	0.1	0.6	***0.6***	***0.4***	***0.4***	***0.4***	***0.3***	***0.3***	0.4	***0.5***	***0.4***	***0.3***
nondurables & services	2.4	1.0	1.9	***1.9***	***1.6***	***1.5***	***1.5***	***1.5***	***1.5***	1.4	***1.7***	***1.6***	***1.4***
bus. fixed investment	0.1	0.2	0.5	***0.5***	***0.5***	***0.5***	***0.5***	***0.5***	***0.5***	0.1	***0.4***	***0.5***	***0.5***
residential investment	0.3	0.3	0.3	***0.3***	***0.3***	***0.2***	***0.2***	***0.2***	***0.2***	0.3	***0.3***	***0.3***	***0.2***
Private Dom Final Sales	3.9	2.0	3.9	***3.9***	***3.3***	***3.1***	***3.0***	***3.0***	***2.9***	3.2	***3.5***	***3.2***	***2.8***
government	-0.3	0.0	0.5	***0.2***	***0.2***	***0.2***	***0.2***	***0.3***	***0.2***	-0.1	***0.1***	***0.2***	***0.2***
exports	0.7	-0.8	0.6	***-0.2***	***0.3***	***0.4***	***0.5***	***0.5***	***0.5***	0.4	***0.2***	***0.3***	***0.5***
imports	-1.6	-1.1	-0.5	***-0.5***	***-0.6***	***-0.6***	***-0.6***	***-0.6***	***-0.6***	-0.6	***-0.8***	***-0.6***	***-0.6***
Final Sales	2.1	-0.2	3.9	***2.9***	***2.7***	***2.6***	***2.7***	***2.7***	***2.6***	2.4	***2.4***	***2.8***	***2.5***
ch. in bus. inventories	0.0	0.9	0.0	***-0.8***	***-0.3***	***0.0***	***0.0***	***0.0***	***0.0***	0.1	***0.2***	***-0.2***	***0.0***
Unemployment, %	5.8	5.6	5.4	5.1	***5.0***	***4.9***	***4.8***	***4.7***	***4.7***	6.2	***5.3***	***4.8***	***4.8***
NF Payrolls, monthly, th.	324	195	231	167	***175***	***185***	***185***	***180***	***175***	260	***192***	***181***	***163***
Cons. Price Index (q/q)	-0.9	-3.1	3.0	***1.5***	***0.5***	***1.8***	***1.8***	***1.9***	***1.9***	1.6	***0.1***	***1.6***	***1.9***
excl. food & energy	1.5	1.7	2.5	***1.6***	***1.7***	***1.8***	***1.8***	***1.8***	***1.9***	1.7	***1.8***	***1.8***	***1.9***
PCE Price Index (q/q)	-0.4	-1.9	2.2	***1.3***	***0.8***	***1.6***	***1.7***	***1.8***	***1.8***	1.4	***0.3***	***1.5***	***1.8***
excl. food & energy	1.0	1.0	1.9	***1.3***	***1.6***	***1.6***	***1.7***	***1.7***	***1.7***	1.5	***1.3***	***1.6***	***1.7***
Fed Funds Rate, %	0.10	0.11	0.13	0.14	***0.19***	***0.20***	***0.40***	***0.67***	***0.93***	0.09	***0.14***	***0.55***	***1.55***
3-month T-Bill, (bond-eq.)	0.0	0.0	0.0	0.1	***0.1***	***0.2***	***0.4***	***0.7***	***0.9***	0.0	***0.1***	***0.6***	***1.5***
2-year Treasury Note	0.5	0.6	0.6	0.7	***0.9***	***1.1***	***1.4***	***1.6***	***1.9***	0.5	***0.7***	***1.5***	***2.4***
10-year Treasury Note	2.3	2.0	2.2	2.2	***2.4***	***2.7***	***2.9***	***3.1***	***3.2***	2.5	***2.2***	***3.0***	***3.3***