

Monthly Economic Outlook

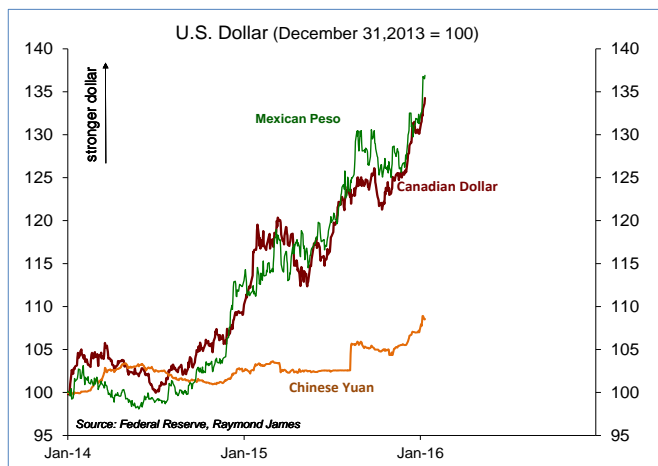
Front-Loading Anxiety and Risk in 2016

- China's stock market troubles have fanned concerns about the strength of the country's economy and the ability of Chinese authorities to stabilize the situation. However, the bigger concern is the yuan, which is under considerable pressure.
- The U.S. economic data have been mixed, with signs of somewhat slower GDP growth, but continued strength in jobs.
- The Fed is still expected to raise short-term interest rates further, but global disruptions are likely to lead officials to delay the second rate hike beyond March.

The Shanghai Composite Index fell 16.7% in the first eight trading day of the new year. Newly implemented circuit breakers, meant to prevent a sharp, panic decline, had the opposite effect. China is undergoing two transformations. One is in economic structure. Growth in recent decades has been fueled by exports and infrastructure spending. The country is moving to an economy driven more by domestic demand. That will take time. Moreover, growth will be slower than what we've seen over the last couple of decades. China's export engine has been sputtering; its manufacturing sector has been soft for many months. However, the overall economy is still likely expanding at a strong pace, just slower than expected.



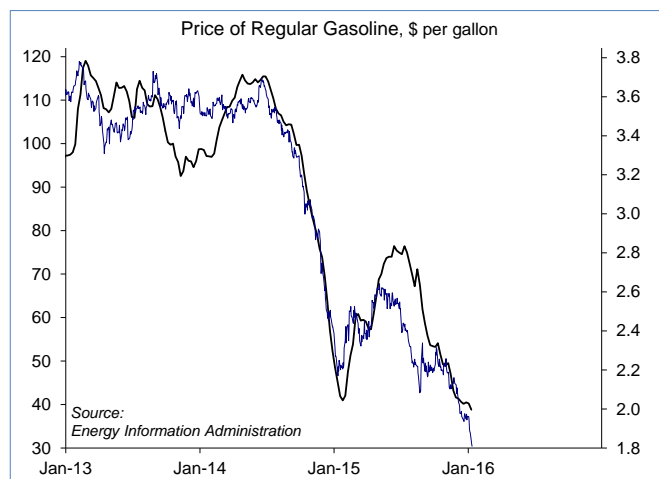
Exchange rates can be thought of as a price, determined by supply and demand. China still enjoys a large trade surplus with the rest of the world, but that has been more than offset by capital outflows. The result is downward pressure on the yuan (relative to the dollar). The People's Bank of China, the country's central bank, has plenty of foreign exchange reserves: \$3.3 trillion at the end of 2015, down from \$4.0 trillion in mid-2014. It spent more than \$100 billion defending the currency in December. Intervention to support the yuan can go on for some time, but not indefinitely. It's widely expected that the PBOC will allow the currency to weaken gradually against the dollar over the course of this year. However, that expectation would make it less desirable for global investors to put money into China (and more desirable for Chinese investors to invest outside the country). That, in turn, adds further downward pressure on the yuan. We are then looking at an unstable situation, where currency pressures can quickly snowball. Chinese officials ought to get a handle on things in the weeks and months ahead, and calm the situation. Increased volatility usually means upside as well as downside volatility, but there's not a lot of confidence in their abilities at this point.



The other major transformation is in China's financial sector, which is expected to become gradually "freer" (or market-driven) over time. The authorities' fumbling with the stock market (last summer and more recently) shows how difficult this transition will likely be. However, while U.S. investors have focused largely on the country's stock market woes, the bigger concern is the currency. The yuan has been tied more closely to the U.S. dollar in recent years. That means that as the U.S. dollar has appreciated against most of the world's currencies, so has the yuan. That is a problem. China isn't necessarily expected to depreciate the yuan to boost exports, but it does need to address growing imbalances.

Global investors have also expressed concerns about the large expansion of private-sector debt in China in recent years. Simply put, debt never matters until it does. The key questions are the ability to service the debt and the ability to roll it over. A sharper slowdown in China's economy would therefore be troublesome. In recent decades, the country has had very large percentages of nonperforming loans in its banking system. That doesn't matter much when you're growing at 10-12% per year. It should be more of an issue with growth at 4-6%. Yet, most of this debt is held internally. A collapse, should it happen, would be unlikely to generate anything close to the degree of global contagion experienced when the U.S. housing bubble burst.

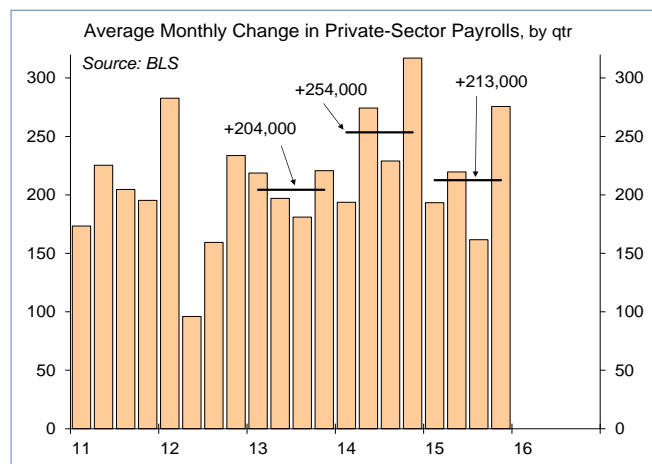
Worries about China (and global growth in general) have led to a flight to safety in long-term Treasuries and generated expectations that the Federal Reserve will be more gradual in raising short-term rates. Worries also put downward pressure on commodity prices. The price of oil, which many see as a gauge of global economic strength, is currently near \$30 per barrel. Hence, we should see a further contraction in U.S. energy exploration (and the capital investment that goes along with that). Commodity exporters, including Canada and countries in Latin America, will have a tougher time.



The U.S. economy is largely self-contained. Real Private-Domestic Final Purchases (PDFP) rose 3.2% in the year ending in 3Q15 (in comparison, real GDP rose 2.1%). Net exports subtracted 0.7 percentage point, but not due to weak exports (exports adding 0.2, while an increase in imports subtracting 0.9). Exports don't turn on a dime and large firms can hedge currency risk a year out. So there may be a lagged impact. Note that nominal imports have fallen, as lower import prices have more than offset an increase in the quantity imported.

Many of the recent economic reports have suggested that GDP growth was slower than expected in 4Q15. Consumer spending growth appears to have been moderately strong, but shipments of nondefense capital goods declined in October and November. Manufacturing activity has been mixed, with continued strength in motor vehicle production, but activity has been generally sluggish otherwise. Moreover, the pace of vehicle sales is likely to level out in 2016, meaning that vehicle production will likely add more modestly to overall growth.

Job growth remained strong in the fourth quarter, but December figures were likely inflated somewhat by mild weather (fewer-than-normal seasonal layoffs in construction). Average hourly earnings were flat in December, but up 2.5% y/y (vs. +2.0% in 2013 and 2014) – better, but not great. Moderate economic growth and strong job gains imply a continued slow pace of productivity growth.



The Fed is primarily focused on labor market slack and the inflation outlook, but global financial market turmoil could lead to a delay in policy action, as it did late last summer.

	4Q14	1Q15	2Q15	3Q15	4Q15	1Q16	2Q16	3Q16	4Q16	2014	2015	2016	2017
GDP (↓ contributions)	2.1	0.6	3.9	2.0	<b>1.3</b>	<b>2.0</b>	<b>2.4</b>	<b>2.5</b>	<b>2.4</b>	2.4	<b>2.4</b>	<b>2.5</b>	<b>2.4</b>
consumer durables	0.4	0.1	0.6	0.5	<b>0.2</b>	<b>0.3</b>	<b>0.3</b>	<b>0.3</b>	<b>0.3</b>	0.4	<b>0.4</b>	<b>0.3</b>	<b>0.2</b>
nondurables & services	2.4	1.0	1.9	1.6	<b>1.3</b>	<b>1.5</b>	<b>1.5</b>	<b>1.5</b>	<b>1.4</b>	1.4	<b>1.7</b>	<b>1.6</b>	<b>1.4</b>
bus. fixed investment	0.1	0.2	0.5	0.3	<b>0.2</b>	<b>0.4</b>	<b>0.4</b>	<b>0.4</b>	<b>0.4</b>	0.1	<b>0.4</b>	<b>0.3</b>	<b>0.4</b>
residential investment	0.3	0.3	0.3	0.3	<b>0.2</b>	<b>0.2</b>	<b>0.2</b>	<b>0.2</b>	<b>0.2</b>	0.3	<b>0.3</b>	<b>0.2</b>	<b>0.2</b>
Priv Dom Final Purchases	3.9	2.0	3.9	3.2	<b>2.3</b>	<b>2.8</b>	<b>2.7</b>	<b>2.7</b>	<b>2.6</b>	3.2	<b>3.3</b>	<b>3.0</b>	<b>2.6</b>
government	-0.3	0.0	0.5	0.3	<b>0.2</b>	<b>0.2</b>	<b>0.2</b>	<b>0.3</b>	<b>0.2</b>	-0.1	<b>0.1</b>	<b>0.2</b>	<b>0.2</b>
exports	0.7	-0.8	0.6	0.1	<b>-0.5</b>	<b>-0.3</b>	<b>0.1</b>	<b>0.2</b>	<b>0.2</b>	0.4	<b>0.1</b>	<b>0.0</b>	<b>0.2</b>
imports	-1.6	-1.1	-0.5	-0.4	<b>0.0</b>	<b>-0.3</b>	<b>-0.3</b>	<b>-0.3</b>	<b>-0.3</b>	-0.6	<b>-0.8</b>	<b>-0.3</b>	<b>-0.3</b>
Final Sales	2.1	-0.2	3.9	2.7	<b>1.8</b>	<b>2.0</b>	<b>2.4</b>	<b>2.5</b>	<b>2.4</b>	2.4	<b>2.3</b>	<b>2.3</b>	<b>2.4</b>
ch. in bus. inventories	0.0	0.9	0.0	-0.7	<b>-0.4</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	0.1	<b>0.2</b>	<b>-0.2</b>	<b>0.0</b>
Unemployment, %	5.8	5.6	5.4	5.1	5.0	<b>4.9</b>	<b>4.8</b>	<b>4.7</b>	<b>4.7</b>	6.2	<b>5.3</b>	<b>4.8</b>	<b>4.8</b>
NF Payrolls, monthly, th.	324	195	231	174	284	<b>195</b>	<b>185</b>	<b>180</b>	<b>175</b>	260	<b>221</b>	<b>184</b>	<b>163</b>
Cons. Price Index (q/q)	-0.9	-3.1	3.0	1.6	<b>0.4</b>	<b>1.0</b>	<b>1.8</b>	<b>1.9</b>	<b>1.9</b>	1.6	<b>0.1</b>	<b>1.4</b>	<b>1.9</b>
excl. food & energy	1.5	1.7	2.5	1.7	<b>2.2</b>	<b>1.9</b>	<b>1.8</b>	<b>1.8</b>	<b>1.9</b>	1.7	<b>1.8</b>	<b>1.9</b>	<b>1.9</b>
PCE Price Index (q/q)	-0.4	-1.9	2.2	1.3	<b>0.6</b>	<b>1.6</b>	<b>1.7</b>	<b>1.8</b>	<b>1.8</b>	1.4	<b>0.3</b>	<b>1.5</b>	<b>1.8</b>
excl. food & energy	1.0	1.0	1.9	1.3	<b>1.3</b>	<b>1.6</b>	<b>1.7</b>	<b>1.7</b>	<b>1.7</b>	1.5	<b>1.3</b>	<b>1.6</b>	<b>1.7</b>
Fed Funds Rate, %	0.10	0.11	0.13	0.14	0.16	<b>0.38</b>	<b>0.40</b>	<b>0.67</b>	<b>0.93</b>	0.09	<b>0.13</b>	<b>0.60</b>	<b>1.54</b>
3-month T-Bill, (bond-eq.)	0.0	0.0	0.0	0.0	0.1	<b>0.3</b>	<b>0.4</b>	<b>0.7</b>	<b>0.9</b>	0.0	<b>0.1</b>	<b>0.6</b>	<b>1.5</b>
2-year Treasury Note	0.5	0.6	0.6	0.7	0.8	<b>1.1</b>	<b>1.3</b>	<b>1.6</b>	<b>1.8</b>	0.5	<b>0.7</b>	<b>1.5</b>	<b>2.3</b>
10-year Treasury Note	2.3	2.0	2.2	2.2	2.2	<b>2.2</b>	<b>2.5</b>	<b>2.8</b>	<b>3.0</b>	2.5	<b>2.1</b>	<b>2.7</b>	<b>3.3</b>