RAYMOND JAMES

Economic Research
Published by Raymond James & Associates

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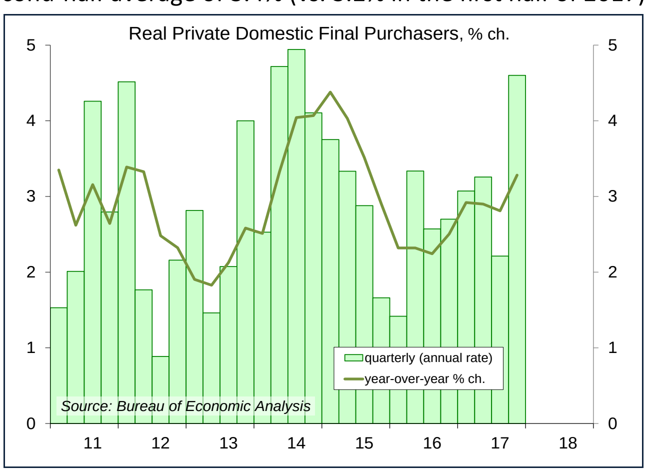
Monthly Economic Outlook

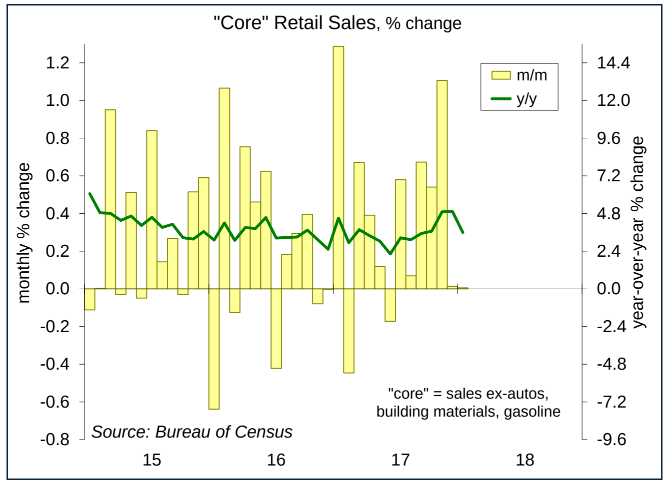
Stumbling and Mumbling

- *Most of the major economic reports for January were on the weak side of expectations, but that followed a strong 4Q18 and the data can be unreliable at the start of the year.*
- *Business optimism, accommodative fiscal policy, and a strong global economy should help to fuel U.S. growth, but job market constraints and tighter monetary policy are expected to be binding beyond the next few quarters. A misstep on trade policy remains an important downside risk.*
- *Over the last couple of years, Federal Reserve policy was about taking the foot off the gas. Going forward, it's about tapping the brakes. The pace will depend on the economic data (specifically, what the data imply for the economic outlook).*

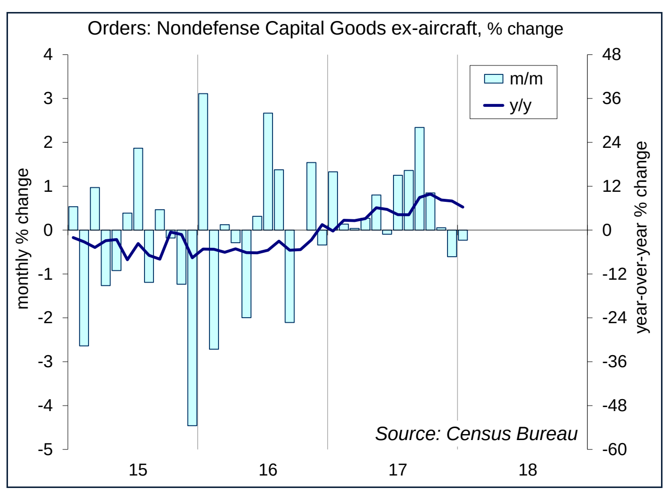
Real GDP rose at a 2.5% annual rate in the 2nd estimate for 4Q17, down from 2.6% in the advance estimate. While the revision was in line with expectations, that itself was somewhat of a surprise (half of the time, the 2nd estimate is more than a half percent above or below the initial estimate). The economy was a lot stronger in 4Q18 than the headline growth figure would seem to suggest, although that strength partly reflected a rebound from hurricane-related softness in 3Q17. Imports (which have a negative sign in the GDP calculation) surged at the end of last year, subtracting two percentage points from headline GDP growth. Private Gross Domestic Purchases (consumer spending, business fixed investment, and residential investment), a better measure of underlying domestic demand, rose at a 4.6% annual rate in 4Q17, vs. +2.2% in 3Q17, for a second-half average of 3.4% (vs. 3.2% in the first half of 2017).



Nearly all of the major economic data releases for January were disappointing. Inflation-adjusted consumer spending, which accounts for 69% of GDP, fell 0.1% (+2.7% y/y). Ex-transportation, durable goods orders fell 0.3%. Single-family building permits fell 1.7%. Factory output edged up a mere 0.1% (+2.0% y/y). Core retail sales were flat.



Granted, January economic figures can be quirky. We had snowstorms and seasonal adjustment can exaggerate the impact of bad weather. Consumer confidence and business sentiment remained high in February. Tax withholding went down in February, leaving workers with more take-home pay, although consumers have not always responded directly to tax cuts in the past. Payroll taxes were lowered two percentage points for two years (2011 and 2012) and surveys showed that less than half were aware of that at the time. Prior to the cut in corporate tax rates, firms generally had the capacity to expand (cash on balance sheets, low borrowing costs), so the upside for capital spending may be limited (although we should see a boost from strong business sentiment in the near term). Past cuts in corporate tax rates have showed up through share buybacks, which appears to be the case currently. Capital investment has been improving worldwide, consistent with the strengthening in the global economy, which has helped to boost U.S. exports. However, there may be some danger of malinvestment, which could be an issue in the quarters ahead.



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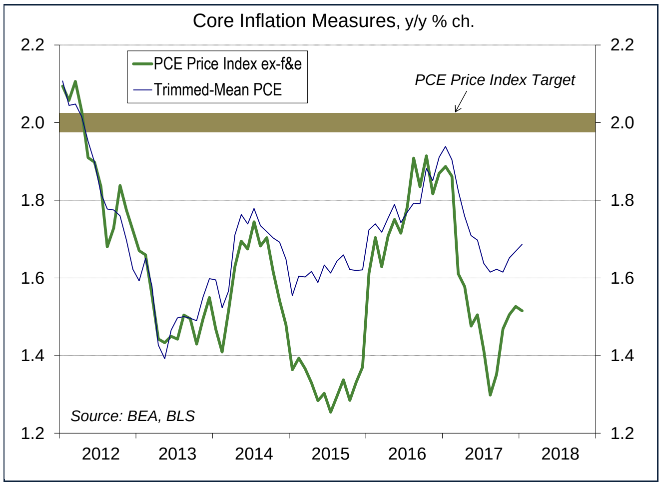
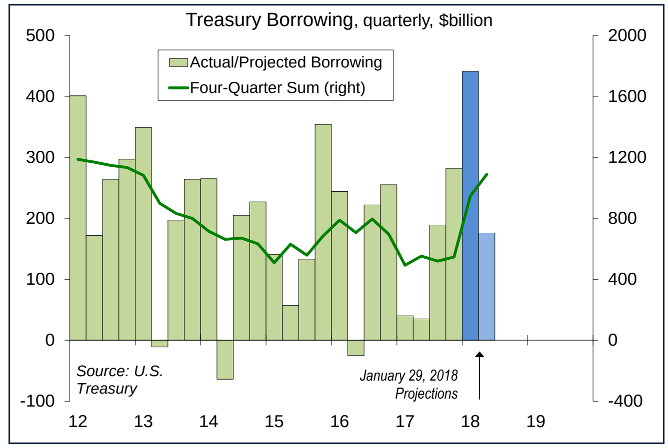
In his first semiannual monetary policy testimony to Congress, Fed Chair Jerome Powell repeated three key themes that the central bank had already made apparent: 1) The economy is strong, with the labor market at or a bit beyond full employment; 2) Further gradual increases in the federal funds rate are likely; and 3) The pace of tightening will be data dependent. The last couple of years have been about the Fed taking the foot of the gas pedal. The question now is how often, and how hard, to tap the brakes. Soft landings are difficult, and there is some risk that the Fed may tighten too much. However, this is more of a risk for 2019 than for 2018.



The core PCE Price Index rose 1.5% over the 12 months ending in January, still below the Fed's 2% goal. That allows the Fed to move gradually. Commodity price pressures picked up in 2017, but are not a threat to consumer price inflation. There are few signs of bottleneck or production pressures. The job market is the widest channel for inflation. Wage growth has remained moderate, reflecting low productivity growth and a decades-long shift in bargaining power toward firms.

Donald Trump campaigned on a platform of protectionist trade policies. As president, he has flirted with greater confrontation with our key trading partners. At day 100, he came close to pulling the U.S. out of NAFTA on a whim, before cooler heads prevailed. Now, the administration intends to impose tariffs on imported steel and aluminum. By themselves, these actions need not be too disruptive for the overall economy. However, there is fear that trade conflict will escalate. The possibility of retaliatory tariffs on U.S. goods, supply chain disruptions, higher input costs, exchange rate volatility, and so on add uncertainty to the economic outlook.



Some investors fear that higher inflation will boost bond yields. However, inflation is likely to remain relatively low (with the core rate trending at or a bit below the Fed's 2% goal). In contrast, the government's borrowing needs have increased significantly in recent weeks. Treasury borrowed $75 billion in 1H17, but expects to borrow $617 billion in 1H18.

The near-term economic outlook remains strong. However, as the job market tightens, the pace of growth in nonfarm payrolls should slow, capping GDP growth.

	1Q17	2Q17	3Q17	4Q17	*1Q18*	*2Q18*	*3Q18*	*4Q18*	*1Q19*	*2Q19*	2017	*2018*	*2019*
GDP (↓ *contributions*)	1.2	3.1	3.2	2.5	*3.5*	*2.4*	*1.9*	*1.9*	*1.9*	*1.9*	2.3	*2.7*	*1.9*
consumer durables	0.0	0.6	0.6	1.0	*0.3*	*0.3*	*0.3*	*0.3*	*0.3*	*0.2*	0.5	*0.5*	*0.3*
nondurables & services	1.3	1.7	0.9	1.6	*1.4*	*1.3*	*1.2*	*1.2*	*1.2*	*1.2*	1.4	*1.3*	*1.2*
bus. fixed investment	0.9	0.8	0.6	0.8	*0.5*	*0.5*	*0.4*	*0.4*	*0.4*	*0.4*	0.6	*0.6*	*0.4*
residential investment	0.4	-0.3	-0.2	0.5	*0.2*	*0.2*	*0.1*	*0.1*	*0.1*	*0.1*	0.1	*0.2*	*0.1*
Priv Dom Final Purchases	3.1	3.3	2.2	4.6	*2.6*	*2.7*	*2.3*	*2.2*	*2.2*	*2.2*	3.0	*2.9*	*2.2*
government	-0.1	0.0	0.1	0.5	*0.1*	*0.1*	*0.1*	*0.1*	*0.1*	*0.1*	0.0	*0.1*	*0.1*
exports	0.9	0.4	0.3	0.8	*0.3*	*0.3*	*0.3*	*0.3*	*0.3*	*0.3*	0.4	*0.4*	*0.3*
imports	-0.6	-0.2	0.1	-2.0	*0.3*	*-0.5*	*-0.6*	*-0.5*	*-0.4*	*-0.4*	-0.6	*-0.5*	*-0.5*
Final Sales	2.7	3.0	2.4	3.3	*3.0*	*2.2*	*1.8*	*1.8*	*1.9*	*1.9*	2.4	*2.6*	*1.8*
ch. in bus. inventories	-1.5	0.1	0.8	-0.7	*0.5*	*0.2*	*0.1*	*0.0*	*0.0*	*0.0*	-0.1	*0.2*	*0.0*
Unemployment, %	4.6	4.3	4.3	4.1	*3.9*	*3.8*	*3.7*	*3.7*	*3.7*	*3.8*	4.4	*3.8*	*3.8*
NF Payrolls, monthly, th.	166	187	128	204	*170*	*140*	*135*	*130*	*125*	*121*	181	*144*	*120*
Cons. Price Index (q/q)	3.0	0.1	2.1	3.3	*3.9*	*2.0*	*2.0*	*2.0*	*2.0*	*2.0*	2.1	*2.6*	*2.0*
excl. food & energy	2.2	0.8	1.8	2.2	*2.9*	*1.9*	*1.9*	*2.0*	*2.0*	*2.0*	1.8	*2.1*	*2.0*
PCE Price Index (q/q)	2.2	0.3	1.5	2.7	*2.8*	*1.9*	*1.9*	*1.9*	*1.9*	*1.9*	1.7	*2.1*	*1.9*
excl. food & energy	1.8	0.9	1.3	1.9	*2.3*	*1.8*	*1.8*	*1.8*	*1.9*	*1.9*	1.5	*1.8*	*1.9*
Fed Funds Rate, %	0.70	0.94	1.16	1.20	*1.46*	*1.69*	*1.91*	*1.96*	*2.16*	*2.17*	1.00	*1.76*	*2.30*
3-month T-Bill, (bond-eq.)	0.6	0.9	1.0	1.2	*1.6*	*1.8*	*1.9*	*2.1*	*2.1*	*2.4*	1.0	*1.9*	*2.4*
2-year Treasury Note	1.2	1.3	1.5	1.7	*2.3*	*2.4*	*2.5*	*2.5*	*2.6*	*2.6*	1.4	*2.4*	*2.6*
10-year Treasury Note	2.5	2.3	2.2	2.4	*2.9*	*3.1*	*3.2*	*3.2*	*3.3*	*3.3*	2.3	*3.1*	*3.3*

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