



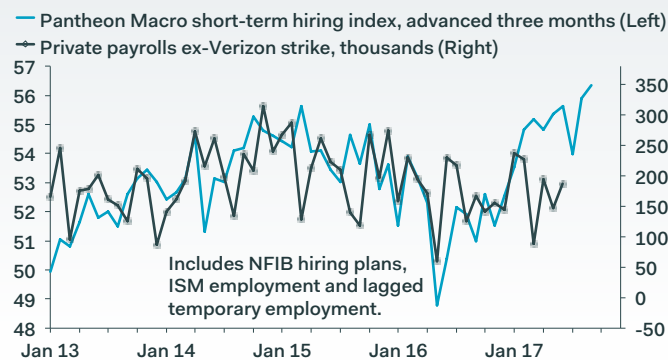
THE UNITED STATES IN H2 2017

IAN SHEPHERDSON, CHIEF ECONOMIST

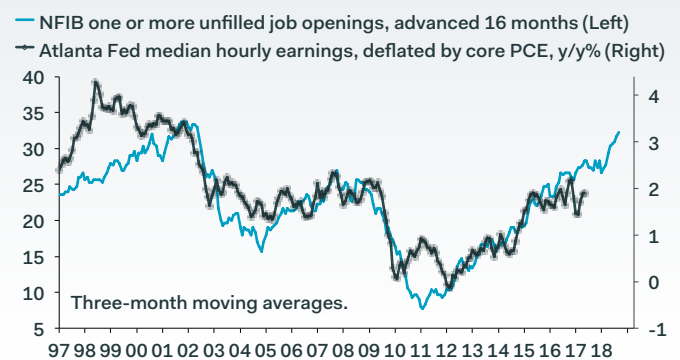
Brace for a Sustained Shift in Interest Rate Expectations

- * Investors are unconvinced that the Fed will raise rates much further, apparently in the belief that the reported slowdown in GDP growth, smaller payroll gains in recent months and the unexpected downshift in core inflation since March are all evidence of a genuine softening in the economy. **We think this view is fundamentally mistaken.** As it unwinds, the second half of the year could be very uncomfortable for both fixed income and equity markets.
- * First quarter growth was depressed by a long-standing seasonal adjustment problem, which likely subtracted as much as one percentage point from the headline numbers, as well as the late Easter, legislatively-mandated delays to income tax refunds, and a long period of unusual weather. **The latest official estimate of Q1 growth is 1.4%, but we think the true rate likely was 2½% or more.**
- * March and April payrolls were depressed by the blizzard which hit large swathes of the country during the survey week. The storm kept people from getting to work, and then had a knock-on effect in April, by delaying the hiring process between the March and April surveys. May payrolls were hit by a seasonal adjustment problem which causes the numbers to be understated when the survey falls early in the month, as it did this year. **Forward-looking surveys are consistent with payroll growth running in excess of 200K over the summer and into the early fall, and that's our base case forecast.**
- * Payroll gains at that pace would easily be enough to push the unemployment rate down further, with a sub-4% rate later this year now a very real possibility. The U.S. has not sustained unemployment below 4% since before the oil crisis of 1973. **This prospect, more than anything else, explains why the Fed is likely to raise rates further than markets expect.**
- * As the labor market has tightened, nominal hourly wage growth has not risen as far as implied by historical experience. **But real wage growth, as measured by the Atlanta Fed's median hourly earning series, deflated by the core PCE, has climbed in line with the rise in the NFIB survey's jobs-hard-to-fill measure.** The survey leads real wage growth by about five quarters, and it now signals much faster real wage growth through the summer of next year, at least. That can only happen if core PCE inflation collapses, or, more likely, nominal wage growth accelerates markedly.
- * **With productivity growth trending at less than 1%, wage growth above 3% is inconsistent with the Fed's inflation target.** In the past, with productivity growth at 2%, the Fed could let wages rise by up to 4%.

EXPECT STRONG PAYROLL GROWTH IN Q3...



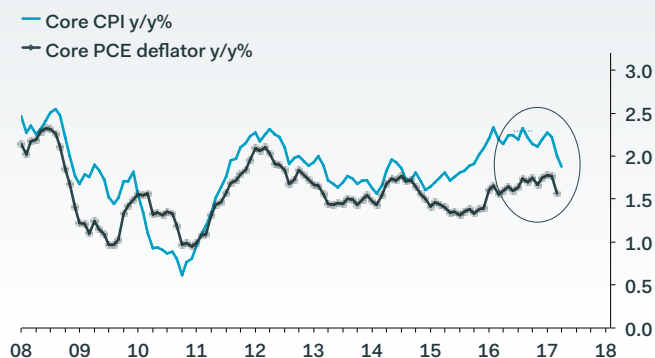
...AND THE LABOR MARKET ALREADY IS VERY TIGHT



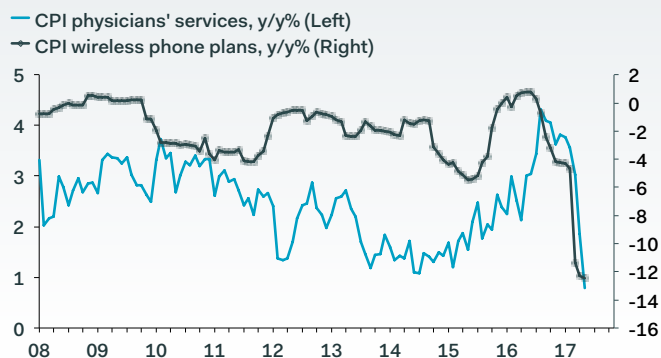
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- * **Core inflation has fallen in recent months, thanks to an array of unconnected and likely temporary factors.** Cellphone service plan prices dropped sharply after Verizon, the market leader, followed others and offered an unlimited data plan. This subtracted 0.13 percentage points from core inflation in March and will hold down the core rate until March 2018. Prescription drug inflation has slowed sharply, but it is now in line with its long-term trend rate and likely won't slow much more. Physicians' services inflation has plunged, for no apparent reason; we suspect sampling error. Airline fares, which are included in the core but are sensitive to oil prices, have dropped and likely will fall a bit further. Used auto prices are falling as a wave of vehicles sold in the past two-to-three years come off lease.
- * **Owners' equivalent rent—31% of the core CPI—is being depressed by a technicality.** It is calculated by stripping out utility costs from primary rents, which measure rents paid by real tenants. The BLS assumes that landlords adjust rents immediately when the utility costs change, but they don't. As a result, the jump in utility inflation, from *minus* 4.7% in January 2016 to *plus* 4.8% in May this year, has pushed down the rate of increase of OER relative to primary rents, and OER is now slowing in absolute terms year-over-year. Further declines are likely, even though rental vacancies remain extremely tight and wage growth is picking up.
- * The weight of OER in the core PCE is much smaller than in the core CPI, and the PCE has a much bigger weighting for medical costs. This raises the possibility that the year-over-year rates might cross over, with core PCE inflation overtaking core CPI, for the first time since late 2010, depending on what happens to healthcare costs over the next year. Either way, though, rising core inflation in the near-term is not going to be the factor persuading the Fed to continue raising rates. **The labor market is the threat.**
- * **The funds rate will remain the Fed's key tool, even as balance sheet run-off begins.** The initial pace of run-off, \$6B per month in Treasuries and \$4B per month in mortgages, likely starting in the fall, will be too small to make much difference to the macroeconomy. That might change as the pace of run-off ramps up to the projected total of \$50B per month over the next year, but for now we think the Fed has established a pattern of raising rates at the end of each quarter, motivated by the continued decline in unemployment.
- * The Fed's latest forecasts are implausible. Unemployment fell by half a percentage point in the four months to June but the Fed now expects no further change from May's 4.3%. But if GDP growth is anything like the Fed's 2¼% forecast, unemployment will keep falling unless productivity growth rebounds strongly. **The forecasts, in other words, have been set up to be wrong, and further undershoots in unemployment will give the Fed every reason to keep raising rates, even as core inflation remains depressed.** We think wage increases will pick up in the fall, but that's not a *necessary* condition for the Fed to hike further.
- * Even with no significant near-term core inflation risk, Treasuries are vulnerable if the Fed hikes at anything like the pace we expect. **A bear flattening of the curve seems a good bet through next spring, though longer notes and bonds could be hit if wage increases accelerate rapidly.** The stock market is vulnerable both to higher yields and legislative disappointment if, as we expect, fundamental tax reform morphs into modest cuts in personal and corporate taxes, and perhaps nothing at all.

CORE INFLATION WON'T KEEP FALLING AT ITS RECENT PACE...



...UNCONNECTED ONE-TIME FACTORS HAVE PUSHED IT DOWN



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Economic Activity (year-over-year %)

	2014	2015	2016	2017F	2018F	2019F
Consumers' spending	2.9	3.2	2.7	2.5	2.0	1.0
Fixed investment	5.5	4.0	0.7	4.5	2.0	-3.0
of which:						
<i>residential</i>	3.5	11.7	4.9	6	0	-5
<i>equipment</i>	5.4	3.5	-2.9	4	3	-3
<i>IP</i>	3.9	4.8	4.7	3	2	-3
<i>non-res. structures</i>	10.3	-4.4	-2.9	7	2	-4
Government spending	-0.9	1.8	0.8	0.5	1.5	2.5
Inventories, change \$B	58	84	22	35	30	-40
Domestic demand	2.5	3.2	1.7	2.6	2.0	0.2
Exports	4.3	0.1	0.4	2.6	3.0	0.0
Imports	4.4	4.6	1.1	3.7	2.0	-3.0
GDP	2.4	2.6	1.6	2.5	2.0	0.5

Labor Market, Costs and Prices (year-over-year)

Productivity growth	0.8	0.9	0.6	0.8	1.0	0.0
Payrolls, monthly average, thousands	251	228	180	200	150	50
Unemployment rate, Q4 average	5.7	5.0	4.7	4.1	3.8	4.5
Hourly earnings, Q4 average	2.1	2.5	2.8	3.0	3.8	3.5
CPI, Q4 average	1.2	0.5	1.8	2.0	2.5	2.0
Core CPI, Q4 average	1.7	2.0	2.1	1.8	2.3	2.0
Core PCE deflator	1.5	1.3	1.7	1.6	2.2	2.0

Other

Current account, % GDP	-2.2	-2.5	-2.8	-3.2	-3.5	3.0
Budget deficit, % GDP, FY	-2.9	-2.1	-2.3	-3.5	-4.0	-4.5
Fed funds, December	0.13	0.375	0.625	1.625	2.625	1.125
10-year notes, Q4 average	2.28	2.19	2.13	2.60	2.75	2.00
30-year bonds, Q4 average	2.97	2.96	2.82	3.30	3.00	2.00
S&P 500, Q4 average	2,014	2,067	2,204	2,300	2,200	2,300