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Brace for a Sustained Shift in Interest Rate Expectations

* **The pace of U.S. economic growth is set to rise next year, with the economy expanding by nearly 3%, on the back of stronger business investment, a modest acceleration in consumption, increased government spending and, perhaps, improving net exports.** The tax cut bill, which we assume will become law very soon, will add a few tenths to growth too, though much of the net fiscal easing will be saving. Unfortunately, the supply-side of the economy already is very stretched, and the tightening labor market means the Fed will raise rates *at least* as quickly as set out in the latest FOMC projections, showing three hikes next year. We expect four.

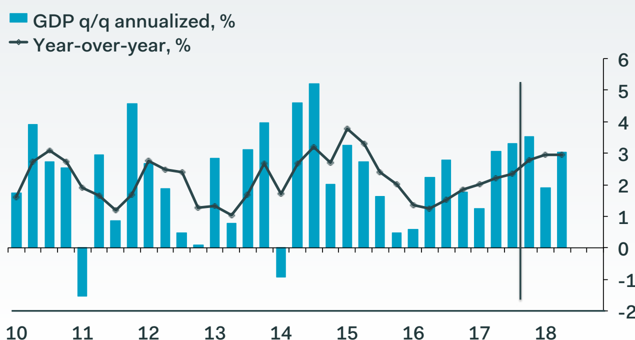
* **Capex is accelerating because the hit from the collapse in oil sector investment in 2015-to-2016 is now reversing.** At the same time, the scarcity of qualified labor means firms can no longer expand output simply by hiring more staff; they need increasingly to invest in equipment and software. Credit is still easily available; the slowdown in the rate of growth of the stock of bank C&I lending reflects the prior slowdown in capex; it's a component of the index of *lagging* indicators for a reason.

* The ageing of the capital stock, and its shrinkage relative to GDP, cannot be reversed in a year or two. Still, growth in fixed investment of 6-to-8% would lift productivity growth in the short-term, so the downward trend in the unemployment rate probably won't accelerate next year. **But if the upturn in productivity growth looks sustainable, estimates of r-star—the real neutral fed funds rate—will rise.**

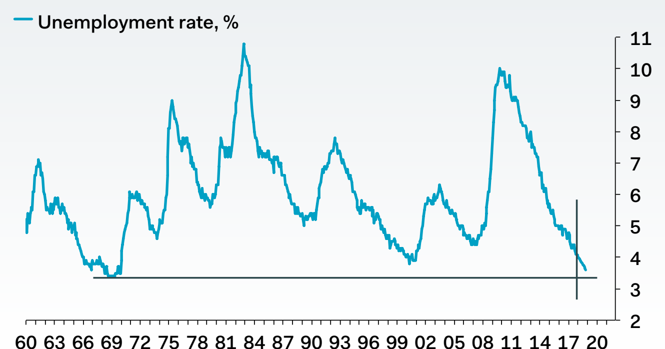
* Consumers' confidence is running far ahead of peoples' ability to spend; real after tax income growth next year should reach about 2½-to-3%, while the sentiment data point to a 5%-plus increase in real spending. The saving rate already is below 4%, so a further sharp decline seems unlikely. **Still, it's hard to see much near-term downside for consumption, which accounts for nearly 70% of GDP.**

* **Stronger growth will push unemployment down to only 3½% or so by the end of next year.** Payroll growth is likely to trend in excess of 200K for the foreseeable future—unless firms can't find that many qualified people to hire—while the labor force is unlikely to expand by more than about 100K per month. The participation rate might rise, but a substantial rebound looks like wishful thinking. Employers appear not to want to take on the people currently outside the labor force. Unemployment has not been at 3½% since 1969, when core CPI inflation was 6%. We aren't expecting a repeat of that, or anything like it, but no-one at the Fed thinks a 3½% unemployment rate can be sustained without triggering faster inflation.

GDP GROWTH IS PICKING UP; IT LOOKS SUSTAINABLE...



...SO UNEMPLOYMENT IS HEADED TO 50-YEAR LOWS



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* **Wage growth remains the dog that didn't bark in this cycle, but it is very dangerous to assume it will remain so quiet.** In metro areas where the unemployment rate already is 3½% or less, growth in hourly earnings is running at 4.0%. That's consistent with the message from the NFIB survey's jobs-hard-to-fill number, which has accurately predicted real wage growth in this cycle. It now suggests that real wage growth—we use the Atlanta Fed median hourly wage measure, less core PCE inflation—needs to rise to about 3% by early 2019, from 2% currently. That requires either a substantial upturn in nominal wage growth, or a renewed and very steep drop in core inflation.

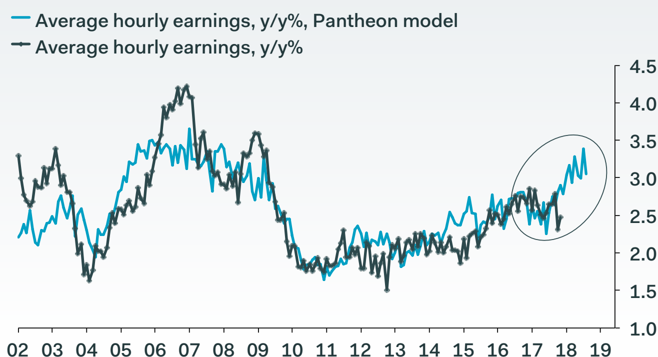
* Core CPI and PCE inflation have been weaker than expected this year. But most of the components which depressed the monthly numbers from March through the summer—cellphone service, hotel room rates, physicians' services, airline fares and owners' equivalent rents—have either fully rebounded or are reversing gradually. The exception is apparel prices, where the year-over-year unexpectedly dropped in May and in November hit a two-year low. But both PPI apparel prices and the path of the dollar over the past year point clearly to a hefty rebound in CPI apparel inflation over the next few months. **The future path of core inflation will look very different to the recent past.**

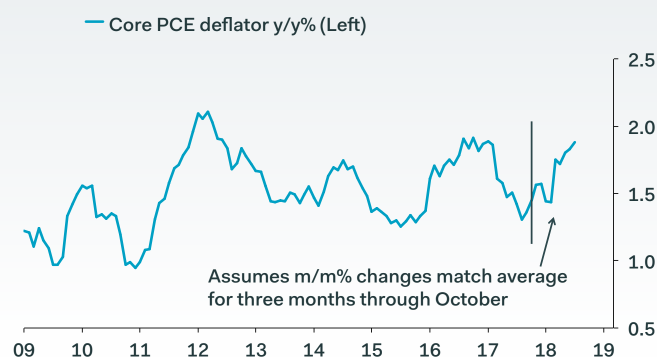
* **By March, when the anniversary is reached of the start of this year's run of soft numbers, we expect the month-to-month trend in the core CPI to be a solid 0.2%. That would be enough to lift core CPI inflation by a full percentage point, to 2**¾%, a year from now. Rent inflation, in particular, is likely to rise markedly as the pace of wage gains pick up; landlords aren't dumb. Core PCE inflation will not rise as far as core CPI inflation, though, because it has a much smaller weight. But it will pick up, and should hit the Fed's 2% target next fall.

* The combination of robust GDP growth, faster wage gains, and rising core inflation, together with the relentless downward trend in the unemployment rate, means the Fed will become increasingly uneasy about future inflation risk, regardless—almost—of the current core inflation rate. **This will translate into four rate hikes this year, with the next coming at Jay Powell's inaugural meeting as Chair.**

* **The fed funds future currently prices-in only 44bp tightening this year, so our forecast implies that investors will be forced into a significant re-think.** The speed of the adjustment will depend on the evolution of the growth, wage, and inflation data as well as the Fed's actions. Conventionally, the curve would be expected to flatten as the Fed hikes, but the 2s-10s spread has already narrowed by almost 50bp over the past half-year. If inflation and wage gains pick up as we expect, a parallel bear shift in the curve is perhaps a better bet than a further flattening.

* Corporate revenue growth will be stronger next year, but margins will be compressed by faster wage growth, while valuations will come under pressure from higher interest rates. At the same time, the Fed will be shrinking its balance sheet at an accelerating pace, while the pace of ECB asset purchases will be halved, so support to markets from central bank liquidity will be much-diminished. **We expect a significant correction in U.S. equities in the spring.**





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Economic Activity (year-over-year %)

	2014	2015	2016	2017F	2018F	2019F
Consumers' spending	**2.9**	**3.6**	**2.7**	**2.7**	**2.7**	**1.5**
Fixed investment	**6.2**	**3.9**	**0.7**	**4.0**	**4.0**	**-1.0**
of which:						
residential	*3.5*	*10.2*	*5.5*	*2*	*4*	*-3*
equipment	*6.6*	*3.5*	*-3.4*	*4*	*6*	*2*
IP	*4.6*	*3.8*	*6.3*	*4*	*3*	*0*
non-res. structures	*10.5*	*-1.8*	*-4.1*	*6*	*2*	*-2*
Government spending	**-0.6**	**1.4**	**0.8**	**-0.1**	**0.5**	**1.0**
Inventories, change $B	**68**	**101**	**33**	**20**	**20**	**-20**
Domestic demand	**2.7**	**3.5**	**1.7**	**2.3**	**2.5**	**1.0**
Exports	**4.3**	**0.4**	**-0.3**	**3.3**	**4.0**	**1.0**
Imports	**4.5**	**5.0**	**1.3**	**3.3**	**3.0**	**1.0**
GDP	**2.6**	**2.9**	**1.5**	**2.3**	**2.7**	**1.0**

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

	2014	2015	2016	2017F	2018F	2019F
Productivity growth	1.0	1.2	0.0	1.4	1.5	0.5
Payrolls, monthly average, thousands	250	226	187	160	175	75
Unemployment rate, Q4 average	5.7	5.0	4.7	4.1	3.3	4.2
Hourly earnings, Q4 average	2.1	2.5	2.8	2.7	3.8	3.5
CPI, Q4 average	1.2	0.5	1.8	2.2	2.2	2.5
Core CPI, Q4 average	1.7	2.0	2.2	1.7	2.7	2.5
Core PCE deflator, Q4 average	1.5	1.3	1.7	1.6	2.1	2.3

Other

	2014	2015	2016	2017F	2018F	2019F
Current account, % GDP	-2.2	-2.5	-2.8	-3.2	-3.0	-2.8
Budget deficit, % GDP, FY	-2.9	-2.1	-2.3	-3.5	-4.5	-5.0
Fed funds, December	0.13	0.375	0.625	1.375	2.375	2.125
10-year notes, Q4 average	2.28	2.19	2.13	2.35	3.00	2.25
30-year bonds, Q4 average	2.97	2.96	2.82	2.80	3.40	2.00
S&P 500, Q4 average	2,014	2,067	2,204	2,625	2,550	2,550

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