



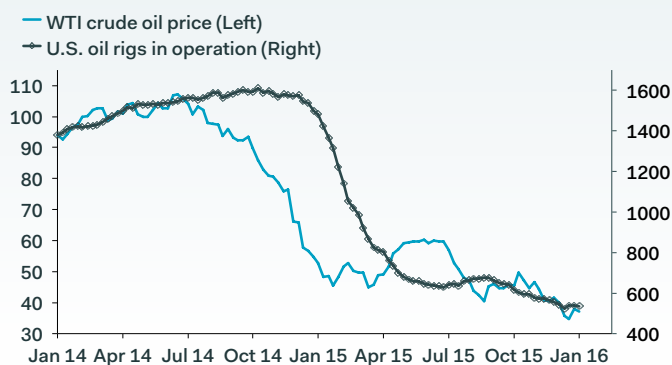
## THE UNITED STATES IN 2016

IAN SHEPHERDSON, CHIEF ECONOMIST

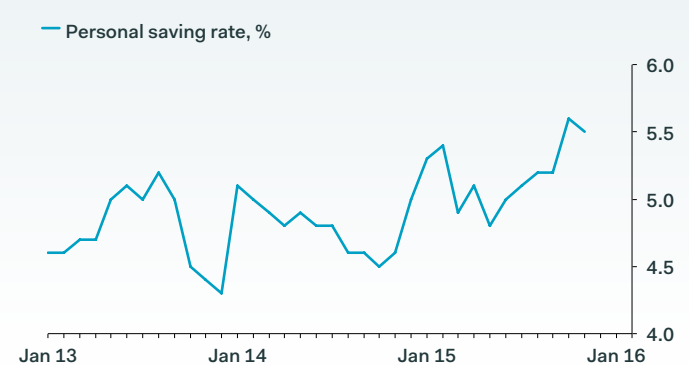
### The Fed Will Be Watching Wages, Not Manufacturing Weakness

- \* **2016 should see the pace of economic growth finally break to the upside after six years averaging just over 2%.** The U.S. consumes twice as much as oil as it produces, so the impact of the collapse in crude oil prices is an unambiguous medium-term positive factor. The drop in the price of WTI from a sustained peak of about \$105 to a sustained low of about \$40 represents a net gain to the U.S. of about \$450B over a full year, equivalent to 1¼% of GDP. With monetary policy still extraordinarily accommodative, and fiscal policy becoming modestly expansionary, overall economic growth should accelerate.
- \* The gains from falling oil prices are hard to spot in the short-term, though, because the cashflow crunch triggered by the plunge in prices has forced an immediate and dramatic collapse in capital spending in the shale oil business, where drillers are mostly small and highly-leveraged. **Capital spending per employee is much higher in the oil sector than any other part of the economy, and oil firms can't save themselves simply by laying off staff; their biggest expense is equipment.** Fracking is an American invention, and much of the equipment used in the process is made in the U.S., so domestic manufacturers have borne the brunt of the hit.
- \* At the same time, the combination of dollar strength, weaker growth in Asia and global oversupply of goods has depressed the manufacturing sector more broadly, pushing the rate of growth of output down nearly to zero. **Only the auto and consumer staples sectors, exposed directly to U.S. household spending and largely immune to the strong dollar, are keeping the aggregate manufacturing numbers above water.** This story likely won't change in 2016, especially if we're right in our view that the dollar will appreciate further, offsetting the likely stabilization in Chinese growth and the continued cyclical upswing in Europe.
- \* The forces which are hurting manufacturing, and the oil sector, though, are benefiting consumers. Cheaper gasoline boosts peoples' discretionary spending power, while the strong dollar and falling global goods prices means cashflow goes further when people choose to spend it. By the end of last year, though, it was clear that some of the windfall from cheaper gas has not been spent; the household saving rate has risen. **Perhaps the biggest single question in the U.S. growth story for 2016 is whether this increase in the saving rate will persist.** We suspect it will not.

THE COLLAPSE IN OIL CAPEX HAS NEARLY RUN ITS COURSE



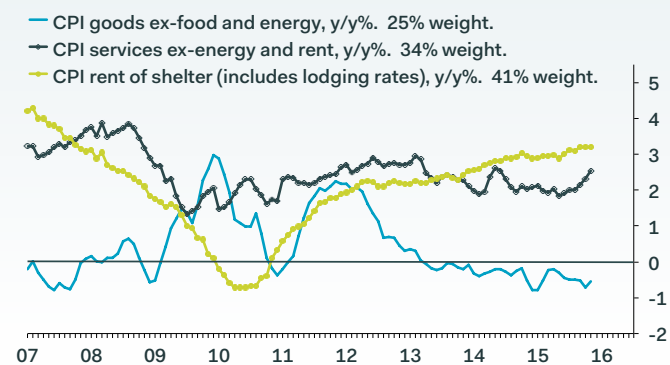
WILL THE INCREASE IN THE SAVING RATE BE SUSTAINED?



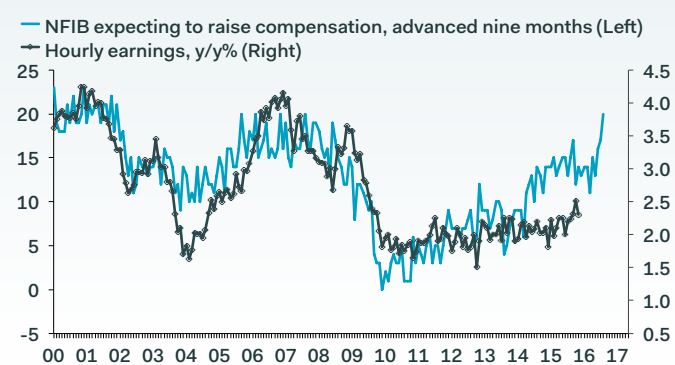
## THE UNITED STATES IN 2016

- \* U.S. consumers typically raise their saving rate only in the face of sustained Fed tightening or a shock, such as the crash of 2008. We do think the Fed ultimately will raise rates further than markets expect, but a rapid near-term tightening is not in the cards. **With households' underlying finances improving—average credit scores are at an all-time high—thanks to the fall in unemployment and sustained low interest rates, we expect people ultimately to spend most of the windfall from cheaper energy.** Consumers' spending ought to accelerate over the course of this year.
- \* The improvement in households' finances ought also to be visible in the housing market, where mortgage applications finally seem to have broken out of their depressed range of the past five years. **Lending standards are easing, so the pool of potential qualified homebuyers has increased substantially, and mortgage rates remain very low.** With inventory very tight, home prices are rising rapidly, so implied real mortgage rates are negative, and that usually draws buyers into the market. 2016 should be a good year for housing, even as the Fed raises short rates.
- \* **The pace of the Fed's tightening will be determined largely by developments in the labor market, rather than GDP growth or the current inflation rate.** The grim state of manufacturing, and the blow-out in high-yield spreads, are not key drivers of policy; the Fed has to consider the whole economy, not specific sectors, and its favored proxy for broad conditions is the unemployment rate. The headline rate is now inside the Fed's estimated Nairu range, 4.8-to-5.0%, and soon will be below it. Wage gains appear finally to have started to pick up, with Chair Yellen specifically citing the upturn in the rate of growth of hourly earnings and compensation costs in the business sector, and *every* survey indicator points to a further acceleration. We expect the Fed to hike in March, June, and then each meeting in the second half, ending the year at 1.875%.
- \* Core inflation has increased modestly over the past year, as accelerating rents have offset falling goods prices. These trends will continue in 2016, but the big difference is that non-rent services inflation is now rising too, thanks largely to faster increases in medical costs. Insurance premiums are rising at a faster pace, because insurers lost money in the first two years of Obamacare. Rising premiums will allow hospitals and other service providers to increase prices to ease their financial pressures too. More broadly, faster wage gains will lift inflation in an array of leisure, education, and household services components. **Both core CPI and core PCE inflation are likely to surprise to the upside over the course of this year.**
- \* The combination of rising cost pressures and weak overseas demand will constrain earnings growth—businesses with no international exposure will outperform—while rising rates will depress valuations. **2016 is likely to be a difficult year for stocks and corporate debt markets.** The Treasury curve will flatten as the Fed raises rates further than markets expect, but a short-term spring steepening can't be ruled out as inflation surprises to the upside but the Fed sticks to its intention to tighten only gradually. Eventually, though, the tightening labor market will force the Fed to move more aggressively.

GOODS PRICES WILL FALL IN 2015 BUT OTHER CORE CPI WILL RISE



THE FED IS WORRIED ABOUT WAGES; IT SHOULD BE



# THE UNITED STATES IN 2016

Economic Activity (year-over-year, %)	2013	2014	2015E	2016F	2017F
Consumers' spending	1.7	2.7	3.1	3.2	3.0
Fixed investment	4.2	5.3	4.0	6.0	8.0
of which:					
<i>residential</i>	9.5	1.8	8	8	8
<i>equipment</i>	3.2	5.8	3	6	7
<i>IP</i>	3.8	5.2	6	6	6
<i>non-res. structures</i>	1.6	8.1	-1.5	4	10
Government spending	-2.9	-0.6	0.8	1.5	1.5
Inventories, change \$B	66	68	95	80	70
Domestic demand	1.3	2.5	3.0	3.2	3.0
Exports	2.8	3.4	1.1	1.0	3.0
Imports	1.1	3.8	5.1	5.0	6.0
GDP	1.5	2.4	2.4	2.8	2.7

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

Productivity growth	0.0	0.7	0.7	1.5	2.0
Payrolls, monthly average, thousands	199	260	210	180	160
Unemployment rate (Q4 average)	7.0	5.7	5.0	4.5	4.5
Hourly earnings (Q4 average)	2.0	2.1	2.5	3.5	4.0
CPI (Q4 average)	1.5	1.2	0.4	1.5	2.6
Core CPI (Q4 average)	1.8	1.7	2.0	2.4	2.6
Core PCE deflator (Q4 average)	1.3	1.5	1.3	1.9	2.5

## Other

Current account, % GDP	-2.4	-2.2	-2.5	-2.8	-3.0
Budget deficit, \$B FY	683	483	436	350	350
Budget deficit, % GDP, FY	-3.9	-2.9	-2.1	-1.9	-1.7
Fed funds, December	0.09	0.13	0.375	1.875	3.00
10-year notes, Q4 average	2.75	2.28	2.19	3.50	3.75
30-year bonds, Q4 average	3.79	2.97	2.96	3.75	3.75
S&P 500, Q4 average	1,796	2,014	2,067	2,050	2,150