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THE **UNITED STATES** IN H1 2017

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Inflation Pressure is Building, Even Before Fiscal Easing

* The U.S. faces **greater uncertainty** now than at the start of any previous year in recent memory. The combination of near-full employment, coupled with accelerating wages and reasonably robust GDP growth, likely would drive the Fed to raise rates several times this year even if nothing else changed. But the incoming administration is promising to ease fiscal policy aggressively, through a combination of tax cuts and spending increases. At this point, the scale, structure and timing of fiscal easing remains unknown.

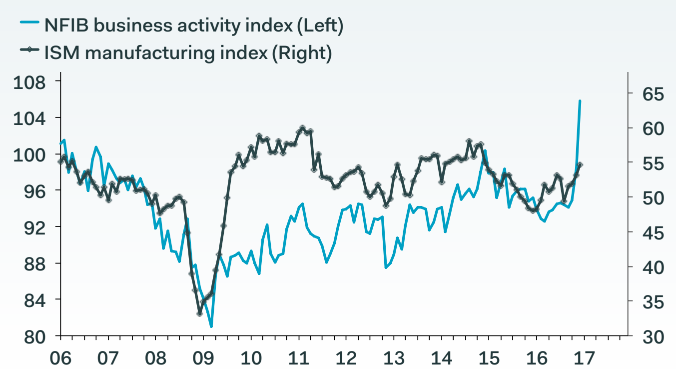
* We do know, though, that the economy cannot absorb a step increase in aggregate demand without generating greater inflationary pressure. The Fed is right to warn, as it did in the December minutes, that "the risk of a sizable undershooting of the longer-run normal unemployment rate had increased somewhat and that **the Committee might need to raise the federal funds rate more quickly than currently anticipated** to limit the degree of undershooting and stem a potential build-up of inflationary pressures." About half the members of the FOMC incorporated some element of fiscal easing into their new forecasts; as details emerge of Congress' plans, we expect the March projections fully to reflect the Fed's estimates of the impact of the impending tax cuts and spending increases.

* Growth strengthened in the second half of last year, thanks in part to **the end of the collapse in capex in the mining sector.** This is a small component of GDP, accounting for only 1.0% of the economy even when spending was at its peak in mid-2014, but it collapsed by 67% from peak to trough. The rebound in oil prices has boosted the rig count by more than two-thirds from its May 2016 low, so we expect the fourth quarter national accounts to show mining capex rising for the first time since the spring of 2014.

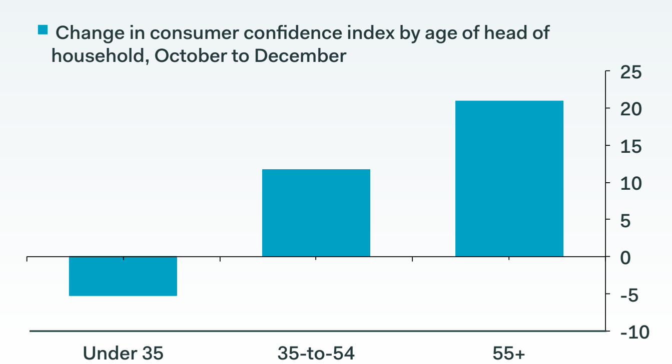
* The meltdown in mining capex triggered a mini-cycle in durable good inventories, and did real damage to manufacturers, wholesalers and an array of other businesses dependent on the oil sector. **This hit too is now fading,** and the NFIB survey's measure of capex intentions, which leads non-oil spending by a couple of quarters, has risen to a nine-year high.

* All surveys of business and consumer confidence have risen sharply since the election. This is puzzling, given that Mr. Trump lost the popular vote by roughly three million. Consumer data clearly show that the surge in optimism has been driven entirely by older households, while younger people are less optimistic than before the election. Business owners tend to be older and whiter than the population as a whole too, so it is entirely possible that all the surveys overstate the private sector's expectations for the economy. It is very important, therefore, to **track indicators of actual spending rather than sentiment.**

BUSINESS SENTIMENT HAS REBOUNDED SINCE THE ELECTION...



OLDER CONSUMERS ARE HAPPIER TOO; THE YOUNG, NOT SO MUCH



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* Mortgage rates have risen by some 70bp since the election, but the initial response in the market has been an *increase* in applications for loans to finance house purchase. It is normal for applications initially to rise when rates spike, because would-be homebuyers rush to lock-in before rates climb even further. Once their demand has been met, activity drops sharply. Bearing in mind that mortgage applications were trending down before the election, after peaking in the spring of last year, **we now expect housing market activity to weaken this year,** making it the first casualty of reflation under the Trump administration.

* Our working assumption is that fiscal easing boosts GDP growth by at least 0.5% this year. **Initially, GDP growth will accelerate as the stimulus begins to flow,** pushing payroll growth up and driving the unemployment rate down to new cycle lows.

* Real wage growth has been rising since 2013, but nominal wage gains have been modest, until recently, because low inflation has made people better off. With both headline and core inflation now well off their lows, **nominal wages are now accelerating** too, and are on course to reach 3½%-plus by the end of this year. In February last year, Fed Vice-Chair Fischer said that 3% wage growth is where the Fed "wants to be". With a 2% inflation target and productivity growth trending at less than 1%, Dr. Fischer's position is easy to understand, and explains why some of his colleagues are now very concerned about inflation risk, even before the fiscal stimulus kicks in.

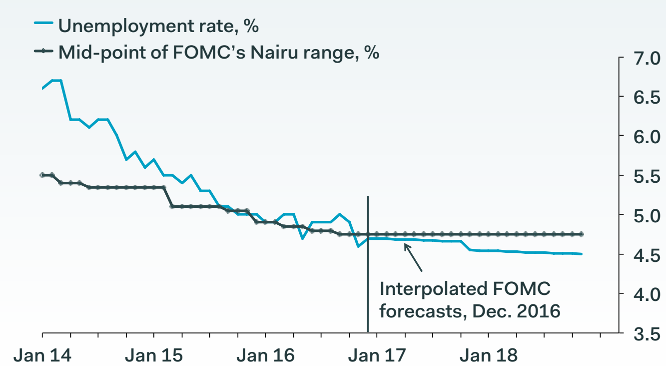
* The Fed's core view that inflation is driven by labor-cost push means that policymakers will have to respond to accelerating wages by raising rates more quickly than currently expected. The December fed funds future is pricing in only two 25bp hikes this year, so the risk is that **the market's adjustment to the change in the inflation picture, and the Fed's response to it, has much further yet to go.**

* **The likely repeal of Obamacare is an inflation-risk wildcard.** No-one yet knows which parts of the program will be repealed, when the repeal will take effect, and what—if anything will replace it. But there can be no doubt that Obamacare is responsible for much, if not all, the benign in medical costs inflation numbers of recent years, and that repeal is likely to be followed by a substantial rebound. Medical services account for 19% of the core PCE deflator, so the adverse impact on the overall inflation picture would be considerable.

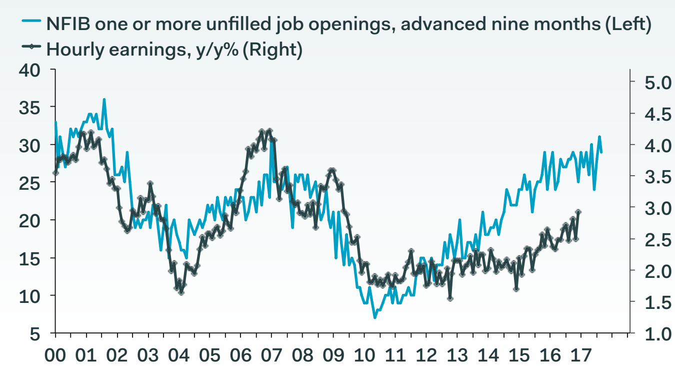
* As well as the uncertainty surrounding the outlook for growth and inflation, and the Fed's reaction function to changing macro picture, Fed hawks are concerned that the *economy's* reaction function to the Fed might be very different to normal. It is possible that **the initial increase in rates might trigger *faster* economic growth**—by signalling that the economy is normalizing, by discouraging capital misallocation, and by raising savers' incomes—requiring further increases in rates before monetary policy begins to restrain growth.

* The euphoric reaction in the stock market to the election result will not last if inflation pressure builds to the extent we fear, forcing the Fed to raise rates aggressively and **raising the specter of a recession in 2018.** Eventually, the Treasury curve will flatten as investors begin to see a slowdown coming, but the risk of a substantial bear steepening this year, with widening corporate spreads, is very real.

THE LABOR MARKET CONTINUES TO TIGHTEN...



...THE FED WILL HAVE TO DEAL WITH RISING INFLATION RISK



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Economic Activity (Full year numbers are year-over-year %; half-year are annualized averages)

						2017		2018	
	2014	2015	2016F	2017F	2018F	H1	H2	H1	H2
Consumers' spending	2.9	3.2	2.7	2.6	2.0	2.0	2.7	1.3	1.2
Fixed investment	5.5	4.0	0.6	5.0	0.0	6.0	2.0	-1.0	-4.0
of which:									
residential	*3.5*	*11.7*	*6*	*7*	*-4*	*10*	*2*	*-3*	*-6*
equipment	*5.4*	*3.5*	*-2*	*4*	*0*	*5*	*4*	*2*	*-2*
IP	*3.9*	*4.8*	*4*	*2*	*1*	*1*	*2*	*2*	*1*
non-res. structures	*10.3*	*-4.4*	*-3*	*10*	*2*	*9*	*6*	*4*	*-2*
Government spending	-0.9	1.8	0.9	1.5	2.0	1.5	2.0	4.0	2.0
Inventories, change $B	58	84	12	40	-15	45	35	0	-30
Domestic demand	2.5	3.2	1.7	3.0	1.0	3.0	2.5	1.0	0.0
Exports	4.3	0.1	0.3	2.5	-1.0	3.0	0.0	-2.0	-2.0
Imports	4.4	4.6	0.9	2.5	0.0	2.5	0.0	0.0	-1.0
GDP	2.4	2.6	1.7	2.8	1.0	3.0	2.5	0.3	-0.5

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

Productivity growth	0.8	0.9	0.6	0.8	1.0	-	-	-	-
Payrolls, monthly average, thousands	251	228	180	200	25	200	160	50	0
Unemployment rate, Q4 average (and end-half)	5.7	5.0	4.7	4.5	5.2	4.6	4.5	4.8	5.0
Hourly earnings, Q4 average (and end-half)	2.1	2.5	2.8	4.0	3.8	3.2	3.8	4.0	3.8
CPI, Q4 average (and end-half)	1.2	0.5	1.8	2.6	2.6	2.5	2.6	2.7	2.6
Core CPI, Q4 average (and end-half)	1.7	2.0	2.1	2.6	2.6	2.5	2.6	2.7	2.6
Core PCE deflator, Q4 average (and end-half)	1.5	1.3	1.7	2.3	2.5	2.1	2.4	2.5	2.4

Other

Current account, % GDP	-2.2	-2.5	-2.8	-3.2	-3.5	-	-	-	-
Budget deficit, % GDP, FY	-2.9	-2.1	-2.3	-3.5	-3.5	-	-	-	-
Fed funds, December (and end-half)	0.13	0.375	0.625	1.875	1.625	1.125	1.875	2.125	1.625
10-year notes, Q4 average (and end-half)	2.28	2.19	2.13	3.50	2.75	3.00	3.50	3.00	2.75
30-year bonds, Q4 average (and end-half)	2.97	2.96	2.82	4.00	2.50	3.80	4.00	3.20	2.50
S&P 500, Q4 average (and end-half)	2,014	2,067	2,204	2,100	1,950	2,200	2,100	1,950	1,950