# THE WEEKLY U.S. ECONOMIC MONITOR

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*Passage of the House tax bill does not guarantee Senate success, but the pressure is on.*

*If taxes are cut next year, the Fed will respond to faster growth with more aggressive rates hikes.*

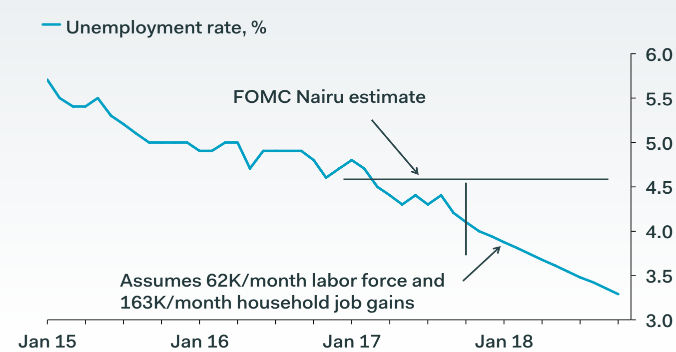
*The faster and further the Fed hikes, the bigger is the risk of an accident, like a recession in 2019.*

## Terrible Timing for Tax Cuts; if they Pass, the Fed Will Hike More Quickly

The passage of the House tax cut bill does not guarantee that the Senate will follow suit with its own bill, still less that both chambers will then be able to agree on a single bill which can then be signed into law. As the healthcare debacle clearly demonstrated, the political interests of House members from heavily gerrymandered districts are very different from Senators, who have to take into account the views of all the voters in their states. Still, the passage of at least some tax cuts now seems likely, though the details are still uncertain.

***The key implications of the tax cuts are that economic growth likely will be a bit stronger next year than would otherwise have been the case, and interest rates and inflation will be a bit higher.*** A $1.5T tax cut package is not peanuts, but that's the 10-year cumulative impact on the deficit. What matters for 2018 is the change in the fiscal stance from this year. This is not as straightforward as it might seem, because estimates vary substantially. *The Joint Committee on Taxation reckons the impact on the deficit next year will be $114B, or 0.6% of GDP, while the Penn Wharton model reckons it will be almost $250B, or 1.3% of GDP.* Note that the official-sounding Tax Foundation says the impact will be a gigantic $369B, but their model is widely acknowledged to be deeply flawed, and the institution is funded largely by corporate donors with a direct interest in lower tax rates. We ignore them.

THIS LABOR MARKET DOESN'T NEED TAX CUTS




We have no hard basis on which to evaluate the relative merits of the JCT and Penn Wharton analyses— their models, inputs and assumptions differ— so we're just going to take the middle ground as our starting point, implying net fiscal easing next year of about $180B, or 0.9% of GDP.

A good deal of this money will be saved, so the impact of GDP growth will be smaller than the headline loss of federal tax revenue. All taxpayers will receive a *federal* tax cut next year, but net state and local taxes will rise for some people in high-tax states because deductions will be capped at $10K, and the skewing of the federal tax cuts to higher income people mean that a substantial proportion likely will be saved. The bipartisan Tax Policy Center reckons that 56.6% of the aggregate value of the personal tax cuts in 2018 will accrue to the top income quintile, with 20.6% going to the top 1% of the income distribution.

The response of the corporate sector to the cut in the headline rate and the other provisions of the bill— including full capex expensing for the first five years, partly offset by capping the net interest deduction—is hard to predict, because the changes are unprecedented in recent times. Again, though, we would expect a substantial proportion of the tax cuts to be saved or, more likely, distributed to shareholders via increased dividends or buybacks.

In short, the uncertainties over the impact of the bill on the pace of economic growth are very great, though the range of possible outcomes of the corporate sector's response is wider than that of the personal sector. Nonetheless, we can sketch out some broad parameters of how it might impact economic growth and the labor market, which ultimately is what the Fed cares about. ***If we assume that between, say, 40% and 80% of the net easing next year is spent, that implies full-year GDP growth will be boosted by 0.4-to-0.7 percentage points.*** Allowing for a modest further pick-up in productivity growth, that suggests payrolls will rise by about 350-to-600K more than would otherwise have been the case, pushing the unemployment rate down by a further 0.2-to-0.4pp.

*The Fed does not want to see any of this.* The unemployment rate already is on track to drop below 3.5% a year from now even with no change in fiscal policy. Over the past year, household employment growth has averaged 163K per month, while labor force growth has averaged just 62K per month. Surveys suggest that the rate of growth of employment is likely to rise markedly over the next few months, regardless of whether Congress cuts taxes, so the rate of fall of unemployment could even accelerate.

*No-one at the Fed thinks the U.S. can run a sub-3.5% unemployment rate without driving up wage inflation markedly.* Indeed, in the quarter of metro areas where unemployment right now already is that low, wages have risen by 4.0% over the past year. This is a big sample, and we have no reason to think that the national wage picture will be any different if the average unemployment rate drops to 3.5%.

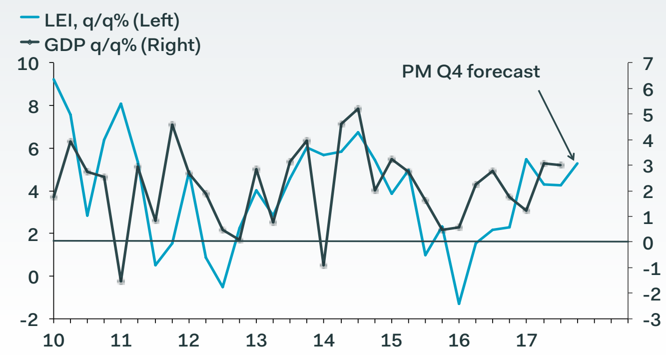
The Fed cannot tolerate 4% wage growth when productivity growth is trending at 1% or less and the inflation target is 2%. Indeed, former Vice-Chair Stan Fischer said last year that the Fed wanted wage growth to rise only as far as 3%. ***Much faster wage gains will result in even more aggressive rate hikes than the Fed currently expects—three next year, and a further two in 2019.*** Markets currently expect the Fed to hike in December and then just once more. That's not enough even the absence of tax cuts, and makes no sense if Congress passes a bill anything like the version now approved by the House.

The faster and further the Fed raises rates, relative to current market expectations, the wider is the range of possible outcomes in markets and the real economy. We don't know where the tipping point is for potential homebuyers and businesses, and neither do we know how bank risk managers will react to much higher rates than they had assumed when projecting loan delinquency rates. ***But it's easy to see how a hefty tax cut at time of full employment could push the Fed into a corner, with a recession the only way out.***

## October LEI set to surge as the storm hit fades

The October index of leading indicators, due today, is set to jump by a huge 1.2%, the biggest increase since November 2013. The biggest single contribution, 0.5pp, will come from the plunge in jobless claims as the post-hurricane spike reversed, but most other components also will boost the index. *We reckon the LEI is set to rise at an annualized rate of 5-to-5½% in the fourth quarter, even allowing for a correction in November, consistent with real GDP growth of about 3%.*

THE STRONG LEI LIKELY WILL SIGNAL 3% GDP GROWTH IN Q4




**Please note the *U.S. Economic Monitor* will not be published on Thanksgiving Day, Thursday November 23, and Friday, November 24.**

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## THIS WEEK IN BRIEF

Note: "**D**" prefix denotes Datanotes for these releases.

### Monday, November 20

• **D: Index of Leading Indicators (10)/10:00 EST**
We expect to see an enormous **1.2%** month-to-month increase, with big positive contributions from falling jobless claims after the hurricane-induced jump in September, rebounding building permits, higher stock prices, elevated consumer sentiment and robust growth in manufacturing new orders. **Consensus: 0.6%.**

### Tuesday, November 21

• **Redbook Chain Store Sales (11/18)/9:00 EST**
Sales growth dipped to a three-month low of **2.3%** year-over-year last week, in the lower part of the pre-hurricane range; we now expect a modest rebound.

• **D: Existing Home Sales (10)/10:00 EST**
The pending sales index suggests that closed sales dropped to about **5.3M** in October, depressed by the hurricanes. Pending sales tend to lead closed sales by one-to-two months. **Consensus: 5.40M.**

### Wednesday, November 22

• **Mortgage Applications (11/17)/7:00 EST**
The purchase applications index has been flat, net, since early September, but the seasonal adjustments are deeply suspect and the true trend probably is stronger. Last week, the index stood at **228.2.**

• **D: Jobless Claims (11/18)/8:30 EST**
Claims jumped by 10K last week to 249K, a six-week high, but this probably was due to seasonal adjustment problems caused by the Veterans Day holiday. We expect claims this week to drop back to about **235K. Consensus: 232K.**

• **D: Durable Goods Orders (10)/8:30 EST**
We expect a **0.3%** increase in total orders, with orders ex-transportation up about **0.5%.** The headline measure will be constrained by a dip in aircraft orders. Core capital goods orders—ex-defense and aircraft—have risen by 1.3% month-to-month in each of the past three months; another decent increase in October is a good bet, though these data can be noisy. **Consensus: Total 0.3%, ex-transportation 0.4%.**

• **Univ. of Mich. Consumer Sentiment (11f)/10:00 EST**
We expect no significant change from the preliminary index, **97.8,** down slightly from a 13-year high of 100.7 in October. **Consensus: 98.0.**

• **D: FOMC Minutes (11/1)/14:00 EST**
The Fed left rates on hold at this meeting but re-affirmed its commitment to a gradual normalization of policy. The statement called the recent pace of economic activity "solid", an upgrade from September's "rising moderately".

### Thursday, November 23

• **Holiday, Thanksgiving Day**

### Friday, November 24

• **No significant data released**

## THIS WEEK'S FUNDING

| | |
|---|---|
| **Monday 20** | Auction: $42B 3-month, $36B 6-month bills |
| | Announcement: four-week bills |
| **Tuesday 21** | Auction: four-week bills |
| | Auction: $13B 2-year FRN (settles Nov. 24) |
| **Wednesday 22** | Announcement: 3-month, 6-month bills (Nov. 20) |
| | Announcement: 2-year notes (Nov. 27) |
| | Announcement: 5-year notes (Nov. 27) |
| | Announcement: 7-year notes (Nov. 28) |
| **Thursday 23** | Nothing |
| **Friday 24** | Nothing |

## PANTHEON'S FINANCIAL FORECASTS

| | | End-month: | | | |
|---|---|---|---|---|---|
| | **4:00pm Fri.** | **Dec** | **Mar** | **Jun** | **Sep** |
| Fed funds target | 1-to-1¼ | 1¼-to-1½ | 1½-to-1¾ | 1¾-to-2 | 2-to-2¼ |
| 2-yr | 1.72 | 1.75 | 1.90 | 2.20 | 2.50 |
| 10-yr | 2.34 | 2.50 | 2.80 | 3.00 | 3.20 |
| 30-yr | 2.78 | 3.00 | 3.30 | 3.40 | 3.50 |
| Curve 10-2 | 62 | 75 | 90 | 80 | 70 |
| Curve 30-2 | 106 | 125 | 140 | 120 | 100 |
| S&P 500 | 2,579 | 2,550 | 2,450 | 2,350 | 2,300 |
| Dollar/Yen | 112.1 | 108 | 112 | 116 | 116 |
| Euro/Dollar | 1.18 | 1.22 | 1.20 | 1.18 | 1.18 |
| Sterling/Dollar | 1.32 | 1.35 | 1.32 | 1.32 | 1.34 |

## PANTHEON'S ECONOMIC FORECASTS

| | | | | |
|---|---|---|---|---|
| **GDP** | Q4 | 2.1% | 2014 year: | 2.4% |
| | Q1 | 1.4% | 2015 year: | 2.6% |
| | Q2 | 3.1% | 2016 year: | 1.6% |
| | Q3 advance | 3.0% | *2017 year:* | *2¼%* |
| | *Q4 forecast* | *3%* | *2018 year:* | *2%* |
| | *Q1 forecast* | *2%* | | |

| | |
|---|---|
| **CPI** | Oct. 0.5% (2.0% y/y); core 0.2% (1.8% y/y) |
| | Dec. 2017 forecast: 2.1% y/y; core 1.8% y/y |
| | Jun. 2018 forecast: 2.7% y/y; core 2.3% y/y |

**Unemployment**: December 2017: 4.1%; June 2018: 3.8%.

**Federal budget:** FY 18 forecast: -$800B (4.0% of GDP)