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SUB-4% UNEMPLOYMENT IS COMING, AND SOON

...HOW WILL THE FED RESPOND?

U.S. ECONOMIC CHARTBOOK, NOVEMBER 2017

DATA AS AT NOVEMBER 8 | IAN C. SHEPHERDSON, CHIEF ECONOMIST
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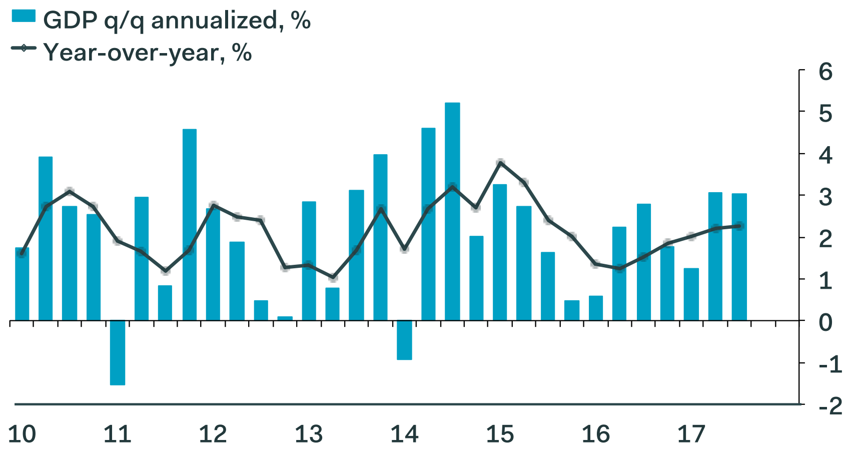
"I'm just glad we got out before interest rates went up again."

Summary

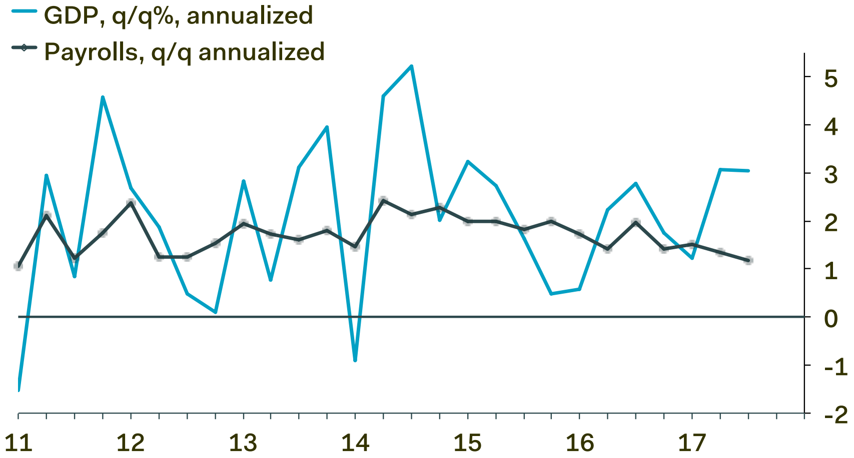
- Back-to-back 3% quarterly GDP growth, for the first time in three years—despite the hurricanes in August and September—suggests that **underlying momentum in the economy is building.** The key development is the acceleration in non-oil business capex, as signalled clearly by the NFIB survey, which the FOMC specifically cited in the September minutes.
- The rebound in October payrolls recovered some of the ground lost after the hurricanes; a further catch-up over the next couple of months is a good bet. **Every indicator of labor demand we follow signals rapid payroll growth over the next few months.** But the apparent shortage of suitably qualified applications means firms will find it hard to recruit all the people they need. That in turn will increase the upward pressure on wages.
- **Headline unemployment is now at a 16-year low of 4.1%, and shows no sign of levelling-off.** If the rates of growth of household employment and the labor force continue their current 12-month trends, the headline unemployment rate will be under 3.5% a year from now. The last time unemployment was that low, in 1969, core CPI inflation was 6%.
- Downward pressure is fading in the array of core CPI components which have depressed inflation since March. Owners' equivalent rents—depressed by a technical problem—and hotel room rates have fully rebounded, while prescription drugs, physicians' services and airline fares have begun to rebound. Used vehicle prices have surged at auction, following the surge in demand after the hurricanes; this will lift the CPI soon. **More broadly, the NFIB survey, which warned of the spring drop in core inflation, points to a modest upturn in the fall.**
- Nominal wage growth continues to run at a slower pace than implied by the unemployment rate and a host of business survey indicators. But *real* wage growth is running close to the rate suggested by historical experience, suggesting that nominal gains have been held down by the very low core inflation rate. **Short-term survey evidence suggests hourly wage growth will rise quite sharply over the winter, breaching 3% early next year.** The month-to-month data are not reliable.
- Political gridlock means that our base case now is that net fiscal easing in fiscal 2018, starting October 1, will be minimal, perhaps only a quarter of a percent of GDP. **It is entirely possible that taxes are not cut at all.**
- The falling unemployment rate is forcing Chair Yellen's hand. **We fully expect a December hike, and we're sticking to our view that rates will rise at each end-quarter meeting in 2018.**
- **Rates likely will peak in early 2019, at 2.625%, but the next recession will be driven mostly by tightening credit availability rather than rising debt service ratios.** Growth will remain at or above 2½% in 2018 as a whole, but signs of slowdown will emerge in the second half, with a mild recession beginning mid-2019. By the second half, the Fed will be easing.

1. BACK-TO-BACK 3% GROWTH FOR THE FIRST TIME IN THREE YEARS...

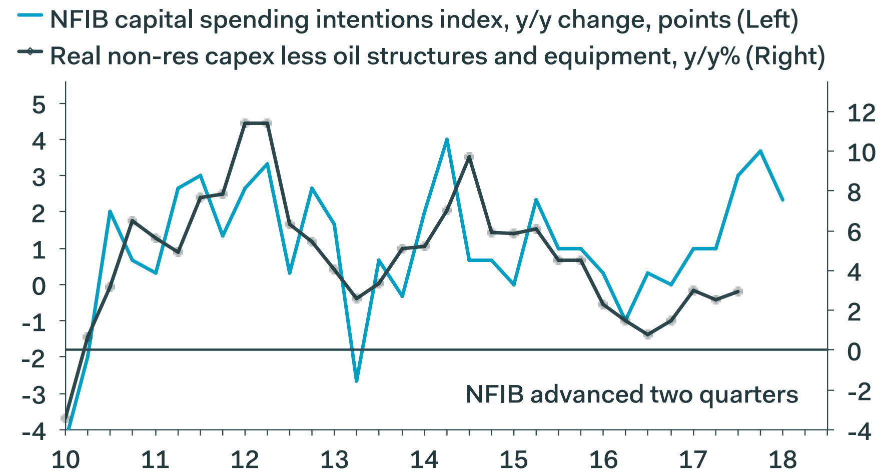


3. CAPEX IS NO LONGER DEPENDENT ON OIL PRICES

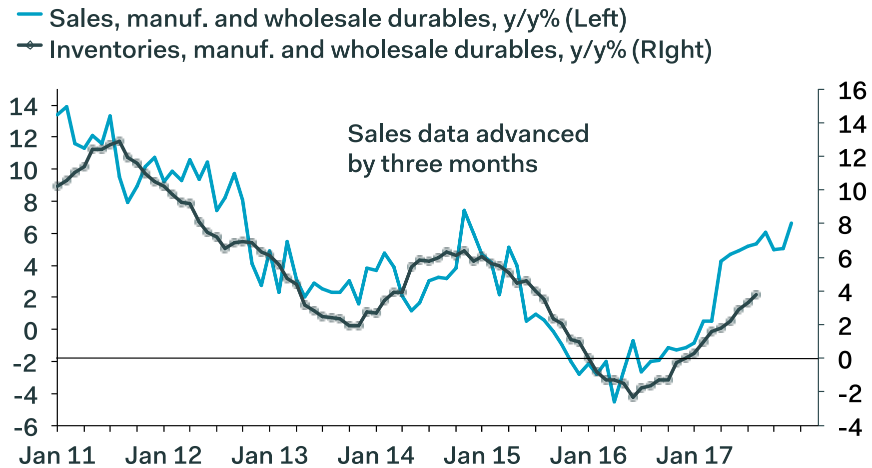
2. ...FOR ONCE, THE JOBS DATA WERE LESS RELIABLE THAN GDP



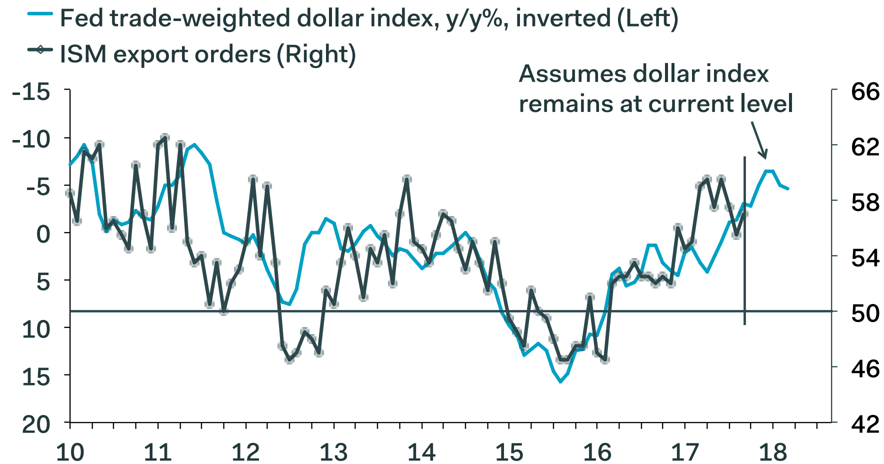
4. ...CONSISTENT WITH STRONG NFIB CAPEX INTENTIONS



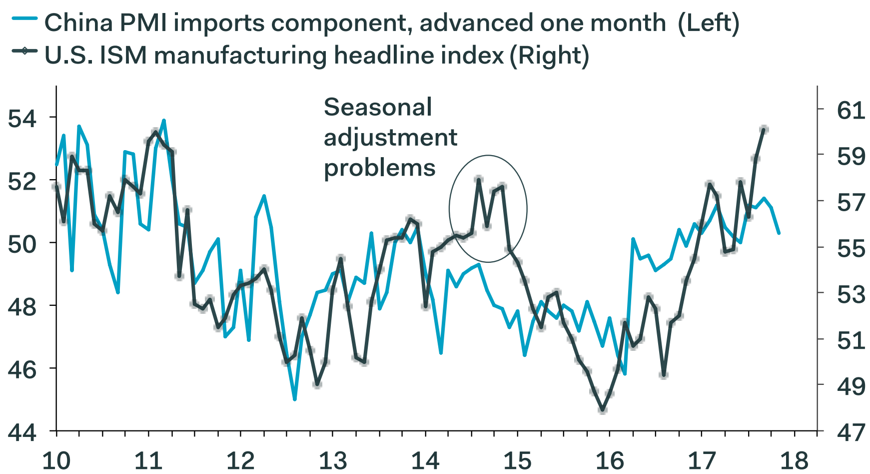
5. THE OIL-INDUCED INVENTORY CRUNCH IS OVER TOO



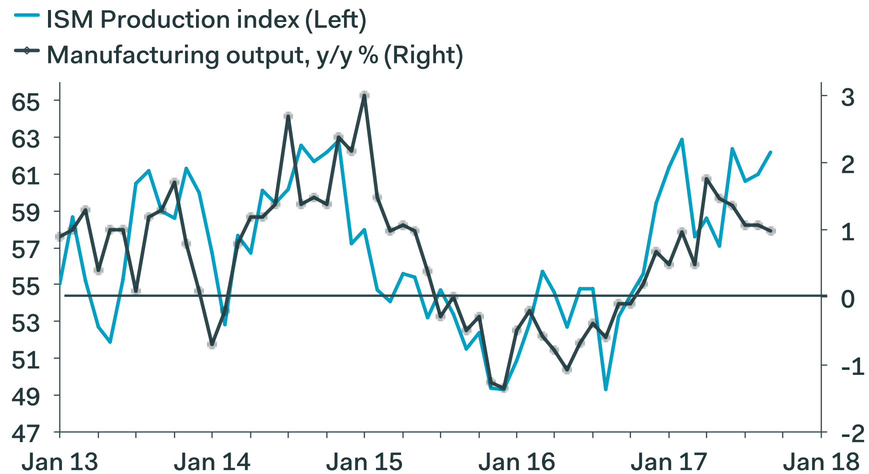
7. EXPORT ORDERS ARE STRONG, MOSTLY DUE TO THE WEAK DOLLAR



6. CHINA DEMAND HAS LIKELY PEAKED; DOMESTIC U.S. DEMAND RISING?



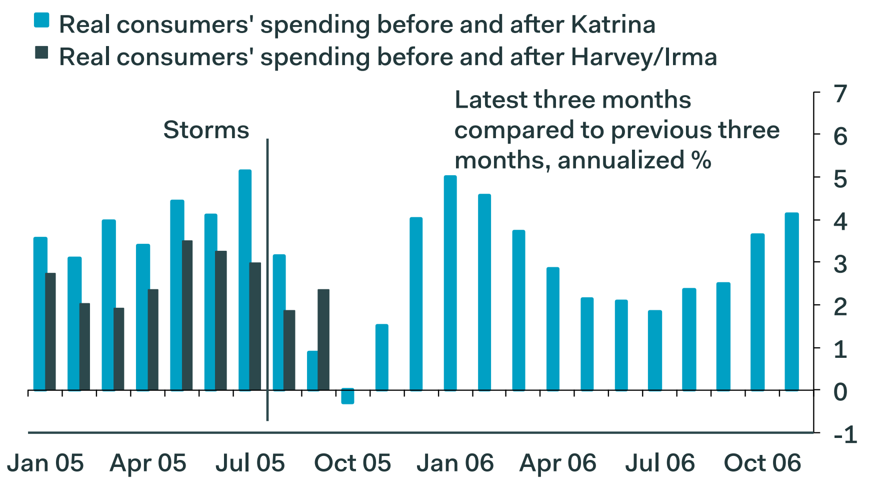
8. MANUFACTURING HAS BEEN HIT BY THE STORMS; IT WILL REBOUND



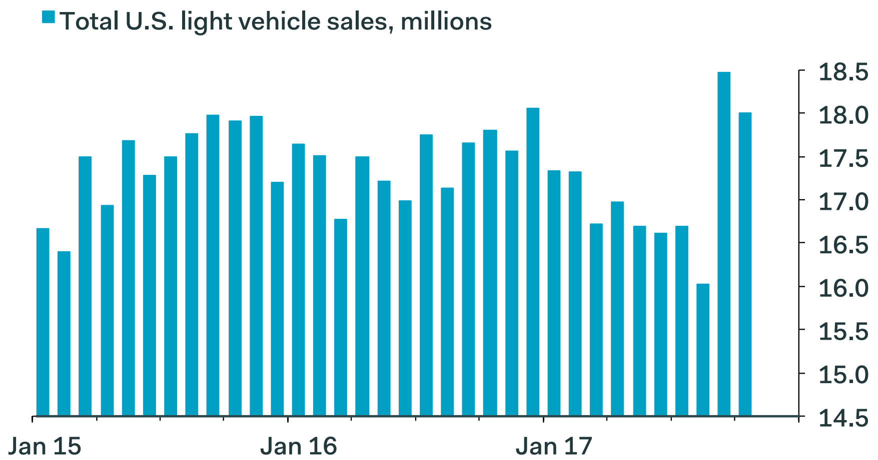
9. CONSUMERS' CONFIDENCE HAS JUMPED; SPENDING LAGGING

11. CHAINSTORE SALES GROWTH SLOWING AS STORM LIFT FADES

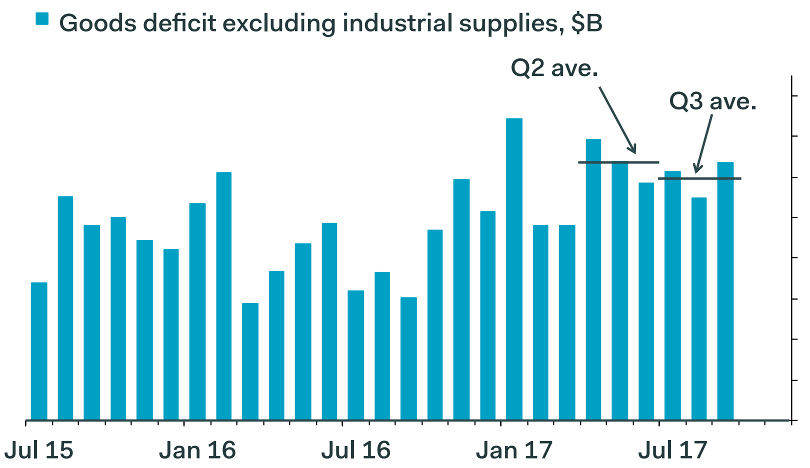
10. HURRICANES SLOWED SPENDING, BUT NOT AS MUCH AS IN 2005



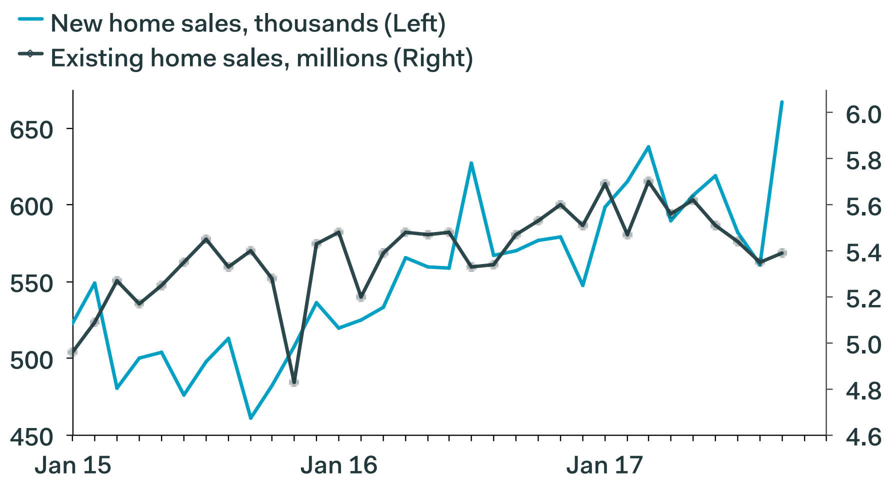
12. AUTO SALES HAVE ROCKETED; THE REPLACEMENT WAVE BEGINS



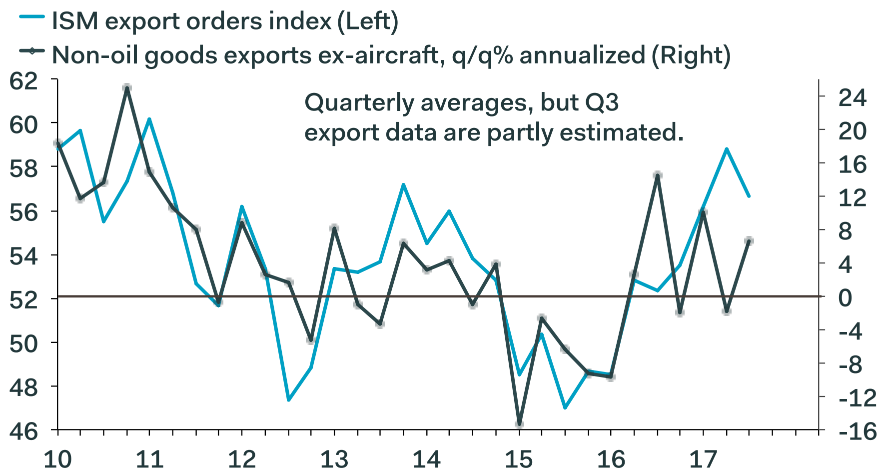
13. THE CORE TRADE DEFICIT HAS STABILIZED...



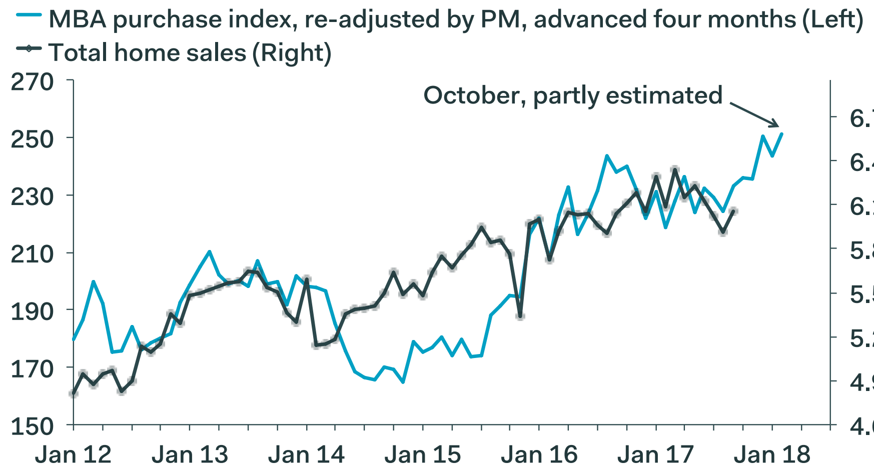
15. HOME SALES WERE HIT ONLY BRIEFLY BY THE HURRICANES...



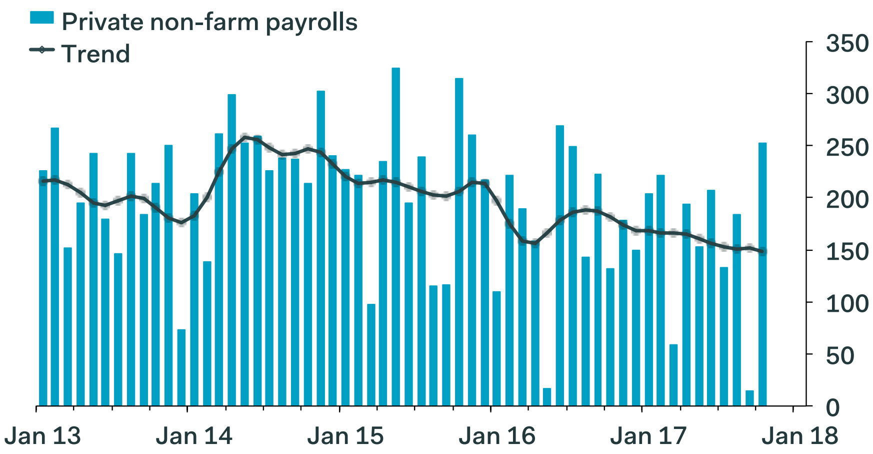
14. ...BUT THE ISM POINTS TO MUCH STRONGER EXPORTS



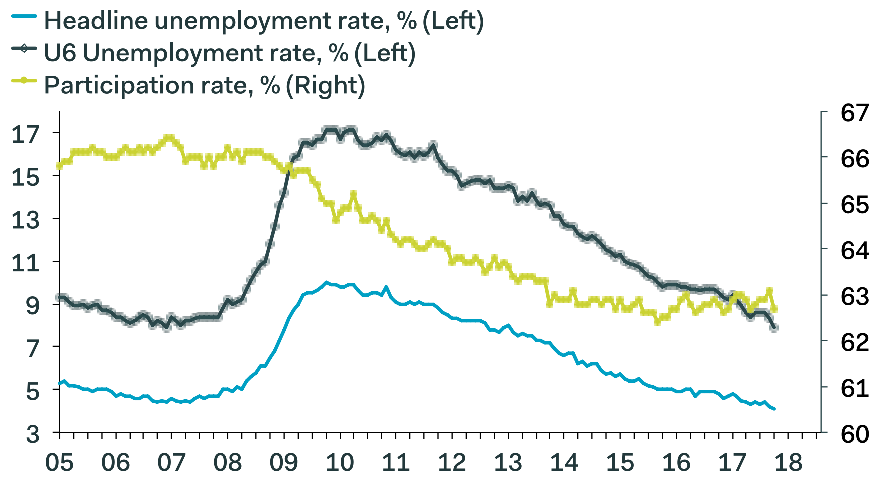
16. ...BUT A Q4 REBOUND IS A DECENT BET



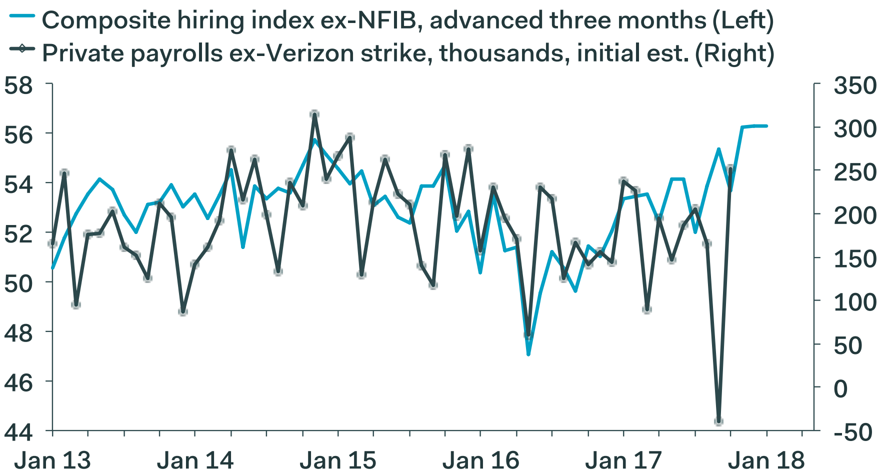
17. PAYROLLS REBOUNDED STRONGLY AFTER THE HURRICANES...



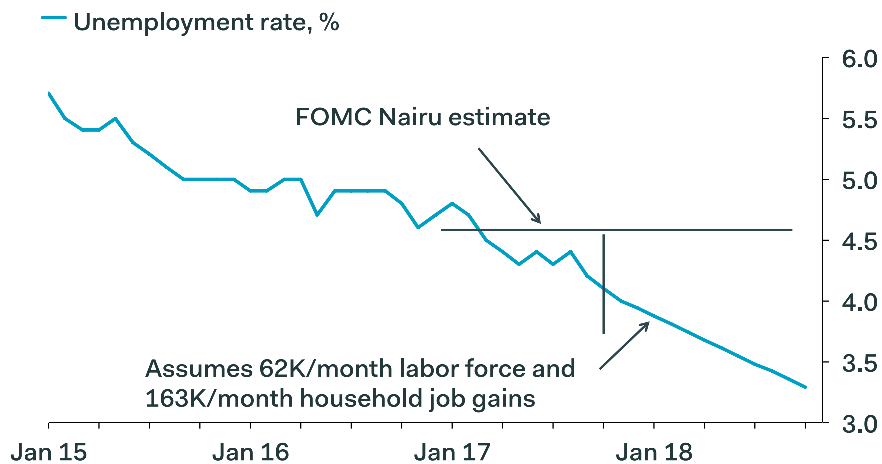
19. THE TREND IN UNEMPLOYMENT IS FALLING; PARTICIPATION STABLE?



18. ...SUSTAINED RAPID GAINS SEEM LIKELY IN THE WINTER

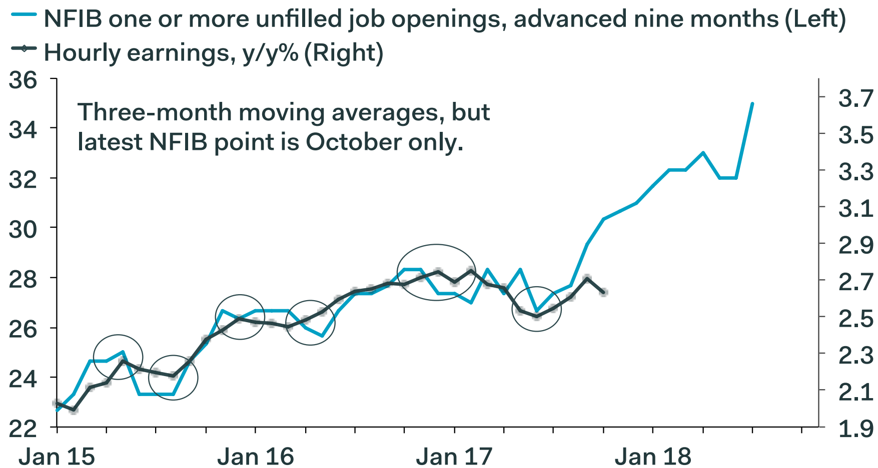


20. THE PROSPECT OF SUB-4% UNEMPLOYMENT IS SCARING YELLEN

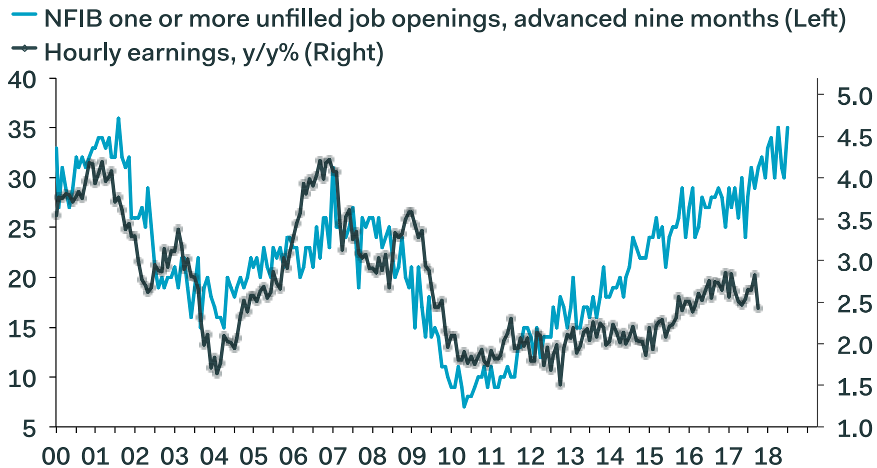


21. *REAL* WAGE GROWTH HAS ACCELERATED SUBSTANTIALLY...

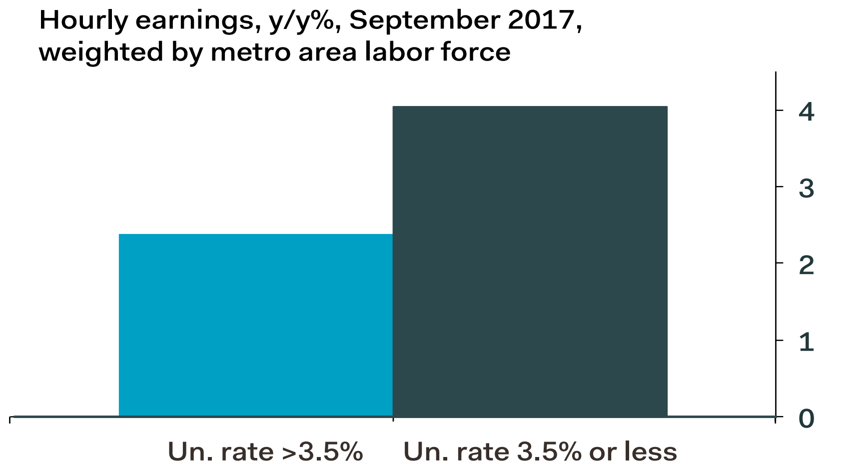
23. ...BUT THE POST-2015 LINK BETWEEN NFIB AND WAGES IS HOLDING



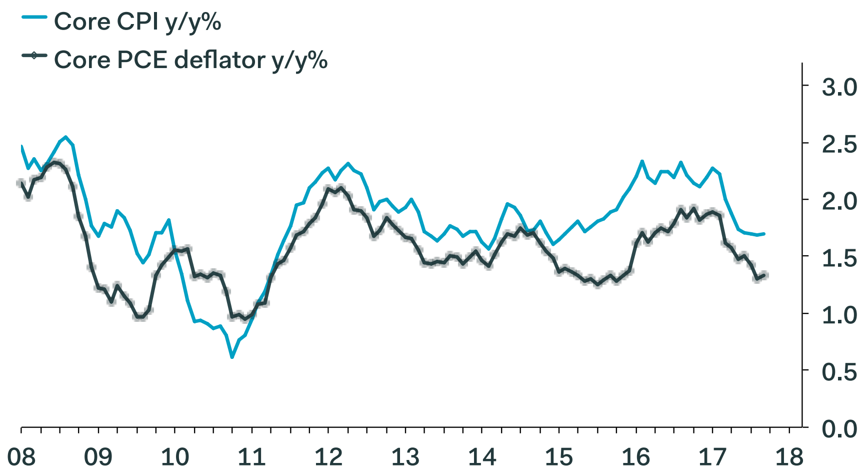
22. BUT *NOMINAL* WAGES ARE SOFT, GIVEN THE TIGHT LABOR MARKET



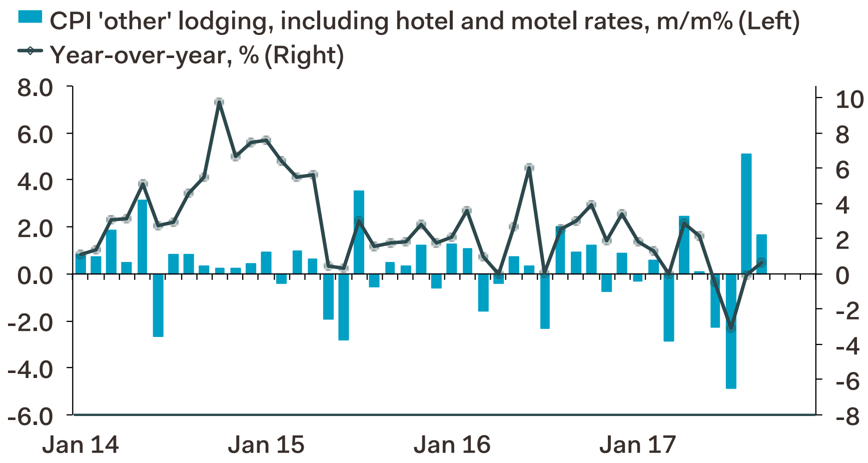
24. WAGE GAINS ALREADY AT 4% WHERE UNEMPLOYMENT IS 3.5% OR LESS



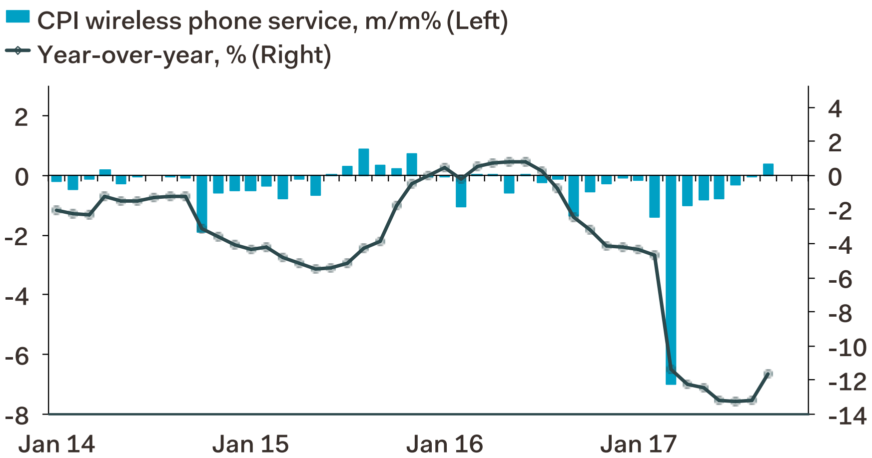
25. CORE INFLATION HAS SLOWED SHARPLY BUT WILL LEVEL OFF SOON



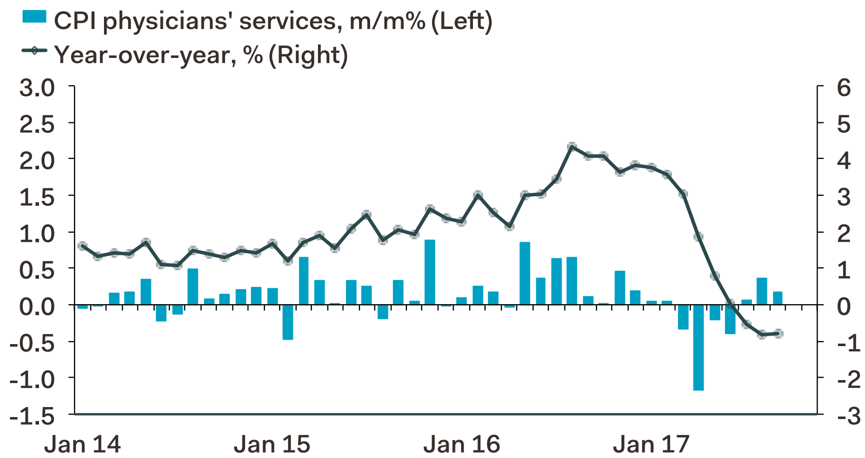
27. HOTEL ROOM RATES HAVE REBOUNDED IN FULL



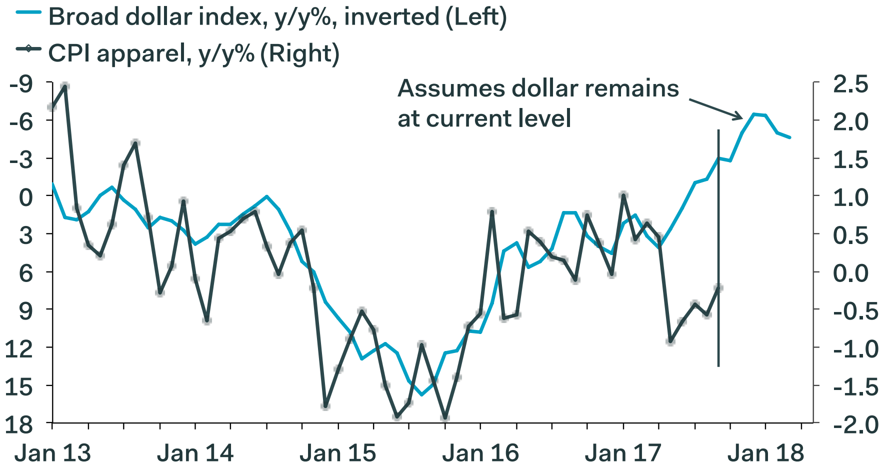
26. THE PLUNGE IN CELLPHONE PLAN PRICES IS OVER



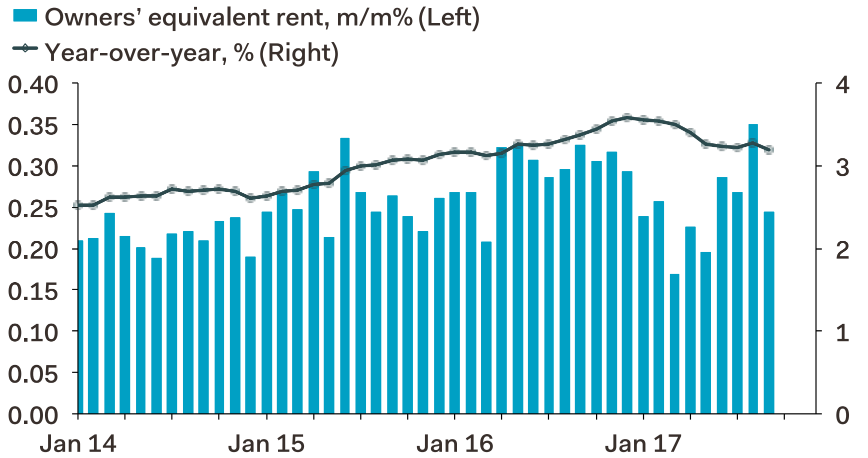
28. PHYSICIANS' SERVICES PRICES ARE CREEPING BACK UP



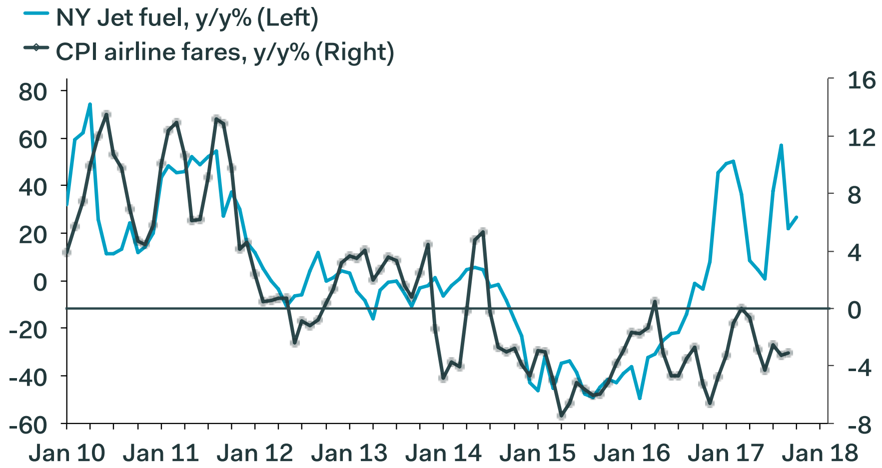
29. APPAREL INFLATION WILL REBOUND



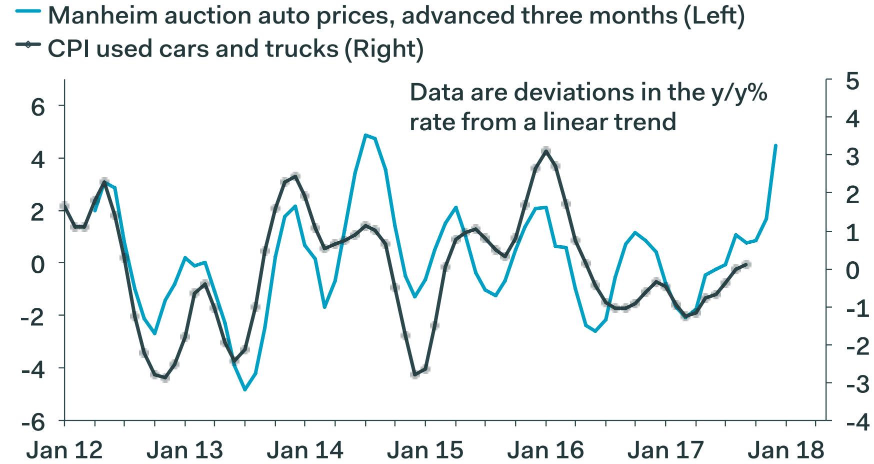
31. ...AND THE TECHNICALITY WHICH DEPRESSED OER IS OVER



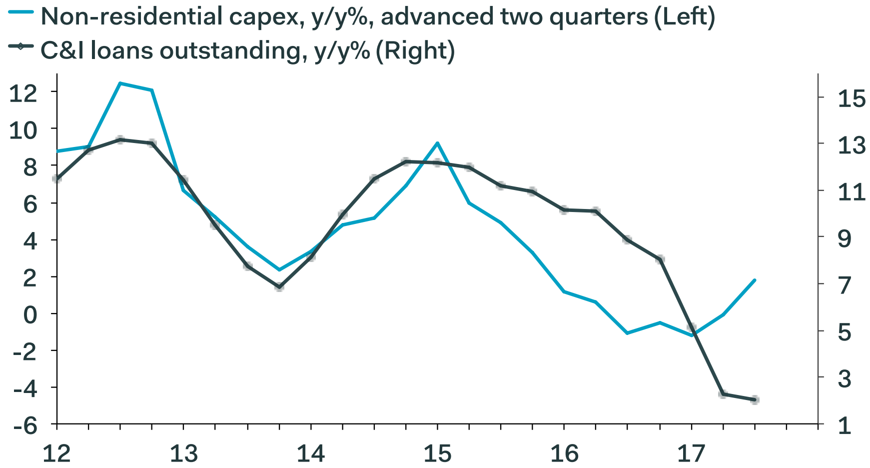
30. CLEAR UPSIDE RISK FOR AIRLINE FARES...



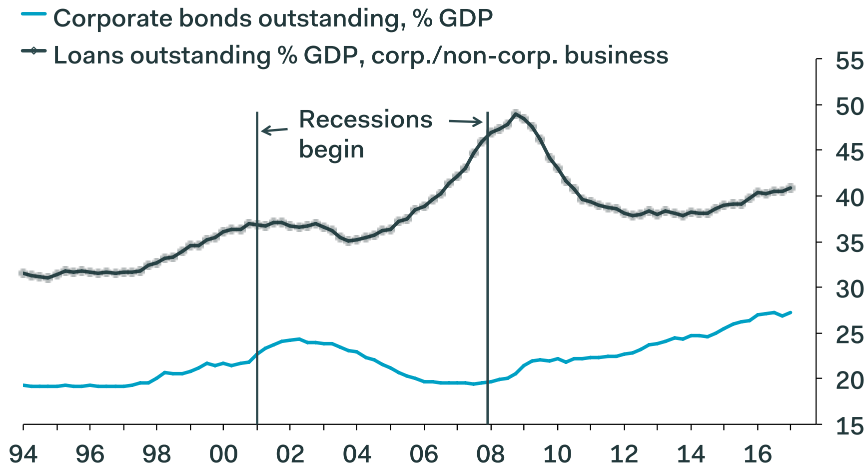
32. USED CAR PRICES WILL RISE SHARPLY VERY SOON



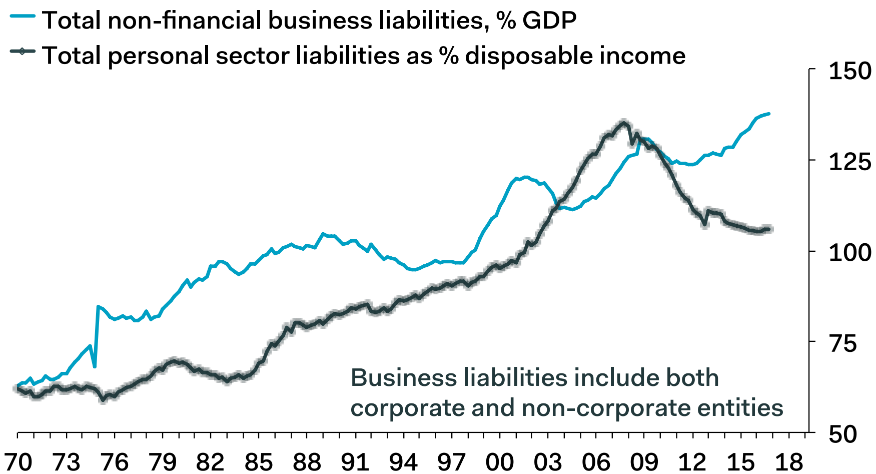
33. SLOWDOWN IN C&I LOAN GROWTH JUST LAGS CAPEX



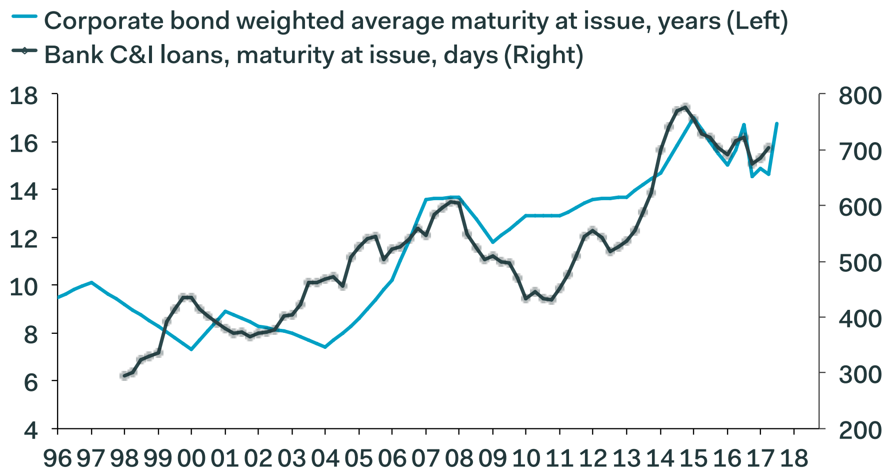
35. BOTH BANK AND NON-BANK DEBT HAVE INCREASED...



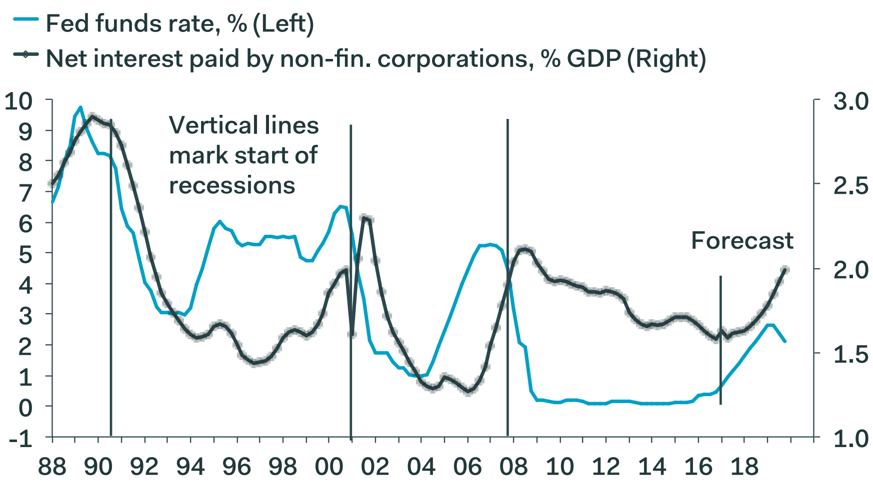
34. NON-FINANCIAL BUSINESS DEBT IS THE KEY RISK AS THE FED HIKES



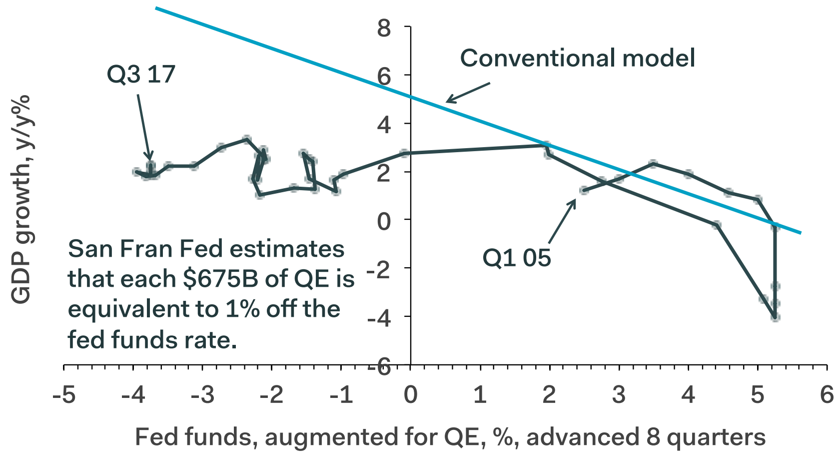
36. ...THOUGH THE MATURITY OF DEBT HAS LENGTHENED



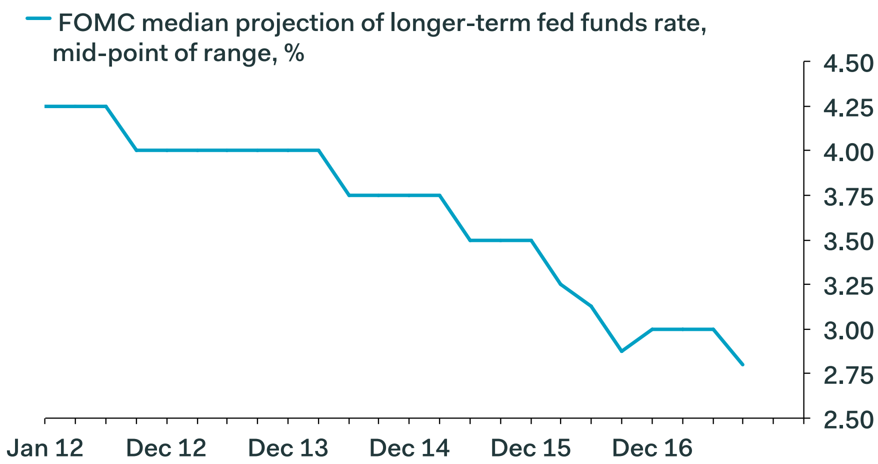
37. HIGHER RATES WILL LIFT DEBT SERVICE RATIOS, EVENTUALLY



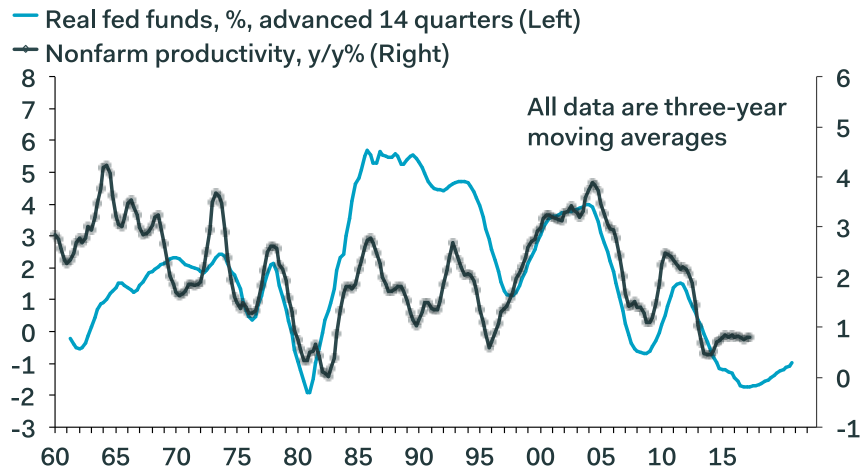
39. HAWKS NOW ARGUE THAT INITIAL RATE HIKES WILL BOOST GROWTH



38. THE FLOOR FOR THE FED'S LONGER-RUN RATE EXPECTATIONS?



40. ...NEGATIVE REAL RATES SIGNAL WEAKNESS, SO WHY INVEST?



Economic Activity (year-over-year %)

	2014	2015	2016	2017F	2018F	2019F
Consumers' spending	2.9	3.6	2.7	2.6	2.5	1.5
Fixed investment	6.2	3.9	0.7	3.8	3.0	-1.0
of which:						
residential	*3.5*	*10.2*	*5.5*	*2*	*4*	*-3*
equipment	*6.6*	*3.5*	*-3.4*	*3*	*3*	*0*
IP	*4.6*	*3.8*	*6.3*	*4*	*2*	*0*
non-res. structures	*10.5*	*-1.8*	*-4.1*	*6*	*2*	*-2*
Government spending	-0.6	1.4	0.8	0.0	0.8	1.0
Inventories, change $B	68	101	33	20	20	-20
Domestic demand	2.7	3.5	1.7	2.3	2.3	0.9
Exports	4.3	0.4	-0.3	3.3	2.0	2.0
Imports	4.5	5.0	1.3	3.3	1.0	1.0
GDP	2.6	2.9	1.5	2.3	2.3	1.0

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

	2014	2015	2016	2017F	2018F	2019F
Productivity growth	0.8	0.9	0.6	0.8	1.0	0.0
Payrolls, monthly average, thousands	250	226	187	160	175	50
Unemployment rate, Q4 average	5.7	5.0	4.7	4.2	3.5	4.5
Hourly earnings, Q4 average	2.1	2.5	2.8	2.8	3.8	3.5
CPI, Q4 average	1.2	0.5	1.8	2.1	2.5	2.5
Core CPI, Q4 average	1.7	2.0	2.2	1.8	2.5	2.5
Core PCE deflator, Q4 average	1.5	1.3	1.7	1.6	2.1	2.5

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	2.30	2.75	2.00
30-year bonds, Q4 average	2.97	2.96	2.82	2.80	3.00	2.00
S&P 500, Q4 average	2,014	2,067	2,204	2,575	2,350	2,450