SUB-4% UNEMPLOYMENT IS COMING, AND SOON

...HOW WILL THE FED RESPOND?

U.S. ECONOMIC CHARTBOOK, NOVEMBER 2017
"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 2% 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...

GDP q/q annualized, %
Year-over-year, %

2. ...For once, the jobs data were less reliable than GDP

GDP, q/q%, annualized
Payrolls, q/q annualized

3. CAPEX is no longer dependent on oil prices

Crude oil, advanced three months (Left)
Orders for non-defense capital equipment, ex-aircraft, $B (Right)

4. ...Consistent with strong NFIB CAPEX intentions

NFIB capital spending intentions index, y/y change, points (Left)
Real non-res capex less oil structures and equipment, y/y% (Right)
5. THE OIL-INDUCED INVENTORY CRUNCH IS OVER TOO

- Sales, manuf. and wholesale durables, y/y% (Left)
- Inventories, manuf. and wholesale durables, y/y% (Right)

Sales data advanced by three months

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

- Fed trade-weighted dollar index, y/y%, inverted (Left)
- ISM export orders (Right)

Assumes dollar index remains at current level

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

- China PMI imports component, advanced one month (Left)
- U.S. ISM manufacturing headline index (Right)

Seasonal adjustment problems

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

- ISM Production index (Left)
- Manufacturing output, y/y% (Right)
9. CONSUMERS' CONFIDENCE HAS JUMPED; SPENDING LAGGING

- Consumer expectations index, quarterly average (Left)
- Real consumption, y/y% (Right)

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

- Real consumers' spending before and after Katrina
- Real consumers' spending before and after Harvey/Irma

11. CHAINSTORE SALES GROWTH SLOWING AS STORM LIFT FADES

- Redbook chain store sales, year-over-year, %
- Four-week moving average

12. AUTO SALES HAVE ROCKETED; THE REPLACEMENT WAVE BEGINS

- Total U.S. light vehicle sales, millions
13. THE CORE TRADE DEFICIT HAS STABILIZED...

- Goods deficit excluding industrial supplies, $B

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

- ISM export orders index (Left)
- Non-oil goods exports ex-aircraft, q/q% annualized (Right)

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

- New home sales, thousands (Left)
- Existing home sales, millions (Right)

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

- MBA purchase index, re-adjusted by PM, advanced four months (Left)
- Total home sales (Right)

Quarterly averages, but Q3 export data are partly estimated.
17. Payrolls rebounded strongly after the hurricanes...

- Private non-farm payrolls
- Trend

18. Sustained rapid gains seem likely in the winter

- Composite hiring index ex-NFIB, advanced three months (Left)
- Private payrolls ex-Verizon strike, thousands, initial est. (Right)

19. The trend in unemployment is falling; participation stable?

- Headline unemployment rate, % (Left)
- U6 Unemployment rate, % (Left)
- Participation rate, % (Right)

20. The prospect of sub-4% unemployment is scaring Yellen

- Unemployment rate, %

Assumes 62K/month labor force and 163K/month household job gains
21. **REAL WAGE GROWTH HAS ACCELERATED SUBSTANTIALLY...**

- NFIB one or more unfilled job openings, advanced 16 months (Left)
- Atlanta Fed median hourly earnings, deflated by core PCE, y/y% (Right)

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

- NFIB one or more unfilled job openings, advanced nine months (Left)
- Hourly earnings, y/y% (Right)

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

- NFIB one or more unfilled job openings, advanced nine months (Left)
- Hourly earnings, y/y% (Right)

Three-month moving averages, but latest NFIB point is October only.

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

- Hourly earnings, y/y%, September 2017, weighted by metro area labor force

Un. rate >3.5%  Un. rate 3.5% or less
25. **Core Inflation Has SLOWED SHARPLY but will Level Off Soon**

- Core CPI y/y%
- Core PCE deflator y/y%

26. **The Plunge in Cellphone Plan Prices is Over**

- CPI wireless phone service, m/m% (Left)
- Year-over-year, % (Right)

27. **Hotel Room Rates Have Rebounded in Full**

- CPI 'other' lodging, including hotel and motel rates, m/m% (Left)
- Year-over-year, % (Right)

28. **Physicians' Services Prices Are Creeping Back Up**

- CPI physicians' services, m/m% (Left)
- Year-over-year, % (Right)
29. APPAREL INFLATION WILL REBOUND

- Broad dollar index, y/y%, inverted (Left)
- CPI apparel, y/y% (Right)

Assumes dollar remains at current level

30. CLEAR UPSIDE RISK FOR AIRLINE FARES...

- NY Jet fuel, y/y% (Left)
- CPI airline fares, y/y% (Right)

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

- Owners’ equivalent rent, m/m% (Left)
- Year-over-year, % (Right)

32. USED CAR PRICES WILL RISE SHARPLY VERY SOON

- Manheim auction auto prices, advanced three months (Left)
- CPI used cars and trucks (Right)

Data are deviations in the y/y% rate from a linear trend
33. SLOWDOWN IN C&I LOAN GROWTH JUST LAGS CAPEX

- Non-residential capex, y/y%, advanced two quarters (Left)
- C&I loans outstanding, y/y% (Right)

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

- Total non-financial business liabilities, % GDP
- Total personal sector liabilities as % disposable income

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

- Corporate bonds outstanding, % GDP
- Loans outstanding % GDP, corp./non-corp. business

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

- Corporate bond weighted average maturity at issue, years (Left)
- Bank C&I loans, maturity at issue, days (Right)
37. HIGHER RATES WILL LIFT DEBT SERVICE RATIOS, EVENTUALLY

Fed funds rate, % (Left)
Net interest paid by non-fin. corporations, % GDP (Right)

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

FOMC median projection of longer-term fed funds rate, mid-point of range, %

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

San Fran Fed estimates that each $675B of QE is equivalent to 1% off the fed funds rate.

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

Real fed funds, %, advanced 14 quarters (Left)
Nonfarm productivity, y/y% (Right)

All data are three-year moving averages
### Economic Activity (year-over-year %)

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<td>Consumers’ spending</td>
<td>2.9</td>
<td>3.6</td>
<td>2.7</td>
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<td>Fixed investment</td>
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<td>of which:</td>
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<td>residential</td>
<td>3.5</td>
<td>10.2</td>
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<tr>
<td>equipment</td>
<td>6.6</td>
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<td>IP</td>
<td>4.6</td>
<td>3.8</td>
<td>6.3</td>
<td>4</td>
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<td>non-res. structures</td>
<td>10.5</td>
<td>-1.8</td>
<td>-4.1</td>
<td>6</td>
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<td>Government spending</td>
<td>-0.6</td>
<td>1.4</td>
<td>0.8</td>
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<td>Inventories, change $B</td>
<td>68</td>
<td>101</td>
<td>33</td>
<td>20</td>
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<td>Domestic demand</td>
<td>2.7</td>
<td>3.5</td>
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<td>2.3</td>
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<td>Exports</td>
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<td>GDP</td>
<td>2.6</td>
<td>2.9</td>
<td>1.5</td>
<td>2.3</td>
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### Labor Market, Costs and Prices (year-over-year)

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<td>Productivity growth</td>
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<td>Payrolls, monthly average, thousands</td>
<td>250</td>
<td>226</td>
<td>187</td>
<td>160</td>
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<td>Unemployment rate, Q4 average</td>
<td>5.7</td>
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<td>Hourly earnings, Q4 average</td>
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<td>2.8</td>
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<td>CPI, Q4 average</td>
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<td>0.5</td>
<td>1.8</td>
<td>2.1</td>
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<td>Core CPI, Q4 average</td>
<td>1.7</td>
<td>2.0</td>
<td>2.2</td>
<td>1.8</td>
<td>2.5</td>
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<td>Core PCE deflator, Q4 average</td>
<td>1.5</td>
<td>1.3</td>
<td>1.7</td>
<td>1.6</td>
<td>2.1</td>
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### Other

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<td>Current account, % GDP</td>
<td>-2.2</td>
<td>-2.5</td>
<td>-2.8</td>
<td>-3.2</td>
<td>-3.0</td>
<td>-2.8</td>
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<td>Budget deficit, % GDP, FY</td>
<td>-2.9</td>
<td>-2.1</td>
<td>-2.3</td>
<td>-3.5</td>
<td>-4.5</td>
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<td>Fed funds, December</td>
<td>0.13</td>
<td>0.375</td>
<td>0.625</td>
<td>1.375</td>
<td>2.375</td>
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<td>10-year notes, Q4 average</td>
<td>2.28</td>
<td>2.19</td>
<td>2.13</td>
<td>2.30</td>
<td>2.75</td>
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<td>30-year bonds, Q4 average</td>
<td>2.97</td>
<td>2.96</td>
<td>2.82</td>
<td>2.80</td>
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<td>S&amp;P 500, Q4 average</td>
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<td>2,067</td>
<td>2,204</td>
<td>2,575</td>
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