Robert A. Dye, Ph.D. Daniel Sanabria @Comerica_Econ

March 1, 2017

February ISM MF Index, Jan. Income, Construction Spending, Fedspeak

Likelihood of a March 15 Fed Rate Hike Climbing Quickly

- The ISM Manufacturing Index increased to 57.7 in February.
- U.S. Personal Income increased by 0.4 percent in January.
- The Personal Consumption Expenditure Price Index jumped by 0.4 percent in January.
- After inflation, Real Consumer Spending fell by 0.3 percent in January.
- Construction Spending declined by 1.0 percent in January.
- We now expect a March 15 fed funds rate hike.

The gears are turning today as the world digests President Trump's first address to Congress, U.S. economic data begins to shape Q1 GDP expectations and Federal Reserve officials hint at a March 15 fed funds rate hike. The ISM Manufacturing Index for February increased to a strong 57.7 percent. Nine out of 10 sub-indexes were above 50 and most increased in February. The new orders index was robust at 65.1 percent. Production was not far behind at 62.9. Employment was solid at 54.2. Anecdotal comments were positive. Seventeen out of 18 industries reported growth in February; only furniture reported contraction.

Now comes the other hand. The income and consumer spending numbers for January are consistent with weaker-than-expected real GDP growth. The pattern of weak first quarters may still be with us. Nominal income was good, gaining 0.4 percent for the month, supported by moderate growth in wages and salaries, and strong growth in rents. However, inflation was hotter than expected and ate up the gain. The personal consumption expenditure price index gained 0.4 percent for the month. After accounting for inflation and taxes, real disposable income fell by 0.2 percent in January. We knew spending was going to be challenged by the reset in auto sales after the December surge. Added to that, it looks like warmer-than-normal temperatures (January was the third warmest globally, according to NASA) meant that spending on services, including residential heating, was unchanged for the month. After adjusting for inflation, real consumer spending fell by 0.3 percent in January, which will be a drag on Q1 GDP. Inflation was warm even outside of energy. The core PCE price index (less food and energy) gained 0.3 percent for the month. That will certainly get the Fed's attention as they discuss interest rate policy at the next FOMC meeting over March 14 and 15.

The value of construction put in place fell by 1.0 percent in January as total public construction dropped by 5.0 percent. Almost all categories of public construction declined. Private nonresidential was unchanged. Private residential increased by 0.5 percent, despite the small dip in housing starts for the month. It is still early, but weaker than expected consumer spending and construction data are negatives for Q1 GDP. We may need to revise down our estimate of 2.2 percent real GDP growth for the first quarter. However, the strong manufacturing data implies a positive offset from business investment and inventories.

Tuesday afternoon, Bill Dudley, President of the Federal Reserve Bank of New York, gave an interview, aired by CNN, that appeared to be designed to pull fed funds rate hike expectations even more forward. Boiled down, Dudley said that conditions do not have to improve for the Fed to launch a near-term rate hike. He said we are *already* on the trajectory that would necessitate a rate hike. Further, he agreed with the interviewer's categorization of the timing of the next rate hike as "obviously fairly soon." Dudley is a "core" member of the FOMC and so his comments were likely coordinated with Janet Yellen. Yellen speaks on Friday, which is the last day of public commentary for the Fed before their pre-meeting media black-out period. Yellen will get the last word, which we expect to be somewhat hawkish. Yellen will stop short of committing the Fed to a March 15 rate hike on Friday because she will wait to see what the February employment report looks like when it comes out on March 10. Right now, it looks like a solid employment report with at least moderate wage growth greenlights the Fed for a March 15 rate hike.

Market Reaction: U.S. equity markets opened with gains. The yield on the 10-year Treasury bond is up to 2.46 percent. NYMEX crude is down to $53.93/barrel. Natural gas futures are up to $2.79/mmbtu.