

Labor Market Dynamics, Inflation and the Fed

The U.S. unemployment rate has fallen faster than we expected. In April it dipped to 4.4 percent, pulled down by strong job growth, especially through February and March, as measured by the household survey of employment. The other input to the unemployment rate calculation is the civilian labor force. It barely increased in April, gaining only 12,000 workers, which also pulled down the unemployment rate. The unemployment rate could easily tick back up in May or June if we get a surge of labor force growth and/or job growth suddenly eases.

Looking past normal monthly fluctuations in the unemployment rate, we agree with the mainstream of macroeconomic thought that assumes the unemployment rate may go a little lower, but is getting close to bottoming out in this cycle. Typically, as the unemployment rate drops, new labor becomes more difficult to find and companies increasingly bid against each other to attract new workers. Wages begin to accelerate. Strong wage acceleration is thought to contribute to undesirable inflation, and so the Federal Reserve pre-emptively raises interest rates, adding some friction to the economy to keep it from running too strong and fueling hyperinflation.

Labor force growth itself is cyclical. During periods of strong economic growth, people who may not otherwise be employed are pulled into the labor market, either attracted by high wages or pulled in with lower barriers to entry, including lower hiring standards. It is normal to see the labor force growing faster than the rate of growth for the working age population when the economy is strong. Likewise, it is normal to see the labor force growing more slowly than the working age population, or even going negative, when the economy is weak. In recessions, inefficient companies go out of business and low productivity labor is laid off.

What we see now is that labor force growth in the first quarter of 2017 was only 0.7 percent over the previous four quarters, fairly close to the growth rate of working age population. This suggests that this economy is not yet pulling large numbers of nonworking adults, who are capable of working, into the labor force. This begs an interesting set of questions. Is there a pool of nonworking adults who are going to step in and fill the demand for new labor as the economy grows through 2017 and beyond? This would tend to keep the unemployment rate higher and allow the economy to grow with less friction in the form of higher interest rates from the Federal Reserve. We expect to see more evidence of the absorption of new workers into the labor force later this year and in 2018.

Conversely, we can also ask, is the unemployment rate going to continue to fall, making it difficult and expensive for companies to find new labor? If the unemployment rate continues to fall perhaps it could approach its post-World War II low of 2.5 percent from May 1953. The more recent low, and better comparison, is 3.8 percent from April 2000. The unemployment rate from the previous cycle bottomed out at 4.4 percent in the spring of 2007.

It looks like we will see a stronger inflationary push from wages in the near term. The Fed will use that as an opportunity to normalize monetary policy by increasing interest rates and draining liquidity with balance sheet reduction. We look for the Fed to increase the fed funds range rate by 25 basis points, to 1.00-to-1.25 percent, on June 14.

U.S. Economic Outlook, Summary

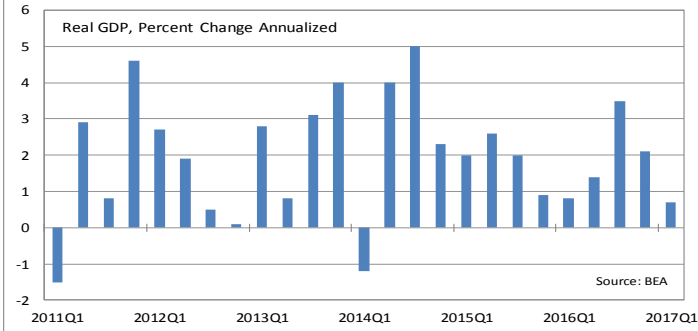
| | 4Q'16a | 1Q'17a | 2Q'17f | 3Q'17f | 4Q'17f | 1Q'18f | 2Q'18f | 3Q'18f | 2016a | 2017f | 2018f |
|--|--------|--------|--------|--------|--------|--------|--------|--------|-------|-------|-------|
| Real GDP (Percent Change Annualized) | 2.1 | 0.7 | 3.0 | 2.9 | 3.1 | 2.7 | 2.7 | 2.6 | 1.6 | 2.2 | 2.8 |
| CPI (Percent Change Year-over-Year) | 1.8 | 2.6 | 2.4 | 2.4 | 2.2 | 1.9 | 2.0 | 2.0 | 1.3 | 2.4 | 2.0 |
| Payroll Jobs (Average Monthly Diff., Ths.) | 169.9 | 185.0 | 184.3 | 181.5 | 178.9 | 173.6 | 171.0 | 169.2 | 194.3 | 182.4 | 169.6 |
| Unemployment Rate (Percent) | 4.7 | 4.7 | 4.5 | 4.5 | 4.4 | 4.4 | 4.3 | 4.2 | 4.9 | 4.5 | 4.3 |
| Federal Funds Rate (Effective) | 0.45 | 0.70 | 0.93 | 1.17 | 1.38 | 1.42 | 1.63 | 1.82 | 0.40 | 1.05 | 1.70 |
| 10-Yr. Treasury Rate | 2.13 | 2.44 | 2.39 | 2.72 | 2.91 | 2.92 | 3.10 | 3.28 | 1.84 | 2.62 | 3.17 |

a = actual f = forecast

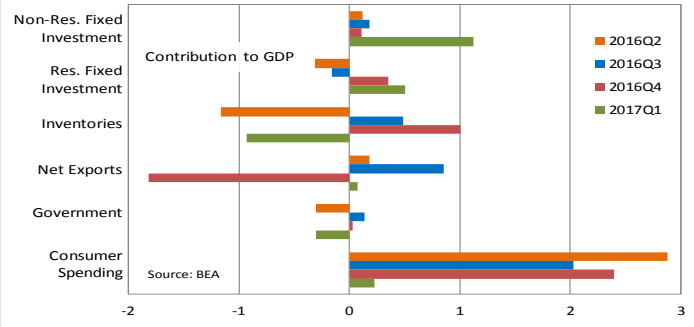
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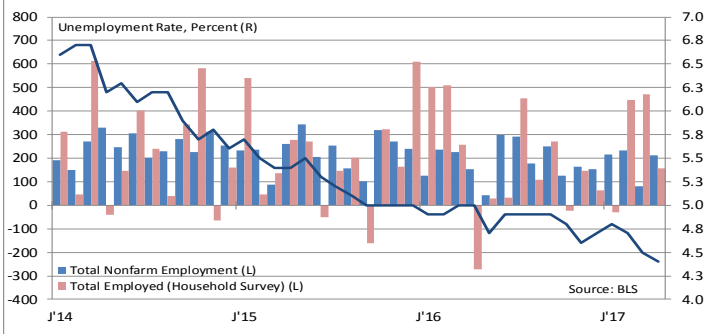
Q1 GDP Growth Slumps at 0.7%



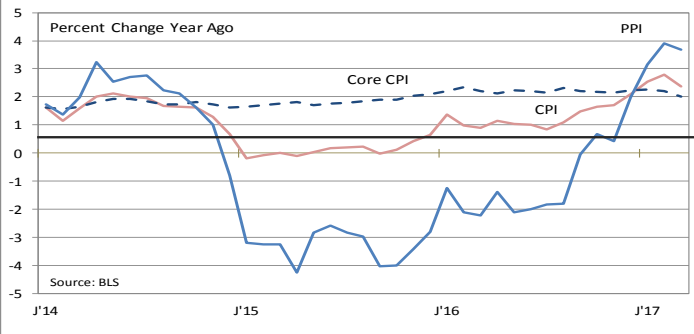
Weak Consumer Spending and Dip in Inventories Drag on Q1 GDP



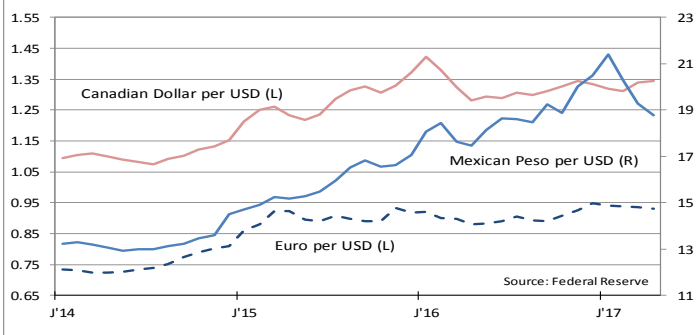
Unemployment Rate Sinks to 4.4% in April



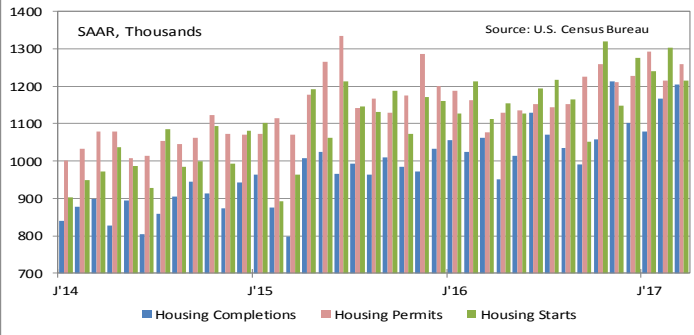
Inflation Likely Peaking



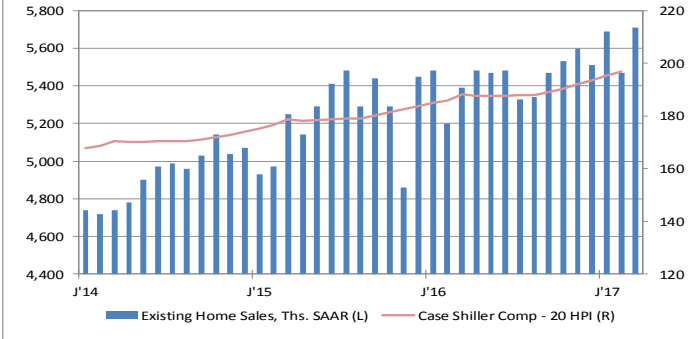
Dollar Easing in Early 2017



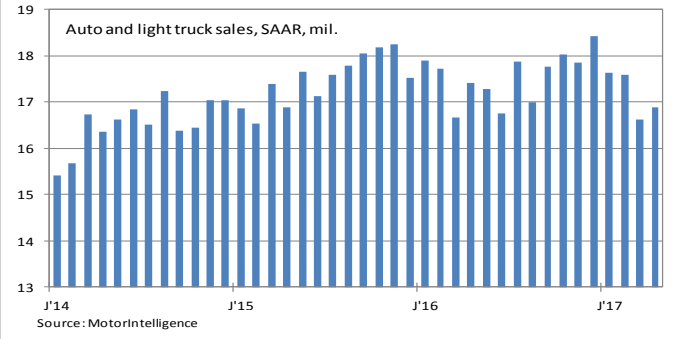
Single-Family Drives Resi. Construction Up



Existing Home Sales Rebound in March



April Auto Sales Improve to 16.9 mln



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| | 4Q'16a | 1Q'17a | 2Q'17f | 3Q'17f | 4Q'17f | 1Q'18f | 2Q'18f | 3Q'18f | 2016a | 2017f | 2018f |
|--|------------|-------------|------------|------------|------------|------------|------------|------------|-------------|------------|------------|
| Output | | | | | | | | | | | |
| Nominal GDP (Billions \$) | 18869 | 19007 | 19241 | 19472 | 19716 | 19941 | 20173 | 20401 | 18569 | 19359 | 20286 |
| Percent Change Annualized | 4.2 | 3.0 | 5.0 | 4.9 | 5.1 | 4.7 | 4.7 | 4.6 | 3.0 | 4.3 | 4.8 |
| Real GDP (Chained 2009 Billions \$) | 16813 | 16842 | 16967 | 17087 | 17218 | 17334 | 17449 | 17562 | 16662 | 17029 | 17505 |
| Percent Change Annualized | 2.1 | 0.7 | 3.0 | 2.9 | 3.1 | 2.7 | 2.7 | 2.6 | 1.6 | 2.2 | 2.8 |
| Pers. Consumption Expenditures | 11670 | 11680 | 11739 | 11795 | 11846 | 11895 | 11948 | 12003 | 11522 | 11765 | 11977 |
| Percent Change Annualized | 3.5 | 0.3 | 2.1 | 1.9 | 1.7 | 1.7 | 1.8 | 1.9 | 2.7 | 2.1 | 1.8 |
| Nonresidential Fixed Investment | 2197 | 2247 | 2283 | 2322 | 2362 | 2400 | 2437 | 2473 | 2189 | 2303 | 2455 |
| Percent Change Annualized | 0.9 | 9.4 | 6.5 | 7.1 | 7.0 | 6.7 | 6.2 | 6.0 | -0.5 | 5.2 | 6.6 |
| Residential Investment | 596 | 615 | 628 | 633 | 640 | 650 | 659 | 668 | 592 | 629 | 664 |
| Percent Change Annualized | 9.6 | 13.7 | 8.7 | 2.8 | 5.0 | 6.3 | 5.7 | 5.5 | 4.9 | 6.3 | 5.5 |
| Change in Private Inventories | 50 | 10 | 29 | 49 | 59 | 64 | 65 | 65 | 22 | 37 | 65 |
| Net Exports | -605 | -603 | -619 | -632 | -625 | -629 | -629 | -632 | -563 | -619 | -631 |
| Government Expenditures | 2908 | 2895 | 2908 | 2921 | 2937 | 2953 | 2969 | 2985 | 2907 | 2915 | 2977 |
| Percent Change Annualized | 0.2 | -1.7 | 1.8 | 1.9 | 2.1 | 2.3 | 2.2 | 2.1 | 0.8 | 0.3 | 2.1 |
| Industrial Prod. Index (2007=100) | 103.3 | 103.7 | 103.9 | 104.2 | 104.3 | 104.5 | 104.6 | 104.7 | 103.1 | 104.0 | 104.6 |
| Percent Change Annualized | 0.7 | 1.5 | 0.9 | 0.9 | 0.7 | 0.5 | 0.4 | 0.4 | -1.2 | 0.9 | 0.6 |
| Capacity Utilization (Percent) | 75.8 | 75.8 | 76.7 | 76.8 | 76.8 | 76.8 | 76.8 | 76.8 | 75.7 | 76.5 | 76.8 |
| Prices | | | | | | | | | | | |
| CPI (1982-84=100) | 242.2 | 244.1 | 245.0 | 246.2 | 247.5 | 248.7 | 249.9 | 251.2 | 240.0 | 245.7 | 250.6 |
| Percent Change Annualized | 3.0 | 3.1 | 1.5 | 2.0 | 2.1 | 2.0 | 2.0 | 2.0 | 1.3 | 2.4 | 2.0 |
| PCE Price Index (2009=100) | 111.5 | 112.1 | 112.5 | 113.0 | 113.6 | 114.1 | 114.7 | 115.3 | 110.7 | 112.8 | 115.0 |
| Percent Change Annualized | 2.0 | 2.4 | 1.2 | 2.0 | 2.0 | 2.0 | 2.0 | 2.0 | 1.1 | 1.9 | 1.9 |
| GDP Price Index (2009=100) | 112.2 | 112.9 | 113.4 | 114.0 | 114.6 | 115.1 | 115.7 | 116.3 | 111.5 | 113.7 | 116.0 |
| Percent Change Annualized | 2.1 | 2.3 | 2.0 | 2.0 | 2.0 | 2.0 | 2.0 | 2.0 | 1.3 | 2.0 | 2.0 |
| Producer Price Index, Finished Goods | 193.9 | 196.8 | 197.5 | 198.3 | 199.3 | 200.3 | 201.2 | 202.2 | 191.9 | 198.0 | 201.7 |
| Percent Change Annualized | 3.4 | 6.2 | 1.4 | 1.7 | 2.0 | 2.0 | 2.0 | 2.0 | -1.0 | 3.2 | 1.9 |
| Crude Oil, WTI (\$/barrel) | 49.2 | 50.0 | 51.0 | 53.0 | 55.0 | 58.0 | 58.0 | 58.0 | 43.1 | 52.3 | 58.0 |
| Labor Markets | | | | | | | | | | | |
| Payroll Jobs (Average Monthly Diff., Ths.) | 169.9 | 185.0 | 184.3 | 181.5 | 178.9 | 173.6 | 171.0 | 169.2 | 194.3 | 182.4 | 169.6 |
| Unemployment Rate (Percent) | 4.7 | 4.7 | 4.5 | 4.5 | 4.4 | 4.4 | 4.3 | 4.2 | 4.9 | 4.5 | 4.3 |
| Average Weekly Hours, Prod. Works. | 33.6 | 33.6 | 33.6 | 33.6 | 33.6 | 33.6 | 33.6 | 33.6 | 33.6 | 33.6 | 33.6 |
| Population (Millions) | 324.4 | 325.1 | 325.8 | 326.4 | 327.1 | 327.7 | 328.4 | 329.0 | 323.5 | 326.1 | 328.7 |
| Percent Change Annualized | 0.8 | 0.8 | 0.8 | 0.8 | 0.8 | 0.8 | 0.8 | 0.8 | 0.7 | 0.8 | 0.8 |
| Personal Income | | | | | | | | | | | |
| Average Hourly Earnings (\$) | 21.75 | 21.86 | 21.99 | 22.12 | 22.26 | 22.41 | 22.56 | 22.72 | 21.56 | 22.06 | 22.64 |
| Percent Change Annualized | 2.3 | 2.0 | 2.3 | 2.4 | 2.5 | 2.7 | 2.8 | 2.9 | 2.5 | 2.3 | 2.7 |
| Real Disp. Income (2009 Billions \$) | 12801 | 12834 | 12930 | 13000 | 13073 | 13149 | 13224 | 13304 | 12685 | 12959 | 13265 |
| Percent Change Annualized | 2.0 | 1.0 | 3.0 | 2.2 | 2.3 | 2.3 | 2.3 | 2.4 | 2.8 | 2.2 | 2.4 |
| Personal Saving Rate (Percent) | 5.4 | 5.7 | 5.6 | 5.6 | 5.6 | 5.6 | 5.6 | 5.6 | 5.8 | 5.6 | 5.6 |
| Housing | | | | | | | | | | | |
| Housing Starts (Ths., Ann. Rate) | 1248 | 1253 | 1253 | 1266 | 1279 | 1293 | 1307 | 1319 | 1176 | 1263 | 1313 |
| Ext. SF Home Sales (Ths., Ann Rate) | 4920 | 4997 | 5006 | 5043 | 5081 | 5115 | 5154 | 5194 | 4828 | 5032 | 5174 |
| New SF Home Sales (Ths., Ann Rate) | 564 | 598 | 603 | 611 | 617 | 623 | 628 | 632 | 560 | 607 | 630 |
| Case/Shiller HPI (Jan. 2000=100) | 185.4 | 188.6 | 191.9 | 195.3 | 198.7 | 201.9 | 205.1 | 208.4 | 181.2 | 193.6 | 206.7 |
| Year/Year Percent Change | 5.4 | 5.8 | 6.9 | 7.5 | 7.2 | 7.0 | 6.9 | 6.7 | 5.2 | 6.9 | 6.8 |
| Consumer | | | | | | | | | | | |
| Household Economic Stress Index | 1.2 | 1.4 | 0.0 | -0.6 | -0.6 | -0.8 | -0.5 | -0.4 | 1.0 | 0.0 | -0.5 |
| Auto Sales (Millions) | 18.1 | 17.3 | 17.1 | 17.2 | 17.0 | 16.8 | 16.6 | 16.5 | 17.6 | 17.2 | 16.5 |
| Interest Rates (percent per year) | | | | | | | | | | | |
| Federal Funds Rate (Effective) | 0.45 | 0.70 | 0.93 | 1.17 | 1.38 | 1.42 | 1.63 | 1.82 | 0.40 | 1.05 | 1.70 |
| Prime Rate | 3.55 | 3.79 | 4.03 | 4.27 | 4.48 | 4.52 | 4.73 | 4.92 | 3.51 | 4.14 | 4.80 |
| 1-Month LIBOR | 0.60 | 0.83 | 1.05 | 1.33 | 1.55 | 1.59 | 1.80 | 1.99 | 0.50 | 1.19 | 1.87 |
| 3-Month LIBOR | 0.92 | 1.07 | 1.22 | 1.50 | 1.72 | 1.76 | 1.96 | 2.15 | 0.74 | 1.38 | 2.03 |
| 1-Yr. Treasury Rate | 0.76 | 0.89 | 1.14 | 1.45 | 1.62 | 1.61 | 1.78 | 1.95 | 0.61 | 1.27 | 1.85 |
| 5-Yr. Treasury Rate | 1.61 | 1.94 | 1.91 | 2.23 | 2.42 | 2.43 | 2.62 | 2.80 | 1.34 | 2.13 | 2.69 |
| 10-Yr. Treasury Rate | 2.13 | 2.44 | 2.39 | 2.72 | 2.91 | 2.92 | 3.10 | 3.28 | 1.84 | 2.62 | 3.17 |
| 30-Year Fixed Rate Mortgage | 3.81 | 4.17 | 4.07 | 4.35 | 4.59 | 4.62 | 4.81 | 4.99 | 3.65 | 4.30 | 4.88 |

a = actual f = forecast

May 8, 2017

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