

Jobs and Inflation and the Intersection of Monetary and Fiscal Policy

The U.S. job machine remains engaged. After a strong 231,000 net new payroll jobs were created in June, another 209,000 were created in July. In five of the first seven months of this year, more than 200,000 net new payroll jobs were created. While it looks like the rate of payroll job growth has stepped down from the robust pace of 2014 and 2015, it remains strong. The U.S. unemployment rate was back down to 4.3 percent in July and is set to go lower. However, despite several different data points that suggest that the U.S. labor market is very tight, wages have not increased as much as expected. That is not to say that they have not increased. Through 2015, average hourly earnings for private sector workers were up about 2 percent year-over-year. That has stepped up to about 2.5 percent year-over-year growth in the four months ending in July. However, it is fair to say that wages are not yet driving inflation up.

Economic theory says that late in the business cycle, when labor markets get tight, inflation starts to accelerate. The reality so far has not lived up to the theory. The headline Consumer Price Index in July was up by just 1.7 percent over the previous 12 months, under the Federal Reserve's "comfort zone" of near 2 percent. After removing volatile food and energy prices, core CPI for July was up the same 1.7 percent over the past year.

The divergence between economic theory and recent performance has created some tension for monetary policy makers. Normally, the Federal Reserve increases the benchmark fed funds rate aggressively in the latter stages of an economic expansion as inflation heats up. The fed funds effective rate was increased from 5.9 percent in September 1986 to 9.9 percent in March 1989, ahead of a surge in the CPI to an eventual high of 6.4 percent year-over-year growth in October 1990. Likewise, the fed funds effective rate was raised from a low of 1.0 percent in June 2004, to a high of 5.3 percent in July of 2007, coincident with the CPI climbing to a peak 4.2 percent year-over-year increase in June 2006. Now, inflation is still muted after 96 months of economic expansion, and the Fed has only slowly raised the fed funds effective rate from near zero through November 2015 to 1.2 percent in July 2017.

We expect the Federal Reserve to leave the benchmark fed funds rate unchanged at the conclusion of the next Federal Open Market Committee meeting on September 20. We look for FOMC Chair Janet Yellen to announce on September 20 that the next chapter of monetary policy will begin this October with the phasing in of balance sheet reduction. The Fed's goal with balance sheet reduction is to gradually ramp up the amount of maturing assets that will not be reinvested and allowed to roll off the Fed's balance sheet. We expect this to have a small tightening effect on liquidity in U.S. financial markets. The goal of the Fed is to have the program "running in the background," so that it is not a lever in the management of monetary policy. It could take several years for the Fed's balance sheet to shrink to the target size.

The Fed may then resume fed funds rate increases at the FOMC meeting of December 12-13. The current implied probability of a December 13 fed funds rate hike, as determined by the fed funds futures market, is about 50 percent. One key issue for the U.S. economy over the next several months is the Trump Administration's success or failure with their fiscal policy agenda. The federal debt ceiling debate looms large after Labor Day. Tax reform will likely have a contentious path through Congress later this fall. Perhaps infrastructure spending comes next year.

U.S. Economic Outlook, Summary

	1Q'17a	2Q'17a	3Q'17f	4Q'17f	1Q'18f	2Q'18f	3Q'18f	4Q'18f	2016a	2017f	2018f
Real GDP (<i>Percent Change Annualized</i>)	1.2	2.6	2.2	2.6	2.5	2.6	2.4	2.1	1.5	2.0	2.5
CPI (<i>Percent Change Year-over-Year</i>)	2.6	1.9	2.0	1.8	1.6	2.2	2.2	2.1	1.3	2.1	2.0
Payroll Jobs (<i>Average Monthly Diff., Ths.</i>)	181.8	163.8	192.9	172.2	171.8	163.1	156.9	155.4	194.3	177.7	161.8
Unemployment Rate (<i>Percent</i>)	4.7	4.4	4.3	4.2	4.2	4.1	4.1	4.0	4.9	4.4	4.1
Federal Funds Rate (<i>Effective</i>)	0.70	0.95	1.14	1.17	1.38	1.42	1.63	1.67	0.40	0.99	1.53
10-Yr. Treasury Rate	2.44	2.26	2.29	2.36	2.60	2.66	2.90	2.96	1.84	2.34	2.78

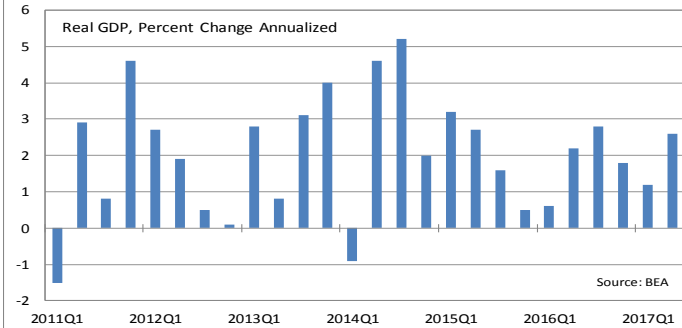
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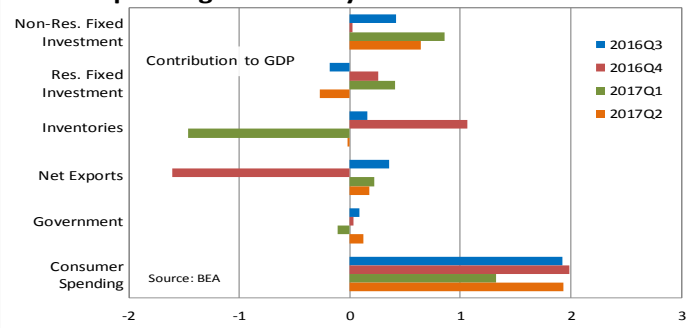
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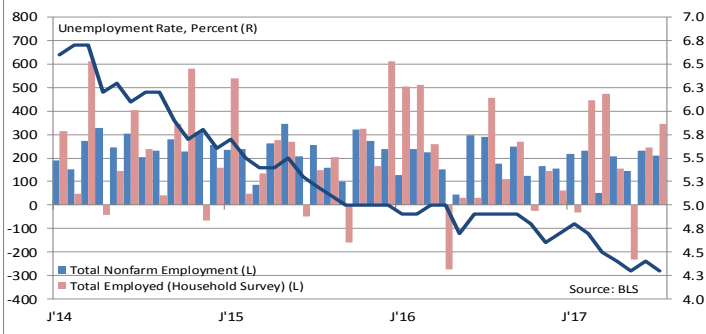
Q2 GDP Growth at a Moderate 2.6%



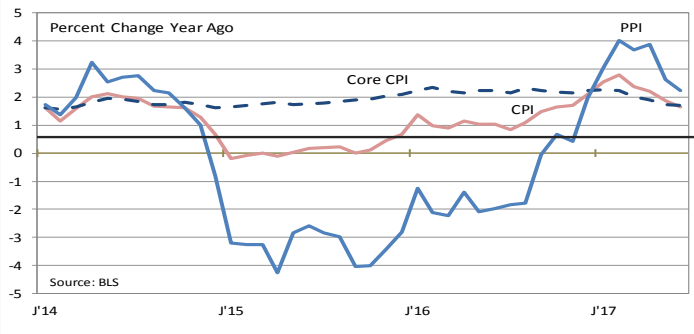
Q2 GDP Bolstered by Stronger Consumer Spending and Steady Business Investment



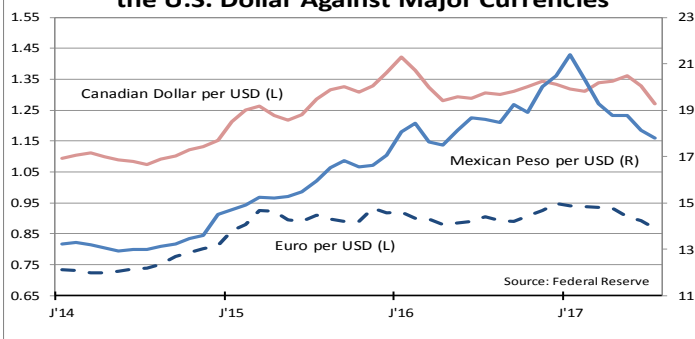
U.S. Added 209,000 Jobs in July



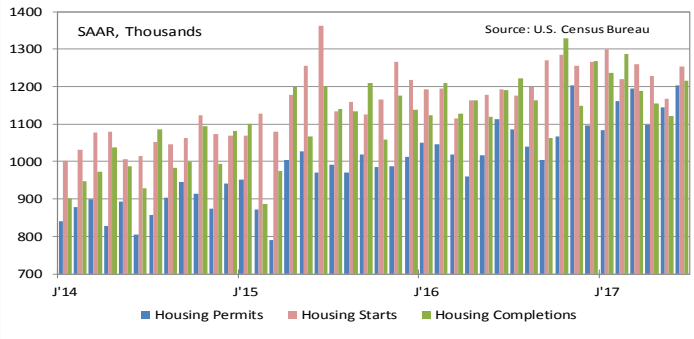
Inflation Indicators Cooled in 2017



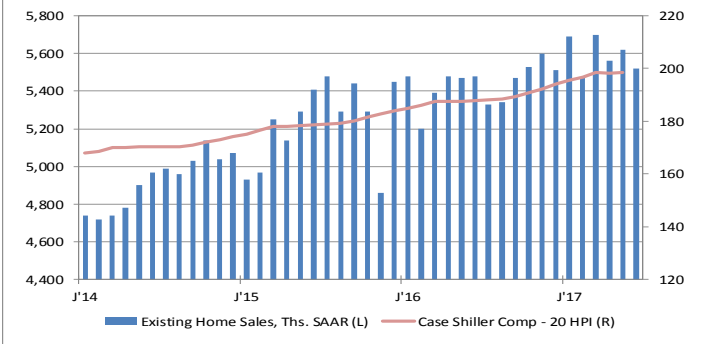
Improving Global Outlook Helps to Weaken the U.S. Dollar Against Major Currencies



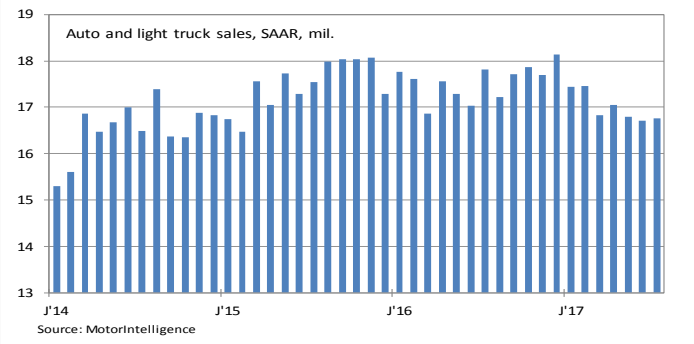
Residential Construction Ticked Up in June



Existing Home Sales Slowed in June



July Auto Sales Up to 16.8 Million Rate



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	1Q'17a	2Q'17a	3Q'17f	4Q'17f	1Q'18f	2Q'18f	3Q'18f	4Q'18f	2016a	2017f	2018f
Output											
Nominal GDP (Billions \$)	19058	19227	19410	19607	19815	20037	20254	20458	18624	19325	20141
Percent Change Annualized	3.3	3.6	3.9	4.1	4.3	4.6	4.4	4.1	2.8	3.8	4.2
Real GDP (Chained 2009 Billions \$)	16903	17011	17104	17216	17324	17436	17539	17632	16716	17059	17483
Percent Change Annualized	1.2	2.6	2.2	2.6	2.5	2.6	2.4	2.1	1.5	2.0	2.5
Pers. Consumption Expenditures	11758	11840	11895	11960	12020	12083	12143	12200	11572	11863	12111
Percent Change Annualized	1.9	2.8	1.9	2.2	2.0	2.1	2.0	1.9	2.7	2.5	2.1
Nonresidential Fixed Investment	2264	2292	2305	2329	2354	2380	2405	2428	2210	2297	2392
Percent Change Annualized	7.1	5.2	2.3	4.1	4.5	4.4	4.4	3.8	-0.6	3.9	4.1
Residential Investment	606	595	604	611	617	623	629	635	587	604	626
Percent Change Annualized	11.1	-6.8	6.1	4.8	3.9	4.0	4.0	4.0	5.5	2.8	3.6
Change in Private Inventories	1	0	14	23	32	42	51	55	33	9	45
Net Exports	-622	-615	-621	-621	-622	-621	-627	-633	-586	-620	-625
Government Expenditures	2897	2902	2910	2917	2925	2932	2940	2948	2900	2906	2936
Percent Change Annualized	-0.6	0.7	1.2	1.0	1.0	1.0	1.1	1.1	0.8	0.2	1.0
Industrial Prod. Index (2007=100)	103.7	104.9	105.0	105.1	105.4	105.6	105.8	105.9	103.1	104.7	105.7
Percent Change Annualized	1.4	4.7	0.5	0.4	1.0	0.8	0.7	0.6	-1.2	1.5	0.9
Capacity Utilization (Percent)	75.8	76.4	76.5	76.5	76.5	76.5	76.6	76.7	75.7	76.3	76.6
Prices											
CPI (1982-84=100)	244.1	243.9	245.2	246.7	248.0	249.2	250.5	251.8	240.0	245.0	249.9
Percent Change Annualized	3.1	-0.3	2.1	2.4	2.1	2.1	2.1	2.0	1.3	2.1	2.0
PCE Price Index (2009=100)	112.2	112.3	112.9	113.5	114.2	114.8	115.3	115.9	110.8	112.7	115.0
Percent Change Annualized	2.2	0.3	2.1	2.4	2.2	2.1	2.0	2.0	1.2	1.7	2.1
GDP Price Index (2009=100)	112.8	113.0	113.5	113.9	114.4	115.0	115.5	116.1	111.4	113.3	115.3
Percent Change Annualized	2.0	1.0	1.6	1.5	1.8	2.0	2.0	2.0	1.3	1.7	1.7
Producer Price Index, Finished Goods	196.8	197.0	198.1	199.2	200.1	201.1	202.1	203.1	191.9	197.8	201.6
Percent Change Annualized	6.3	0.4	2.2	2.3	1.9	2.0	2.0	2.0	-1.0	3.1	1.9
Crude Oil, WTI (\$/barrel)	50.0	51.0	48.0	50.0	50.0	50.0	52.5	52.5	43.1	49.8	51.3
Labor Markets											
Payroll Jobs (Average Monthly Diff., Ths.)	181.8	163.8	192.9	172.2	171.8	163.1	156.9	155.4	194.3	177.7	161.8
Unemployment Rate (Percent)	4.7	4.4	4.3	4.2	4.2	4.1	4.1	4.0	4.9	4.4	4.1
Average Weekly Hours, Prod. Works.	33.6	33.7	33.7	33.7	33.6	33.6	33.6	33.6	33.6	33.7	33.6
Population (Millions)	325.1	325.8	326.4	327.1	327.7	328.4	329.0	329.7	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 (\$)	21.86	22.00	22.14	22.28	22.43	22.59	22.75	22.92	21.56	22.07	22.67
Percent Change Annualized	2.0	2.5	2.5	2.6	2.8	2.8	3.0	3.0	2.5	2.4	2.7
Real Disp. Income (2009 Billions \$)	12678	12778	12853	12933	13038	13141	13245	13346	12608	12811	13193
Percent Change Annualized	2.8	3.2	2.4	2.5	3.3	3.2	3.2	3.1	1.4	1.6	3.0
Personal Saving Rate (Percent)	3.9	3.8	3.8	3.8	3.8	3.8	3.8	3.8	4.9	3.8	3.8
Housing											
Housing Starts (Ths., Ann. Rate)	1238	1164	1228	1237	1248	1259	1269	1278	1177	1217	1263
Ext. SF Home Sales (Ths., Ann Rate)	4993	4930	4970	4991	5028	5064	5101	5136	4828	4971	5082
New SF Home Sales (Ths., Ann Rate)	617	597	611	616	621	627	632	637	561	610	629
Case/Shiller HPI (Jan. 2000=100)	188.2	189.6	192.1	194.6	197.1	199.7	202.3	205.0	181.2	191.1	201.0
Year/Year Percent Change	5.6	5.6	5.8	5.0	4.7	5.3	5.3	5.4	5.1	5.5	5.2
Consumer											
Household Economic Stress Index	1.7	0.7	0.5	1.0	1.0	1.0	0.9	0.8	1.0	1.0	0.9
Auto Sales (Millions)	17.2	16.8	16.7	16.6	16.5	16.5	16.3	16.2	17.5	16.9	16.4
Interest Rates (percent per year)											
Federal Funds Rate (Effective)	0.70	0.95	1.14	1.17	1.38	1.42	1.63	1.67	0.40	0.99	1.53
Prime Rate	3.79	4.04	4.24	4.27	4.48	4.52	4.73	4.77	3.51	4.09	4.63
1-Month LIBOR	0.83	1.06	1.24	1.32	1.55	1.59	1.80	1.84	0.50	1.11	1.69
3-Month LIBOR	1.07	1.20	1.31	1.30	1.49	1.51	1.72	1.75	0.74	1.22	1.62
1-Yr. Treasury Rate	0.89	1.12	1.22	1.27	1.47	1.51	1.73	1.78	0.61	1.12	1.63
5-Yr. Treasury Rate	1.94	1.81	1.84	1.91	2.15	2.21	2.45	2.51	1.34	1.87	2.33
10-Yr. Treasury Rate	2.44	2.26	2.29	2.36	2.60	2.66	2.90	2.96	1.84	2.34	2.78
30-Year Fixed Rate Mortgage	4.17	3.99	3.95	4.03	4.28	4.36	4.62	4.68	3.65	4.03	4.49

a = actual f = forecast

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