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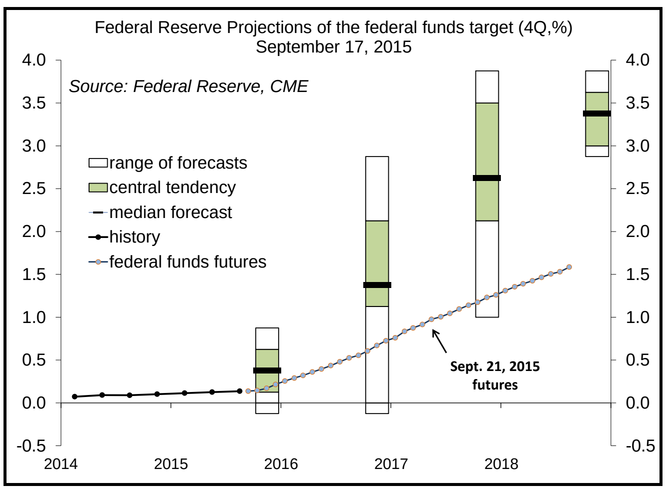
Monthly Economic Outlook

Fed Delays / Government Shutdown Looms

- *Global financial and economic developments are expected to have a mixed, but uncertain, impact on the U.S. economy. The Federal Reserve is still set to raise short-term interest rate. Officials appear to be mixed, but are generally cautious.*
- *Slower global growth and an inventory correction may restrain GDP growth, but domestic demand should benefit from lower commodity prices and is expected to remain strong.*
- *Showdowns over the FY16 budget and the debt ceiling may lead to a government shutdown. While a shutdown would likely have a limited impact on the economy, it could add to financial market anxieties in the weeks ahead.*

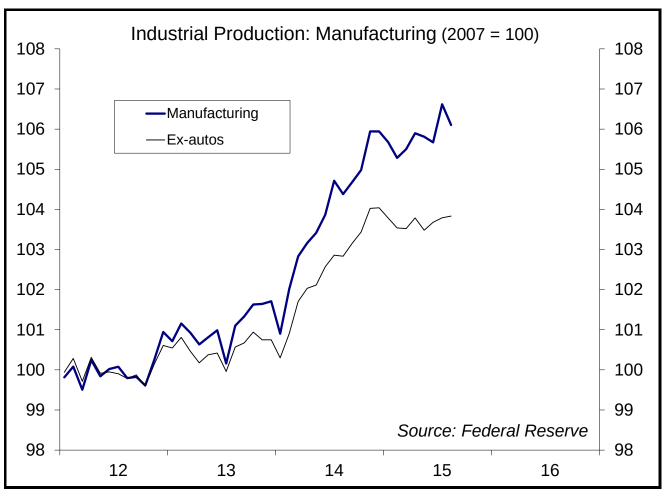
Comments from senior Fed officials in late August pointed to a mid-September start to monetary policy normalization. The economic recovery has made sufficient progress. The Fed has to set monetary policy with an eye to where the economy will likely be in 12 to 18 months. Labor market slack has been reduced significantly, and while some slack obviously remains (as evidenced by above-normal levels of long-term joblessness and involuntary part-time employment), there would be less slack a year from now. While there is no pressing need for the Fed to hit the brakes, it does have to consider taking the foot off the gas pedal. Monetary policy would still be very accommodative even after the first couple of Fed rate hikes. However, signs of slower growth in China and other emerging economies, along with increased financial market volatility and falling commodity prices, led officials to delay.



The dots in the revised dot plot, which shows senior Fed officials' projections of the appropriate year-end level of the federal funds rate, once again drifted a little lower relative to the plot from three months earlier. There remained a wide range in the individual policy forecasts for 2016 and 2017. However, 13 of the 17 officials still expected to raise short-term interest rates by the end of the year. At the same time, the federal funds futures market continues to suggest a much shallower glide path for short-term rates than what most Fed officials are anticipating. While there wasn't much change in the Fed's policy statement, the tone was a bit more cautious. Officials noted that market-based measures of inflation compensation (the difference in yield between inflation-adjusted Treasuries and fixed-rate Treasuries with the same maturity) have moved lower.

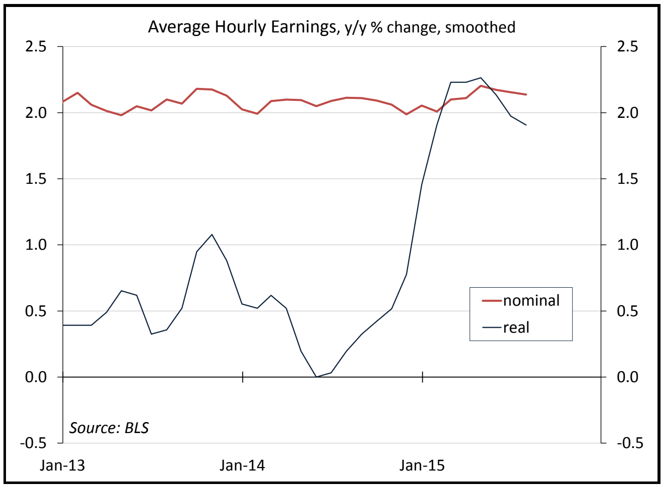
China is currently in the early stages of two important transitions. One is the move from an economy driven largely by exports and infrastructure spending to one driven more by consumption. This kind of transformation takes time and we are likely to find that growth is a lot slower at the end. The other change is a general liberalization of China's capital markets. History has shown that such transitions are fraught with peril. Currently, we're seeing evidence of capital outflows – a situation that bears watching closely in the months ahead.

China is now the third-largest export market for the U.S., but the country accounted for less than 8% of total exports in 2014 (less than 1% of U.S. GDP). However, while the direct impact on the U.S. economy of slower Chinese growth may be limited, there is fear of a broader slowdown in the global economy. China's imports of raw materials have fallen sharply in recent months. Commodity exporters (such as Australia, Brazil, and Canada) will have a tougher time.



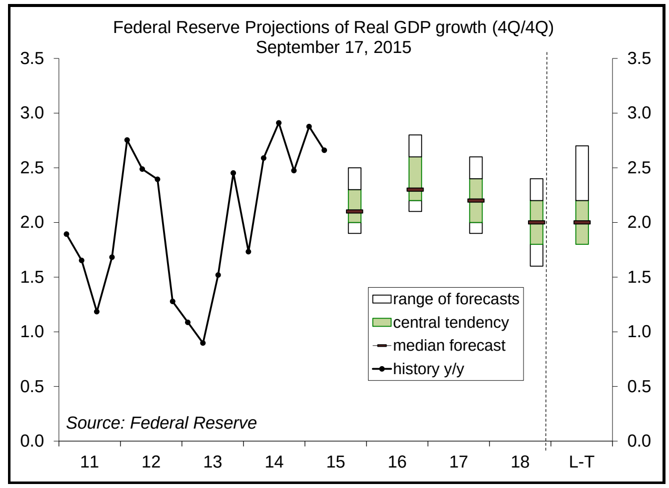
U.S trade data show up late (we currently only have data for July) and are subject to large revisions. So it's hard to gauge the overall impact of a strong dollar and slower global growth on current GDP growth. Auto production has been strong, but non-auto manufacturing activity has been mixed and generally lackluster in recent months. Still, a soft manufacturing sector does not imply weakness in the overall economy.

The price of imported oil is half of what it was a year ago. However, we've also seen price declines in imported raw materials and finished goods. Producer price data show negative pipeline pressures. There's little sign of inflation in "stuff." However, 59% of the CPI is in non-energy services. Shelter costs (roughly a third of the CPI) rose 3.1% in the 12 months ending in August. Inflation in non-shelter services is driven partly by wage growth. Despite a further decline in the unemployment rate, average hourly earnings are still rising at a relatively soft pace (a bit above 2% year-over-year).



While nominal wage growth has remained unimpressive, real wage growth (reflecting the drop in gasoline prices) has been substantial. In the first half of the year, consumers may have doubted the staying power of low energy prices – but the added purchasing power should continue to support consumer spending growth into the important holiday shopping period. A long-lasting decline in energy prices is also beneficial to the outlook for car sales and housing activity.

In the Fed's revised projections, GDP growth was expected to be moderate over the next few years – a bit beyond a sustainable pace as labor market slack is taken up. However, expectations of potential GDP growth edged lower. The aging of the population will reduce the pace of labor input, while productivity growth may remain relatively subdued. Slower economic growth abroad and slower trend-growth at home would pose a number of challenges for investors.



The new federal fiscal year begins October 1. At this point, Congress has yet to complete any of the 12 appropriations bills and the Tea Party Republicans are threatening a standoff. Without a Continuing Resolution to fund the government, we will see another shutdown. A short shutdown would have a limited impact on the economy. The 16-day shutdown in 2013 merely shifted growth around a little. However, a shutdown may add to financial market volatility. Note also that, even if Congress comes up with a short-term budget fix, it will still have to raise the debt ceiling by early December.

	3Q14	4Q14	1Q15	2Q15	3Q15	4Q15	1Q16	2Q16	3Q16	4Q16	2015	2016	2017
GDP (↓ *contributions*)	4.3	2.1	0.6	3.7	2.4	2.6	2.6	2.7	2.7	2.6	2.5	2.7	2.5
consumer durables	0.5	0.4	0.1	0.6	0.4	0.4	0.4	0.4	0.3	0.3	0.4	0.4	0.3
nondurables & services	1.8	2.4	1.0	1.5	1.5	1.6	1.5	1.5	1.5	1.5	1.6	1.5	1.4
bus. fixed investment	1.1	0.1	0.2	0.4	0.5	0.5	0.5	0.5	0.5	0.5	0.4	0.5	0.5
residential investment	0.1	0.3	0.3	0.3	0.4	0.3	0.2	0.2	0.2	0.2	0.3	0.2	0.2
government	0.3	-0.3	0.0	0.5	0.2	0.2	0.2	0.2	0.3	0.2	0.1	0.2	0.2
Domestic Final Sales	3.8	3.0	1.7	3.2	3.4	3.0	2.7	2.7	2.7	2.6	2.8	2.8	2.5
exports	0.2	0.7	-0.8	0.7	0.4	0.3	0.4	0.5	0.5	0.5	0.2	0.4	0.5
imports	0.2	-1.6	-1.1	-0.4	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6	-0.9	-0.6	-0.6
Final Sales	4.3	2.1	-0.2	3.5	3.0	2.7	2.6	2.6	2.7	2.6	2.3	2.7	2.5
ch. in bus. inventories	0.0	0.0	0.9	0.2	-0.5	-0.1	0.0	0.0	0.0	0.0	0.2	-0.1	-0.0
Unemployment, %	6.1	5.8	5.6	5.4	5.2	5.0	4.9	4.8	4.7	4.7	5.3	4.8	4.8
NF Payrolls, monthly, th.	237	324	195	226	200	190	185	185	180	175	205	180	158
Cons. Price Index (q/q)	1.2	-0.9	-3.1	3.0	1.5	0.5	1.8	1.8	1.9	1.9	0.1	1.6	1.9
excl. food & energy	1.4	1.5	1.7	2.5	1.6	1.7	1.8	1.8	1.8	1.9	1.8	1.8	1.9
PCE Price Index (q/q)	1.2	-0.4	-1.9	2.2	1.3	0.8	1.6	1.7	1.8	1.8	0.3	1.5	1.8
excl. food & energy	1.4	1.0	1.0	1.8	1.4	1.6	1.6	1.7	1.7	1.7	1.3	1.6	1.7
Fed Funds Rate, %	0.09	0.10	0.11	0.13	0.14	0.19	0.20	0.40	0.67	0.93	0.15	0.55	1.55
3-month T-Bill, (bond-eq.)	0.0	0.0	0.0	0.0	0.1	0.1	0.2	0.4	0.7	0.9	0.1	0.6	1.5
2-year Treasury Note	0.5	0.5	0.6	0.6	0.7	0.9	1.1	1.4	1.6	1.9	0.7	1.5	2.4
10-year Treasury Note	2.5	2.3	2.0	2.2	2.2	2.4	2.7	2.9	3.1	3.2	2.2	3.0	3.3