Zacks
INVESTMENT MANAGEMENT

ECONOMIC OUTLOOK

DECEMBER 2016

INDEPENDENT

RESEARCH | THINKING | RESULTS

THE OUTLOOK IN BRIEF

The Last Pre-Trump Baseline, Above-Trend Growth Rising Inflation

The broad outlines of the forecast are little changed from recent forecasts, as we produced the numbers prior to the election. This becomes the last "Pre-Trump Baseline" as post-election market moves and expected policy changes are now in the mix. While we believe we know the general direction of the macro effects of policies likely to implemented, the details with respect to size, scope and timing are unknown. Assuming no tariff increases or mass deportation of illegal aliens, we expect in future forecasts to lean toward higher near-term growth, inflation, interest rates and the dollar, relative to this baseline. Markets have already priced in much of this, perhaps too much. In this base forecast we expect modestly above-trend growth averaging just over 2% through 2018, a continued downward drift in the unemployment rate to 4.3% by mid-2018 and a gradual rise in core inflation to the Fed's target for overall PCE inflation of 2% by mid-2018.2. That configuration results in a cautious Fed that gradually raises the policy rate, and imparts, along with a normalizing term premium, an upward trend to term Treasury yields. Risk spreads are expected to narrow over the forecast horizon, helping to sustain equities in the face of rising risk-free rates.

Following solid Q3, GDP growth to slow in Q4 to 1.5%.

- BEA's advance estimate of Q3 GDP growth was 2.9%, up substantially from 1.1% growth over the 1st half of the year.
- Q3 GDP growth was boosted by the beginning of a rebound in inventory investment and by a surge in exports of soybeans. We expect inventory investment to continue to boost GDP growth in Q4, tempered by a reversal of the soybean export surge.
- Final sales to private domestic purchasers grows 2.1% in Q4 (in line with the recent trend), but a sharp decline in net exports subtracts nine-tenths from Q4 GDP growth.

GDP growth over 2017-2019 reduced by higher dollar.

- GDP grows 2.0% averaged over 2017-19, one-tenth slower than in last month's forecast.
- The dollar is about 2½% stronger in this month's forecast, and declines in net exports subtract an average of six-tenths per year, two-tenths more than last month.
- This is partially offset by somewhat stronger domestic final sales, with fundamentals of strong employment, wages, and wealth supporting solid growth of PCE averaging 2.5% over 2017-2019.
- Nonresidential fixed investment will accelerate as the drop in oil field investments ends and as TFP accelerates.
- Residential investment will regain momentum, aided by a rise in starts and an end to the decline in the value per unit.

Inflation to reach Fed's 2% target by mid-2018.

- Core PCE inflation was 1.4% last year and is on track for 1.8% this year (both measured Q4/Q4).
- Core inflation is expected to continue to drift higher, as the effects of the recent rise in the dollar and drop in oil prices wane and as inflation expectations, anchored near 2%, pull inflation higher.

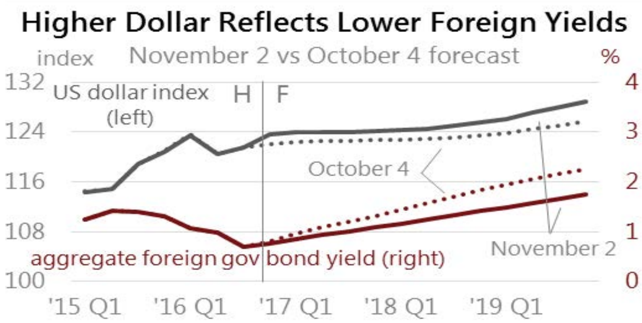
Same Fed policy; gradual rate hikes.

- GDP growth, for the most part, has been disappointing, core inflation remains below the Fed's 2% objective, and global uncertainties persist.
- This, as well as policy asymmetry, uncertainty about the level of the neutral rate and its forward path, argues for a shallow path of rate hikes. We expect only one in 2016 (in December), followed by three in 2017.
- We view the "terminal" neutral funds rate to be 2¾%, but the top of the target range won't hit 2¼% until 2018Q4.
- In this pre-Trump forecast, the 10-yr yield ends 2016 shy of 2%, 2017 near 2 1/3 %, and 2018 near 3%.

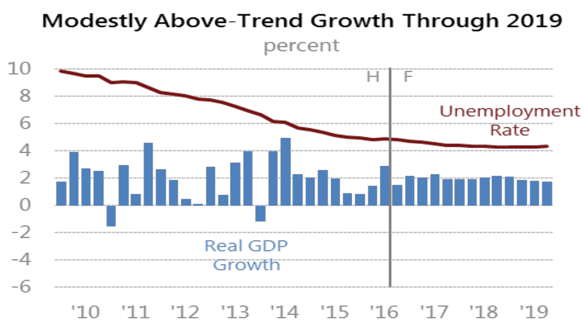
THE OUTLOOK IN FULL

Weaker Near-term Momentum, More Drag from Trade

Relative to our early October base forecast, we lowered our projection of Q4 GDP growth by four-tenths to 1.5%. This reflected downward revisions to our projections for PCE, equipment spending, and the change in inventory investment. This lowered the near-term momentum in our forecast. Furthermore, over the next three years, our forecast for GDP growth is 2.1%, 2.0%, and 1.9%, each one-tenth lower than in last month's forecast. This markdown is more than accounted for by increased drag from net exports stemming from a higher dollar.

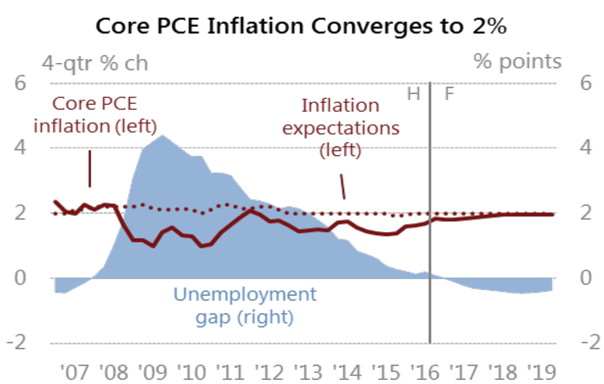


Sources: Macroeconomic Advisers, Oxford Economics, Fed Reserve.

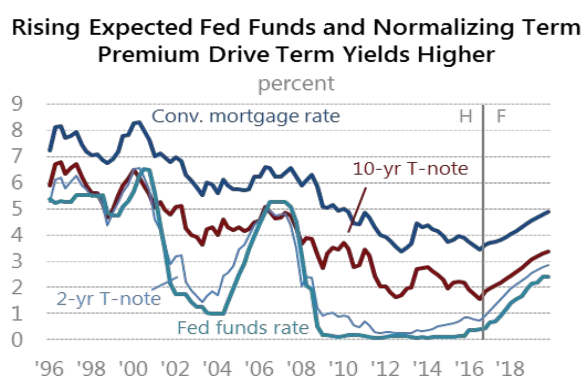


Sources: Macroeconomic Advisers, BEA, BLS

Two factors combined to boost the dollar relative to last month's forecast. First, the jump-off was higher. That is, the dollar begins the forecast at a higher level due to some unanticipated strengthening over the inter-forecast period. Second, our colleagues at Oxford Economics marked down their projections for several key foreign sovereign yields. And while our US interest-rate forecast is little changed from last month, the higher path for relative domestic yields raised demand for the US dollar.

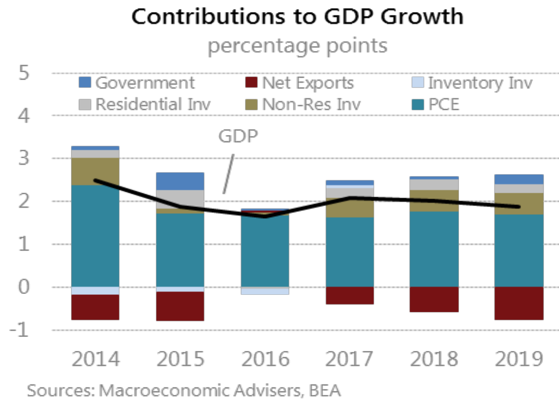


Sources: Macroeconomic Advisers, Philly Fed, BEA, BLS



Sources: Macroeconomic Advisers, Federal Reserve

With somewhat slower growth in this month's forecast, the unemployment rate troughs at 4.3%, one-tenth higher than in last month's forecast. Furthermore, the unemployment rate begins to turn up at the end of 2019, the leading edge of our baseline assumption of a "soft landing from below." With a somewhat higher path for the unemployment rate and lower import prices (stemming from a higher dollar), core PCE inflation peaks at 2.0%, one-tenth below the peak in in last month's forecast, when core PCE inflation briefly touched 2.1%.



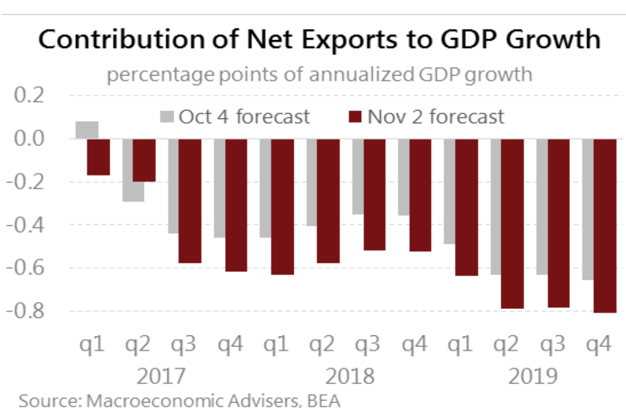
Rise in Inventory Investment This Year, Solid Underpinnings After

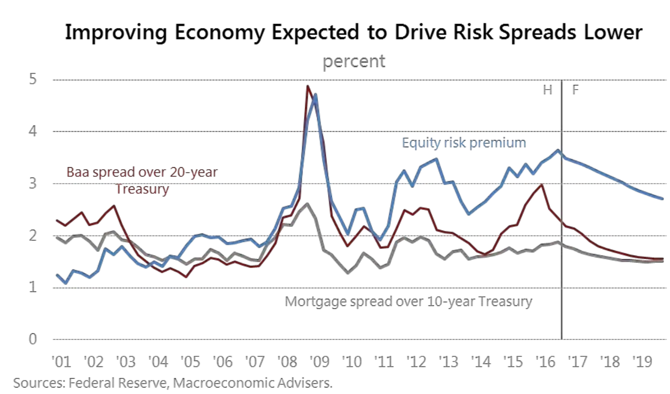
Early in our forecast, growth is fueled by rising inventory investment, but solid underpinnings form the basis for solid growth over the next three years. Inventory investment reached a peak of $114 in the first quarter of 2015, but then declined to -$10 billion by the second quarter of this year. Given the trend in final sales, declines in inventories were not sustainable, so inventory investment rose to $13 billion in the third quarter — an increase that added six-tenths to GDP growth — and is forecast to rise further to $36 billion in the fourth quarter, adding another six-tenths to GDP growth. Over the broader forecast horizon, several factors drive growth. First, recent declines in risk premia in equity and fixed income markets have boosted risk asset prices. Second, the recent upturn in oil prices is helping to boost mining activity, which had subtracted from GDP growth in recent quarters. Third, demographics and further easing in credit availability help promote a resumption of solid growth in residential investment. Finally, the fiscal positions of the federal and state & local government sectors are expansionary and are expected to contribute to GDP growth over the forecast.

Forecast Overview

	2014	2015	2016	2017	2018	2019
Real GDP*	2.5	1.9	1.7	2.1	2.0	1.9
			1.7	2.2	2.1	2.0
Pvt Final Dom Dem*	3.8	2.7	2.0	2.7	3.0	2.8
			2.2	2.7	2.9	2.8
Unemployment Rate**	5.7	5.0	4.8	4.4	4.3	4.4
			4.8	4.4	4.2	4.2
Core PCE Inflation*	1.6	1.4	1.8	1.9	2.0	2.0
			1.9	1.9	2.1	2.0

* Q4 to Q4 percent change, ** Q4 average
Note: Prior forecast values shown below each line.





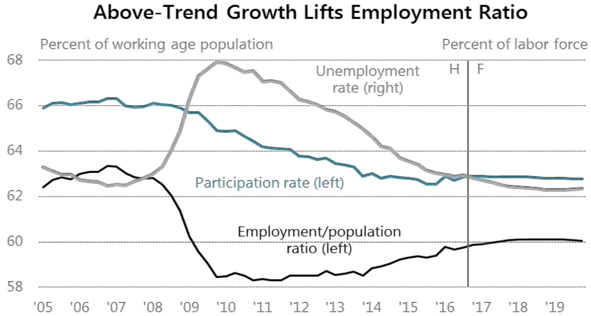
	16-Q3	16-Q4	17-Q1	17-Q2	17-Q3	2015	2016	2017	2018	2019
Gross Domestic Product	2.9	1.5	2.1	2.0	2.3	1.9	1.7	2.1	2.0	1.9
	0.3	*-0.4*		*-0.4*	*-0.1*			*-0.1*	*-0.1*	*-0.1*
Private final domestic demand	1.6	2.1	2.6	2.6	2.9	2.7	2.0	2.7	3.0	2.8
	-0.5	*-0.3*	*0.2*	*-0.2*			*-0.2*		*0.1*	
Personal cons. expenditures	2.1	1.8	2.3	2.2	2.4	2.6	2.5	2.4	2.6	2.5
	-0.8	*-0.3*	*0.1*	*-0.1*			*-0.2*	*0.1*	*0.1*	*0.1*
Nonres. fixed investment	1.2	3.8	3.5	3.4	4.0	0.8	0.6	3.7	4.1	4.0
	0.5	*-0.6*	*0.3*	*-0.1*				*0.1*		
Residential investment	-6.2	2.2	5.0	6.2	7.7	13.1	-1.2	6.2	6.1	5.2
	0.1	*1.4*	*0.2*	*-4.0*	*-1.4*		*0.4*	*-1.2*	*0.9*	*0.2*
Gov't cons. & gross invest.	0.5	0.0	0.7	0.5	0.5	2.2	0.1	0.4	0.3	1.2
	0.7	*-0.3*		*0.2*	*0.1*		*0.1*			
Chng. in private inventories*	0.5	0.6	0.0	0.0	0.3	-0.1	-0.1	0.1	0.0	0.0
	0.1	*-0.2*	*0.2*	*-0.2*	*0.1*					
Net exports*	0.8	-0.9	-0.2	-0.2	-0.6	-0.7	0.0	-0.4	-0.6	-0.8
	0.3		*-0.3*	*0.1*	*-0.2*		*0.1*	*-0.1*	*-0.2*	*-0.2*

Note: Positive differences from previous forecast shown in teal, negative differences shown in red.
* Contributions to GDP growth in percentage points.

Labor Markets Continue to Tighten; Growth of Hourly Comp Firms

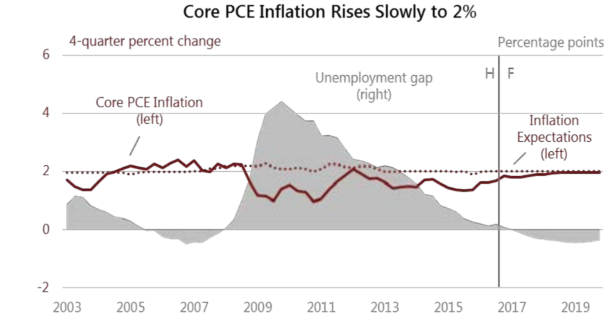
Modestly above-trend GDP growth and weak productivity growth early on are expected to combine to drive additional declines in the unemployment rate in our forecast. A sideways drift in the labor force participation rate reflects a boost mainly from expected declines in long-term unemployment offset by a declining demographic trend. The unemployment rate is projected to fall to 4.3% by the second half of 2018, four-tenths below the NAIRU, and remain there through most of 2019. We believe the Fed would welcome a sustained decline in the unemployment rate to below the NAIRU to cure remaining labor-market slack and to help inflation move back to target. Indeed, in response to tightening labor markets, the trend in growth of hourly compensation is expected to continue to firm in the forecast. Over the first ten months of this year, payroll gains have averaged about 180 thousand per month. In our forecast, we expect payroll gains to average about 175 thousand per month through 2017, but then slow to an average of about 100 thousand per month during 2019, as growth of productivity recovers and growth of hours worked slows.

Above-Trend Growth Lifts Employment Ratio



Sources: Macroeconomic Advisers, BLS

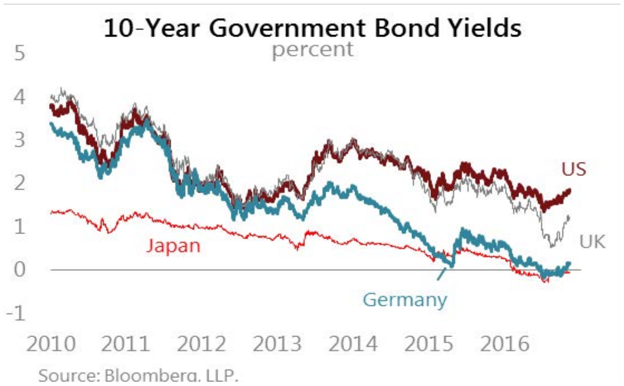
Core PCE Inflation Rises Slowly to 2%

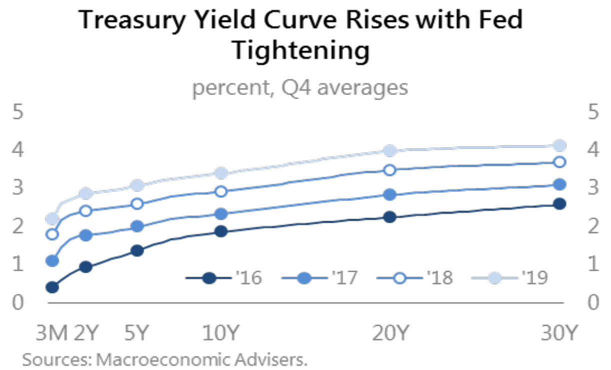


Sources: Macroeconomic Advisers, BLS, Survey of Professional Forecasters

Core Inflation Rises to 2.0% in 2018

The 12-month measure of core PCE inflation was 1.6% from March to July, then rose to 1.7% in August and September. We expect core inflation to rise to 1.8% this year, 1.9% in 2017, and 2.0% in both 2018 and 2019. On a headline PCE basis, we expect inflation to rise from 1.6% this year to 1.9% in 2017, then remain close 2.0% thereafter. Energy prices have risen unevenly in recent months. After a 7.6% increase (annualized) in the fourth quarter of 2016, energy-price increases are expected to average close to 2% through 2019. Increasing restraint on inflation in the forecast is suggested by declines in non-energy import prices that are larger than in last month's forecast. Nevertheless, stable long-run inflation expectations (at 2%) are expected to help pull actual inflation to 2%.





Fed Rate Hikes, Widening Term Premia Push Term Yields Higher

Recent developments and FOMC statements suggest that the Committee is likely to raise the target for the federal funds rate by a quarter point to a range of ½% to ¾% at the upcoming meeting on December 14. Thereafter, the timing and pace of rate hikes will be influenced by economic developments. So long as labor markets continue to strengthen and, importantly, forecasts for a rise of inflation to the Fed's 2% target are supported by incoming data, the Fed is likely to raise the target for the funds rate gradually over the next few years. We anticipate 3 quarter-point rate hikes in 2017 and 3 more in 2018, with the federal funds rate expected to rise gradually to 2¾% within a few years.

Holding Period Returns on Treasuries

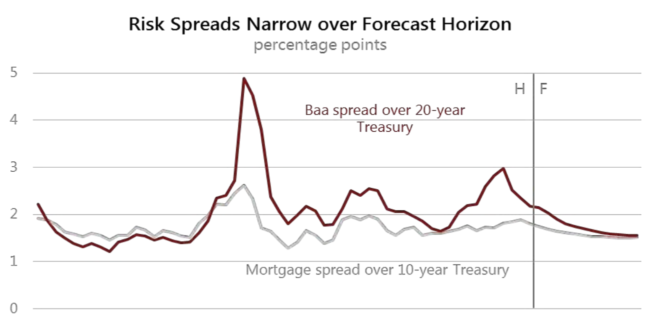
1-year holding period return through Q4, percent

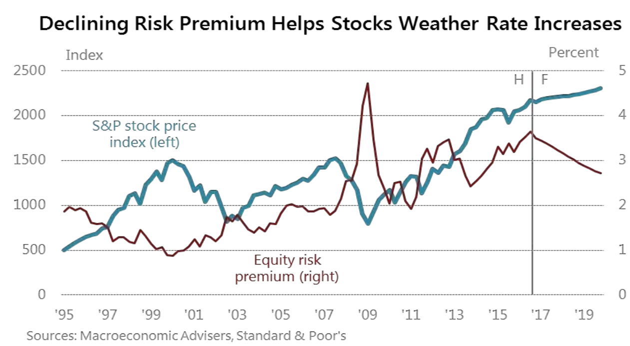
	'15	'16	'17	'18	'19
2-year T-Note	0.62	0.91	0.22	1.25	2.12
Rates view	-0.32	-0.30	-0.88	-0.64	-0.41
Rolldown	0.39	0.37	0.17	0.11	0.10
Interest income	0.54	0.83	0.93	1.77	2.42
10-year T-Note	3.57	5.52	-1.67	-2.05	-0.40
Rates view	0.69	2.80	-3.96	-4.72	-3.67
Rolldown	0.60	0.53	0.44	0.34	0.34
Interest income	2.28	2.19	1.85	2.33	2.93
30-year T-Bond	3.81	11.75	-6.77	-7.09	-3.62
Rates view	0.31	8.08	-10.02	-10.66	-7.62
Rolldown	0.53	0.71	0.67	0.47	0.31
Interest income	2.97	2.97	2.58	3.09	3.69

Note: "Interest income" includes return from coupon reivestment.

Fed Rate Hikes, Widening Term Premia Push Term Yields Higher

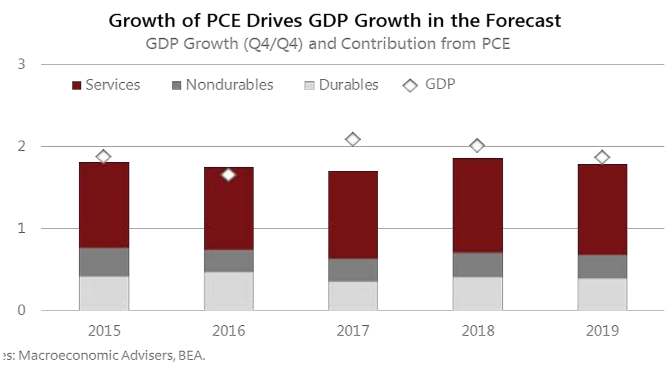
We expect Treasury yields to move higher over the forecast horizon, reflecting the gradually rising path for the fed funds rate and a gradual rebound in term premia. The 10-year Treasury Note yield is projected to rise 192 basis points from 1.56% in the third quarter of this year to 3.48% in the fourth quarter of 2019 (somewhat less of an increase than in last month's forecast). Slightly more than 1 percentage point of the increase is accounted for by a widening of the 10-year term premium. In addition, the average expected funds rate over the 10-year horizon is projected to rise about 80 basis points by 2019, reflecting both expected increases in the actual funds rate and evolving market expectations as the tightening proceeds. Investment returns on longer-maturity fixed income instruments do not fare well as rates are rising. The table at lower right includes our decomposition of the implied 1-year holding period return for the years ending in the dates indicated at the top of the columns. Returns on longer-term Treasuries over 2016 are likely to be positive in light of recent declines in yields.

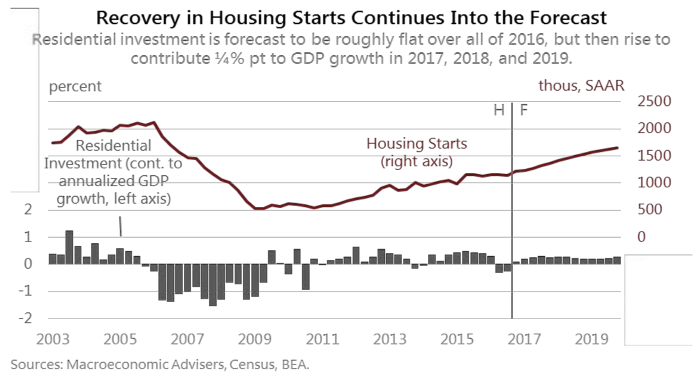




Risk Spreads Continue to Narrow from Elevated Levels

Risk spreads widened from mid-2014 into early 2016, with the spread between the Baa corporate bond yield and the 20-year Treasury Bond yield widening from a post-recession low of 160 basis points at the end of April 2014 to as high as 320 basis points in mid-February 2016. Risk spreads began to narrow thereafter and, despite a brief widening related to the Brexit vote at the end of June, have continued to narrow since. As of November 1, the Baa spread was 220 basis points, down nearly 10 basis points over the inter-forecast period and down roughly 40 basis points from the Brexit spike. Implied volatility (as measured by the VIX) has also retreated following a spike related to the referendum, reaching a low of 11.34 by mid-August. The VIX rose during the inter-forecast period, averaging roughly 14.8. Looking ahead, as the expansion continues and foreign economies recover, and as nominal GDP growth improves, the acceleration in cash flows broadly should help drive risk spreads lower. In addition, as downside risks associated with foreign "melt-down" scenarios recede, risk spreads should continue to ease, with the Baa spread narrowing to 156 basis points by 2019 Q4. Meanwhile, mortgage spreads have edged up in recent months. We look for a gradual narrowing to roughly 150 basis points by the end of 2019.





Market Jumps after Election

We foresee the balancing of three primary forces acting on equity values: (i) a rising yield curve ; (ii) a guarded outlook for earnings; and (iii) perceptions of declining risk. The first two forces restrain equity values, while the latter boosts them. The earnings outlook is guarded in part due to rising interest costs, but also because a continued tightening of labor markets, we believe, will precipitate an acceleration in unit labor costs sufficient to arrest the long secular decline in labor's share of National Income. Meanwhile, after completion of this forecast, stocks rose upon the election of Donald Trump. Valuations were buoyed by the enhanced prospects of pro-growth policies in 2017. In addition, the equity premium dropped sharply as investors seemed relieved the election ordeal is over and the outcome now known.

Consumption Moderates from 2016 Q2 Rebound

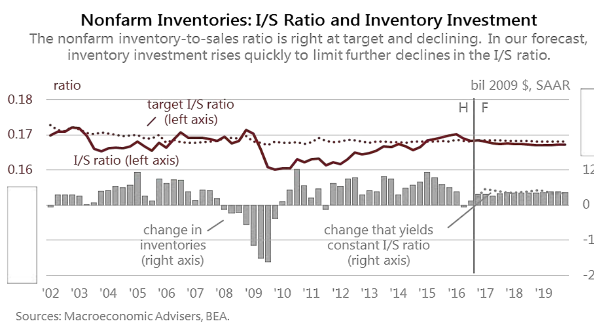
According to the BEA's advance estimate, PCE growth moderated from 4.3% in 2016 Q2 to 2.1% in Q3, four-tenths shy of our estimate. Data on consumer spending were generally soft during the inter-forecast period, with unexpected weakness in both real core retail sales and real PCE through September, though vehicle sales posted a solid reading in October. Overall, data released since our previous forecast implied a downward revision of three-tenths to Q4 PCE growth, to 1.8%. Looking ahead, consumer spending remains a critical component driving the near-term GDP forecast, rising 2.4% over 2017 (Q4/Q4), 2.6% over 2018 (Q4/Q4), and 2.5% over 2019 (Q4/Q4), each one-tenth higher than last month's forecast. The projected path for PCE adds roughly 1¾ percentage points to GDP growth over the forecast horizon, on average. This forecast is supported by solid fundamentals for consumer spending, including continued solid gains in employment, firming real wage growth, and continued increases in household net worth.

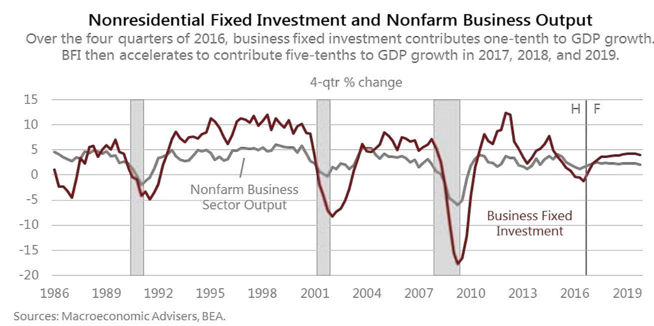
Starts to Resume Rising Following a Year-Plus Pause

Since the second quarter of 2015, the pace of housing starts has been essentially flat at roughly 1.2 million. In the forecast, we expect starts to continue the broad recovery that had been underway prior to this recent pause. From 1,108 thousand in 2015, housing starts are expected rise to 1,614 thousand by 2019. The resulting projection for residential investment contributes about ¼ percentage point to GDP growth in each of the coming three years. The broad recovery is expected to reflect continued favorable affordability as well as pull from solid underlying demographics. In the very near term, single-family housing starts are expected to ease in October following a pace in September that was above a pace consistent with the underlying trend in permits. Indeed, we made no specific adjustment to our October starts forecast for Hurricane Matthew, so we view there to be some downside risk to our October starts assumption. In any event, single-family starts are expected to continue to firm in the following months.

Mining Investment to Rise & Lead a Broader Investment Recovery

After rising 5.0% over the four quarters of 2014, nonresidential fixed investment slowed to grow only 0.8% last year and is forecast to grow 0.6% this year. Growth of business fixed investment then picks up in our forecast to an average annual rate of 3.9% from 2017 through 2019. The contributions to GDP growth (Q4 over Q4) are one-tenth for this year and five-tenths over each of the next three years. The recent weakness in part reflects normal accelerator effects stemming from deceleration in business output; slower growth of output requires slower growth of the capital stock, which implies downward pressure on the level of business fixed investment. But the recent weakness also reflects slumping fixed investment in oil drilling structures and oilfield machinery stemming from the collapse of oil prices since mid-2014. Recent increases in oil prices, however, portend an end to this source of drag. Indeed, rig counts are now rising. We look for increases in mining activity over the next two quarters to add one-tenth to GDP growth per quarter.



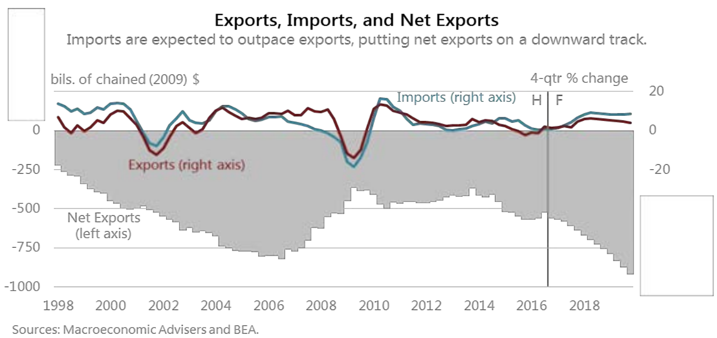


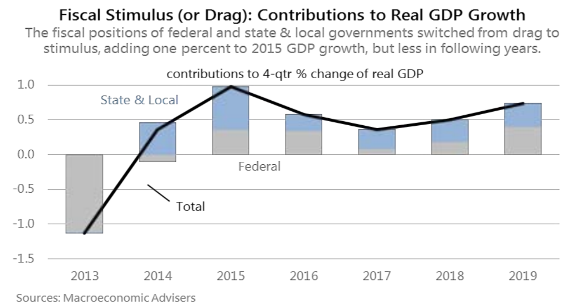
Inventory Investment to Add 0.6 ppt to Q4 Growth, Then Stabilize

Inventory investment reached an unsustainably low level of -$10 billion in the second quarter of this year. As we expected, inventory investment rose sharply in the third quarter (to +$13 billion), adding six-tenths to third-quarter GDP growth. We estimate that further increases in inventory investment would be necessary to stabilize the inventory-to-sales ratio at the current level, which we view to be sustainable. Therefore, we forecast another sharp increase in inventory investment in the fourth quarter (to +$36 billion), which would add six-tenths to fourth-quarter GDP growth. After this, we don't anticipate sharp moves in inventory investment, although we do forecast an upward drift to nearly $50 billion that will add one-tenth to 2017 GDP growth.

More Drag from Net Exports, as Lower Foreign Yields Raise USD

Growth of both exports and imports have slowed recently, but are expected to rise in the forecast, with the balance suggesting continued drag on GDP from falling net exports. After subtracting seven-tenths from GDP growth in 2015, net exports are expected to be neutral this year before declining enough to subtract four-tenths from GDP growth next year, six-tenths over 2018, and eight-tenths over 2019. Two primary factors are driving net exports lower. First is a relative price effect, whereby the recent increase in (and currently elevated level of) the dollar has made imports relatively cheap and exports relatively expensive. Second is an income effect. Import-weighted domestic demand rises faster in much of our forecast than export-weighted foreign GDP. All else equal, this puts downward pressure on net exports. Relative to last month's forecast, the drag from net exports is larger, reflecting weaker foreign growth and a stronger US dollar. The latter stems from materially lower foreign government bond yields, which raise demand for US securities and puts upward pressure on the US dollar.



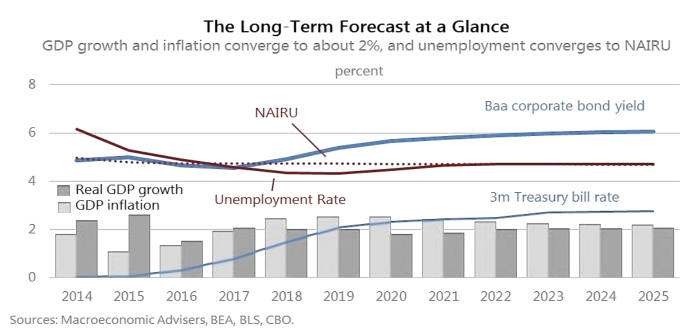


Fiscal Outlook

We assume that: (a) in FY 2018 federal discretionary spending reverts to the "sequestration baseline" set under the Budget Control Act of 2011 as later amended; (b) entitlement spending remains on "autopilot"; (c) there are no changes to current tax law; (d) fiscal "speedbumps", including a possible shutdown of the federal government in December absent an interim "continuing resolution" and re-imposition of the debt ceiling in March 2017, are negotiated without incident; (d) state & local governments maintain balanced budgets. Under these assumptions, federal, state & local policies on spending and taxation will contribute roughly 0.5 percentage point to GDP growth from 2016 through 2019. Meanwhile, in August CBO updated its 10-year Budget and Economic Outlook. The new projections show deficits rising to 4.6%, and debt to 85%, of GDP by 2026. CBO's long-term budget analysis implies that under current policies the debt-GDP ratio will rise to 141% by 2046, pushing up the 10-year note yield by about 70 basis points relative to a policy that maintains debt-GDP ratio at its current 77%. It is against this backdrop that the fiscal policy proposals of President elect Donald trump will be assessed.

2% GDP Growth: TFP Acceleration, Continued Immigration

The LTF was last published on September 19, 2016. However, following completion of this month's base forecast, we extended the simulation through 2025 to produce a LTF update. The first four years of the LTF update (through 2019) are identical to the current short-term forecast (STF). Beyond the STF, we set monetary policy to move the economy toward a full-employment growth path consistent with the FOMC's 2% inflation objective. Secular GDP growth is accounted for mainly by growth of the labor force and of productivity. Census projections assume immigration accounts for up to 40% of projected population growth without regard to legal limits. Population aging persistently depresses the participation rate, while a cyclical rebound and increasing life expectancy temporarily offset that impact. In the LTF update, we assume TFP growth rises towards its historical average of 1%; otherwise secular GDP growth would be slower and "terminal" interest rates lower.



Monthly GDP Off to a Great Start in Q3; Inflation Moving Up

Monthly GDP rose 0.2% in August and is estimated to have increased 0. 4% in September. These figures are consistent with BEA's advance estimate of 2.9% GDP growth in the third quarter. The estimated level of monthly GDP in September is 1.3% above the third-quarter average at an annual rate. Implicit in our base forecast of 1.5% growth of GDP in the third quarter is a decline in October that is fully accounted for by an assumed decline in agricultural exports reflecting our view that a surge in soy bean exports over the summer will get completely reversed by November. Growth of monthly GDP is expected to resume a rising trend by December. When we completed this forecast, we had assumed monthly payroll gains averaging roughly 190 thousand per month over the next several months, helping to re-establish a downward drift in the unemployment rate. Over the 12 months ending in September, the core PCE price index rose 1.7%, or an average of 0.14% per month. Over the next several months, we assume average monthly increases of 0.16%, and the 12-month increase rises to 1.9% by December.

Risks to the Outlook

Every economic forecast is conditional on events subject to considerable uncertainty. Here we identify several risk factors, both domestic and global, that, depending on how they evolve, could have a significant impact on our forecasts of both economic growth and financial returns.

Domestic Risk Factors

Fiscal policy: Fiscal policy risks are two-sided. On the one hand, if, under President Trump, Republicans drop past insistence that tax cuts and new infrastructure spending be paid for over the 10-year budget scoring window, fiscal stimulus could raise GDP growth in the second half of 2017 and then into 2018 and 2019. On the other hand, if tax cuts are enacted but paid for by offsetting by spending cuts, the net effect could be to slow GDP growth over the horizon of the short-term forecast.

Immigration and Trade Policy: Trump's policies on immigration and trade, by shrinking the labor force, undermining global trades flows, and heightening uncertainty might lead to slower GDP growth and higher unemployment.

Surge in oil prices: Declines in U.S. oil production resulting from the recent decline in exploration and drilling, combined with supply disruptions in other oil-producing nations, could lead to a quick evaporation of the current glut in oil markets as global growth strengthens. In that case, oil production may not recover quickly enough to prevent a rebound in oil prices to a range of $70 – $80 by late 2017.

Strong recovery in home prices: Home prices have risen at a solid pace the last several years. The "rise" draws potential buyers into the market, but the "level" of prices may become problematic, especially with still tight lending standards. If standards fail to loosen, it may be hard to sustain the recent pace of home price appreciation and rising starts.

Higher dollar: Net capital inflows reacting to widening interest differentials and "rest of world" uncertainties pushed the dollar higher since mid 2014. If the ECB continues easing while the Fed begins tightening, a further rise in the dollar would imply both additional drag from net exports and further restraint on inflation. This would complicate Fed policy and communication..

Jump-Off Assumptions for Key Monthly Indicators*

	Aug '16	Sep '16	Oct '16	Nov '16	Dec '16	Jan '17
Monthly GDP	0.2	0.4	-0.1	0.1	0.2	0.2
Real PCE	-0.2	0.3	0.2	0.1	0.2	0.2
Retail Sales & Food Services	-0.2	0.6	0.8	0.2	0.2	0.2
Light Vehicle Sales (mil, SAAR)	16.9	17.7	17.9	17.3	17.3	17.3
Construction Spending	-0.5	-0.4	0.7	0.4	0.5	0.5
Orders for core capital goods	1.2	-1.2	0.1	0.0	0.1	0.4
Housing starts (thous, SAAR)	1150	1047	1207	1213	1220	1227
Trade deficit (bil $)	40.7	35.9	41.8	42.8	42.8	43.4
Business inventories	0.2	0.2	0.2	0.2	0.3	0.3
Vehicle Assemblies (mil, SAAR)	12.2	12.3	12.3	12.3	12.3	12.1
Nonfarm payroll emp. (ch, thous)	167	156	183	190	198	197
Unemployment rate (%)	4.9	5.0	4.9	4.8	4.8	4.7
PCE price index	0.2	0.2	0.3	0.3	0.1	0.1
PCE price index: gasoline	-0.8	5.1	6.5	5.6	-0.8	0.1
Core PCE price index	0.20	0.11	0.14	0.16	0.16	0.16

* Gray text is historical, maroon text is assumption. All data are in 1-month % change unless otherwise indicated.

Global Risk Factors

China: The risk of a sharper slowing in China, with global financial and real spillovers, has loomed large and the slowing in growth to date has already impacted global commodity markets to such an extent that it has proven to have a material adverse effect in resource-rich emerging economies. China continues to struggle to transform its economy from one driven by investment to one driven by consumption, and coordinating the slowing in one sector with speed-up in the other will be difficult to time precisely. In addition, the troubling number of non-performing loans poses a risk to the Chinese economy.

Japan: The risk of a recession is still apparent in the Japanese economy as falling exports and weak corporate investment resulted in an almost flat Q2 growth figure. Consumer spending accounts for 60% of total GDP but has been weak, restrained by the absence of significant wage increases, despite record earnings for large companies in recent years. Furthermore, the absence of structural reform keeps growth of potential GDP very low, while growth of aggregate demand is still dependent on government stimulus in the form of public investment and subsidies to low-income families. Japan's cabinet approval of another stimulus package in August, in addition to potential investments related to the 2020 Olympic Games, might temporarily boost growth, but they are unlikely to solve the chronic structural issues.

UK: The UK's decision to leave the Eurozone led to an immediate global downward financial correction which was quickly followed by a healthy rebound. As the UK works to solve its internal political problems ahead of the exit negotiations, uncertainty over the eventual outcome will remain high. In the meantime, attracting and retaining businesses as well as human capital will be somewhat more challenging. On top of that, the high court ruled that triggering article 50 of the Lisbon treaty and thus officially initiating the Brexit process cannot happen unless it is approved by the British Parliament. As a result, Brexit could be delayed and possibly lead to more division across the political spectrum which will hinder the negotiations with the EU. Recent elevated fears of a "hard Brexit," stoked by a hard line taken by some European leaders, has pushed the Pound close to decades-low levels and roiled UK financial markets. The sharp decline in the Pound will have some limited spillovers to its major trading partners.

Eurozone: Problems remain in the Eurozone periphery that could evolve into more serious issues with potential spillovers. Spain and Portugal have failed to meet the budget deficit limits imposed by the European Union, while Italy's banking sector is saddled with $360 billion in non-performing loans. Moreover, Italy faces a referendum on constitutional reforms in December which can have major political implications. Even though Spain and Portugal were not fined by the Eurozone, they are required to make additional adjustments to their budgets in the coming years. While this will allow them to achieve a smoother growth path, it may also lead to larger fines in the future if they fail to meet the more lenient targets. (Spain is already projected to miss the next target.) In addition, Spain hasn't had a functioning government since last December and there will likely be a third round of elections since the political parties have failed to produce a coalition government. Meanwhile, the Italian government cannot bail-out Italian banks, as it would be against EU rules.

The European banking sector more generally is under fire as negative interest-rate policies, uncertainty in financial markets, and stricter regulation has led to a decline in earnings. Mario Draghi has warned that Europe is "overbanked." In the coming months, European banks are projected to dramatically cut their personnel and adjust wages downward. The fines levied on Deutsche Bank are one more hit to a sector that will continue to struggle to recover.

Middle East: There remains some risk of a widening conflict in the Middle East that intensifies the refugee crisis, spawns additional terror attacks, results in financial disruptions and causes household and business spending to turn more cautionary. The recent dust-up between Saudi Arabia and Iran is only the latest manifestation of deep-rooted sectarian hostility that has spilled into open conflict repeatedly in recent years.

Turkey: Instability in Turkey in the aftermath of the failed coup adds to European uncertainty. Thousands of military, judiciary, civil service and education workers have been suspended, detained or are being investigated. Meanwhile, the Turkish economy was under pressure as travel and tourism revenues declined over the summer and the Lira is close to a historical low against the US dollar. Both Standard & Poor's and

Moody's downgraded Turkey's outlook to negative following the failed coup in the summer but Standard & Poor's recently upgraded Turkey's outlook to "stable" noting that despite Turkey's high private sector external debt the government is enacting the right policies to reduce any external vulnerabilities.

Furthermore, relations between Turkey and the European Union are strained as Europe has not agreed to visa liberalization for Turkish citizens, while Turkey blames European leaders for not being supportive of Turkey's post-coup anti-terrorism policy. According to Turkish officials, the deal between Turkey and the EU over the refugee crisis will be in jeopardy if the EU doesn't agree to visa liberalization for Turkish citizens by the end of the year. If the deal breaks down, the influx of refugees will surge dramatically posing another source of economic and political tensions in Europe.

Greece: The risk of a Greek default and exit from the Eurozone has significantly diminished but it hasn't been completely erased. Although the Greek government received the necessary funding to continue servicing debt payments, the road ahead remains bumpy as Greece has to approve more austerity and structural changes in order to receive additional funding. Furthermore, the funding provided by the EU to Turkey has kept the number of refugees arriving to Greece at a very low level in recent weeks but a potential fallout in the negotiations between Turkey and the EU will lead to a surge in that number posing another risk to the already weak Greek economy.

[1] Unless otherwise noted, all quarterly growth rates are expressed as compound annual rates, all expenditure components of GDP are chained 2009 dollars, and all annual growth rates are stated as Q4 over Q4.

	History										
	2016.3	2016.4	2017.1	2017.2	2017.3	2017.4	2018.1	2015	2016	2017	2018
Real GDP & Components		% change annual rate						q4/q4			
GDP	2.9	1.5	2.1	2.0	2.3	1.9	1.9	1.9	1.7	2.1	2.0
Personal Consumption Expenditures	2.1	1.8	2.3	2.2	2.4	2.6	2.7	2.6	2.5	2.4	2.6
Business Fixed Investment	1.2	3.8	3.5	3.4	4.0	3.8	3.9	0.8	0.6	3.7	4.1
Real Activity		quarterly averages, unless noted						annual avg.			
Private Housing Starts (thous units)	1138	1213	1234	1270	1318	1367	1412	1108	1165	1297	1477
Light Vehicle Sales (mil units)	17.5	17.5	17.2	17.1	17.1	17.0	17.0	17.4	17.3	17.1	16.9
Industrial Production (% ch, a.r.)	1.8	-0.6	0.0	2.2	2.7	2.2	2.1	-1.6	-0.3	1.8	2.1
Manuf. Capacity Util. (%)	75.0	74.8	74.6	74.6	74.7	74.8	74.8	75.5	75.0	74.7	74.9
Unemployment Rate (%)	4.9	4.8	4.7	4.6	4.5	4.4	4.4	5.3	4.9	4.6	4.3
Prices, Productivity, & Costs		% change annual rate, unless noted						q4/q4			
CPI (all urban)	1.6	3.9	1.4	2.4	2.4	2.2	2.3	0.4	1.9	2.1	2.2
Core CPI (all urban)	1.9	2.2	2.3	2.0	2.1	2.2	2.2	2.0	2.2	2.2	2.2
PPI (finished goods)	1.4	4.1	0.9	2.6	2.6	2.6	2.6	-3.4	0.9	2.2	2.4
Compensation Per Hour	3.3	1.7	2.7	2.7	3.0	3.2	3.3	3.1	1.9	2.9	3.4
Output Per Hour	2.6	-0.5	0.5	0.7	1.0	0.8	0.9	0.4	0.3	0.8	1.2
Price of WTI Crude Oil ($/barrel)	44.9	48.0	47.9	49.4	50.3	50.9	51.5	48.7	42.9	49.6	52.9
Selected Interest Rates		quarterly average (%)						annual avg.			
Federal Funds Rate	0.40	0.44	0.64	0.68	0.92	1.19	1.39	0.13	0.39	0.86	1.64
10-Year Treasury Bond Yield	1.56	1.85	1.95	2.06	2.19	2.32	2.46	2.14	1.77	2.13	2.68
Baa Corporate Bond Yield	4.26	4.42	4.48	4.53	4.56	4.63	4.73	5.00	4.66	4.55	4.91
Incomes & Related Measures		% change annual rate, unless noted						q4/q4			
Corporate Profits	12.0	-2.4	-2.0	3.6	4.4	2.7	2.2	-11.2	5.0	2.2	3.7
HH Net Worth, Equities (qrtrly rate)	4.0	-1.1	1.6	0.4	0.4	0.1	0.2	-2.1	4.3	2.6	1.2
Federal Surplus (FY, Uni, bils $)	-746	-585	-784	-246	-483	-519	-720	-478	-518	-508	-469

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