The Moderation of Great Expectations

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10-Year Treasury Ebbs with Policymakers

Yields traded in a relatively tight range to start 2017. Fear of a faster Fed path pushed yields outside (above) that range before an unchanged dot plot and growing fiscal uncertainty sent yields to post-election lows.

Fed Minutes highlight “considerable uncertainty” on fiscal changes

Donald Trump sworn in

Cycle-high hourly earnings

Fed hives, leaves dots unchanged

Reports GOP lacks support for healthcare bill

Weak April CPI, retail sales

Fed hikes, hawkish slant, leaves dots unchanged, announced roll-off cap sizes

French election fears

Minutes mention reinvestments

May payrolls, earnings miss

Surprisingly hawkish talk from ECB, BoE, BoC

Fed shifts markets to March

Questions about timing of tax reform, infrastructure

98k March NFP

Weak May PCE

Weak May CPI

WSJ: Trump likes low rates

French Election

Comey memos

Mnuchin questions tax timeline

Weak May CPI

Stock Record Highs: Dow – 22, S&P – 24, Nasdaq – 38

Cycle-high hourly earnings

UK Parliament to vote on Brexit plan

Questions about timing of tax reform, infrastructure

Brexit triggered

98k March NFP

Mnuchin questions tax timeline

Weak May CPI

Surprisingly hawkish talk from ECB, BoE, BoC

Fed hives, leaves dots unchanged

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Sources: Bloomberg, Vining Sparks
But Remains Relatively Range-Bound

Treasury yields were volatile in 2016. While shorter yields were anchored by monetary policy prognostications, longer yields fell to all-time lows before jumping to recent highs following the election.

Sources: Bloomberg, Vining Sparks
Markets are optimistic. However, uncertainty about the actual pace of growth and inflation remains high; largely the byproduct of growing concerns about the pace of change in Washington.

- **Consumer**: Consumer poised to drive growth again on an improving labor market and rising wages, although the strength will be partially offset by higher healthcare costs

- **Labor Market**: While some see the labor market as very tight already, there appears to be a larger number of possible market re-entrants available to fill job openings keeping wage growth moderate

- **Housing**: Crosscurrents in housing likely to yield an even slower rate of growth for the sector in 2017

- **Inflation**: Rising oil and commodity prices are expected to lift headline inflation; rents and medical care are likely to provide a floor for core inflation; wage growth expected to remain moderate; the Dollar will be the wild-card

- **Federal Fiscal Policy**: New tax, regulatory, and fiscal policies are likely to boost growth beginning in the second half of the year; there remains great uncertainty about the implementation

- **U.S. Economic Outlook**: Overall, the pace of economic growth is projected to increase in 2017 although structural challenges will remain in place longer term

- **FOMC Policy**: Fed is likely to hike twice on an improving U.S. economy and stable inflation; FOMC complexion to change

- **Global Uncertainty**: Populism in the West will make for potentially market-moving general elections in Germany, France, the Netherlands, and likely Italy; Brexit expected to be initiated in 2017

- **Interest Rates**: The potential for stronger growth, faster inflation, and higher interest rates has increased in 2017

Source: Vining Sparks
Consumers Driving Growth

Consumer spending has been the stalwart of U.S. economic activity for several consecutive years. Even after a weak 1Q, expectations are for a rebound in consumer spending.

Sources: BEA, Vining Sparks
Unemployment Continues to Improve

In addition to the improvement in headline unemployment, various other measures have also strengthened with fewer marginally attached, including discouraged workers, and more full-time jobs.

Sources: BLS, Vining Sparks
Consumers have Reason to be Confident

The consumer is in an increasingly better position to be the main engine of growth. An improving labor market, increasing net worth, and low interest rates are all helping drive confidence.

Sources: BLS, Federal Reserve, BEA, AAA, Bankrate, Vining Sparks
Result – Strong Consumer Confidence

Consumer confidence began fading after 2014 but rebounded to the highest levels since early 2000s after the U.S. presidential election. Confidence remains high.

Sources: University of Michigan, Conference Board, Vining Sparks
Consumers Expected to Drive Growth

Consumer spending has been the stalwart of U.S. economic activity for several consecutive years. Even after an extremely weak 1Q, expectations are for a rebound in consumer spending.
Business Confidence Strong but Softens

Despite the legislative failure on healthcare and questions surrounding tax reform, businesses remain confident largely on expectations for an easing of the regulatory burden.
Business Investment Slows in 2Q

After contracting for six out of eight quarters, business investment in equipment looked to be trending higher. However, that trend appears to have weakened in 2Q17.

Sources: BEA, Vining Sparks
Housing Activity Remains Choppy

While housing activity continues to grow, the pace of growth continues to be very choppy and the overall growth rates continue to trend more slowly.

Sources: S&P CoreLogic, BLS, NAR, Census Bureau, NAHB, Vining Sparks
High Expectations from Fiscal Policy

President Trump’s proposed economic policies boosted optimism. But the key to that optimism creating activity will depend on the timing and details of implementation of those policies.

- **Immediately - Regulatory Relief Begins**
  - Recent executive legislation likely to be targeted through the Congressional Review Act
    - President can ask agencies to revisit enforcement plans on older regulations

- **H1 2017 - Affordable Care Act**
  - 2017 Budget Resolution to take aim at tax and spending policies under Affordable Care Act (1-2 years to have effect)
    - Would likely cause some people to lose health insurance coverage
    - Creates new incentive for people to re-enter labor force to attain private insurance

- **H2 2017 - Comprehensive Tax Reform Process**
  - 2018 Budget Resolution to focus on comprehensive tax reform
Fiscal Policy Optimism Fading

There are a host of factors complicating any potential healthcare or tax reform efforts. As such, many economists are discounting future policy changes.

- Circus between media and Executive Branch keeping Congressional Republicans weary and distracting from economic agenda
- Small Senate majority requires reconciliation, slowing process for tax reform
- Health insurance is complex, not the root cause of rising healthcare prices
  - Building consensus on reforms proving difficult
  - Some Republicans do not want to own healthcare
- Outstanding Debt Keeps Deficit Hawks on Guard
  - Proposed BAT which died quickly
  - Unlikely to agree to large deficit-funded tax cuts
  - Unlikely to agree to infrastructure spending package
The optimistic agenda laid out by candidate Trump, and subsequently the White House, is likely to fade into a few small deals boosting growth less than 0.5% per year.

- $1 to $2 Trillion in Tax Cuts ($100-$200B / Year)
  - Much of the Tax Cuts Deficit Financed, Temporary
  - Impact Potentially Not until 2H18
- Small Infrastructure Spending Package ($25-50B / Year) Financed by One-Time Repatriation Tax
  - Likely in the Form of Public-Private Partnerships
- Significant Deregulation
  - Example – Treasury’s financial sector deregulation proposal, 80% of which can be accomplished by executive action and Cabinet, 20% of which would require Congress
- No Structural Change to Healthcare Delivery Mechanism
Inflation Has Reversed Trend

While Core CPI was already trending slightly above 2.0%, Core PCE appeared to be moving in the direction of the FOMC’s target as well. That trend has reversed.

Sources: BLS, Vining Sparks

Feb. 15, 2017 Bloomberg News – The Fed Is Behind the Curve: “rates are too low and the Fed’s monetary policy is overly accommodative, and this will become increasingly apparent as inflation increases”

Mar. 13, 2017 Goldman Sachs Economics Group: “standard policy rules suggest that the Fed is modestly to moderately behind the curve”
Inflation expectations rose on economic optimism and concerns of global reflation. However, expectations have pulled back after peaking in late-January.
The broad-based nature of the recent decline in inflation should give pause to the Fed, whose rate projections are based on weaker inflation being transitory.

Sources: BLS, Vining Sparks
Earnings Growth Has Lost Momentum

Earnings growth had broken out of the 2.0-2.5% range and appeared headed for a 3.0%-plus growth rate. The pace of growth has since slowed.

Kashkari: “I’m looking for wage growth as an indicator that ... maybe now we’re going to start seeing inflation, and maybe that’s going to lead us to needing to raise interest rates”
Global Reflation Has Not Occurred

While there is a lot of optimism about global reflation, that is dependent on better global growth which remains elusive.

Sources: BOJ, Eurostats, BLS, Vining Sparks
Fed Finally Turned Hawkish, Too Late?

The Fed has now hiked four times, including three hikes in the last seven months.

Sources: Bloomberg, Federal Reserve, Vining Sparks
Why the FOMC Turned Hawkish

The FOMC surprised the markets by being as hawkish as they have been over the past seven months, particularly the March rate hike and balance sheet announcement.

- Fed wanted to get away from “emergency policy”
- Concerns were growing about asset bubbles
- Unemployment rate of 4.7% was well below expected sustainable rate
- Earnings growth rose to 2.9% and PCE inflation was trending higher
- Economic growth appeared stable
- Market conditions appeared to take potential rate hikes in stride
- Possibility of fiscal stimulus increased risks to faster inflation
FOMC Expecting to Remain Hawkish

The Fed continues to project three hikes in 2017 and the commencement of their balance sheet adjustment program, despite the weaker inflation data.

**FOMC’s Target Rate Projections**

*By Year-End*

- **2017 YE Target Rate**: 1.375
- **2018 YE Target Rate**: 2.125
- **2019 YE Target Rate**: 2.938
- **Longer Run**: 3.000

Sources: Federal Reserve Summary of Economic Projections, Vining Sparks
Fed Surprises with Balance Sheet Details

In an effort to prevent market disruption, the Fed has gone to great lengths to describe in detail, and well in advance, what its slowing of portfolio reinvestments will look like.

- Monthly caps on amount of the portfolio allowed to run off
- Any cash flow in excess of the monthly caps would be reinvested
- Initial caps of $10 billion
- Quarterly cap increases of $10 billion
- A final $50 billion cap that would be maintained until the balance sheet is normalized
- Eventual goal of reducing balance sheet to $1.5 to $3 trillion
- Projected to begin this year

Source: Vining Sparks

June FOMC Meeting Minutes: “The Committee expected to begin implementing a balance sheet normalization program in 2017”
Markets Projecting Slower Path

Fed Funds Futures now project only one additional rate hike over the next 12 months followed by one additional hike over the following 12 months.

Sources: June FOMC SEP projections, Bloomberg, Vining Sparks
Investors have been surprised by how much the Fed has hiked this year, but are now less convinced that the Fed will hike as much as they project going forward.

Sources: Bloomberg, Vining Sparks
Global Central Bank Policy Shift?

Markets became alarmed in June that other central banks might turn more hawkish than expected, sending yields quickly higher.

Sources: Bloomberg, Vining Sparks
Risks to growth – upgraded from "tilted to the downside" to "broadly balanced"

"...stronger momentum in the euro area economy...yet to translate into stronger inflation dynamics."

"very substantial degree of monetary accommodation is still needed for underlying inflation pressures to build up..."

Host of factors keeping inflation low are "...on the whole temporary..."

"...the threat of deflation is gone and reflationary forces are at play..."
Summer Policy Shifts at Central Banks

The Minutes from the ECB’s June meeting showed discussion of potentially changing the outlook for QE and provided insight into the economic metrics that support the ECB’s optimism.

“it was argued that the improved economic environment with vanishing tail risks, in principle, suggested also revisiting the easing bias with respect to the asset-purchase program.”

Sources: ECB, Markit, European Commission, Eurostat, Bloomberg, Vining Sparks
Phillips Curve Isn’t Working There Either

While continued gains in employment should support consumption, according to the ECB, they continue to be disappointed by the reluctance of inflation to respond to a stronger labor market.

Sources: Eurostat, Vining Sparks
Central Bankers Elsewhere

While other major economies are dancing a dance of their own, the melody of the song is the same; significant inflation pressures remain evasive, except in the U.K. – and it’s the unkind, currency-driven variant.

Bank of England
Rate hike may become “necessary” if trade-off between inflation and economic growth lessens

Bank of Canada
“Extraordinarily low” rates have “done their job”...“excess capacity being used up steadily”

Bank of Japan
BoJ expects “moderate expansion” to continue, forecasts core inflation won’t rise to 2% before 2020

Sources: UK ONS, Statistics Canada, Japan’s Ministry of Internal Affairs and Communications, Vining Sparks
Summary

While global growth has been more encouraging than in previous years, stubbornly weak inflation likely to curtail hawkish tilt from central bankers in 1H17.

- Mid-Year Economic Review and Outlook
  - Consumer expected to remain growth engine despite weak 1Q
  - Business confidence still strong, but pulls back from post-election euphoria
  - Housing remains choppy with slower rate of growth expected
  - Fiscal policy expectations have lost some steam; still expected to boost growth
  - Inflation has weakened as 2017 has progressed; earnings growth continues to confound the models

- Monetary Policy
  - Despite weaker inflation, FOMC has proven to be stubbornly hawkish
  - Other central banks have turned more hawkish for varying reasons
  - Fears of a global shift from monetary policymakers has investors on edge
  - Expect recent trend to be short-lived given weak rates of inflation globally
Year-End Interest Rate Expectations

Longer maturity interest rates are still expected to rise slightly into year-end, although forecasters continue lowering their year-end rate forecasts.
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