2018 Economic Outlook – 2Q Update

The Sky Is the Limit – And the U.S. Economy Is Closer

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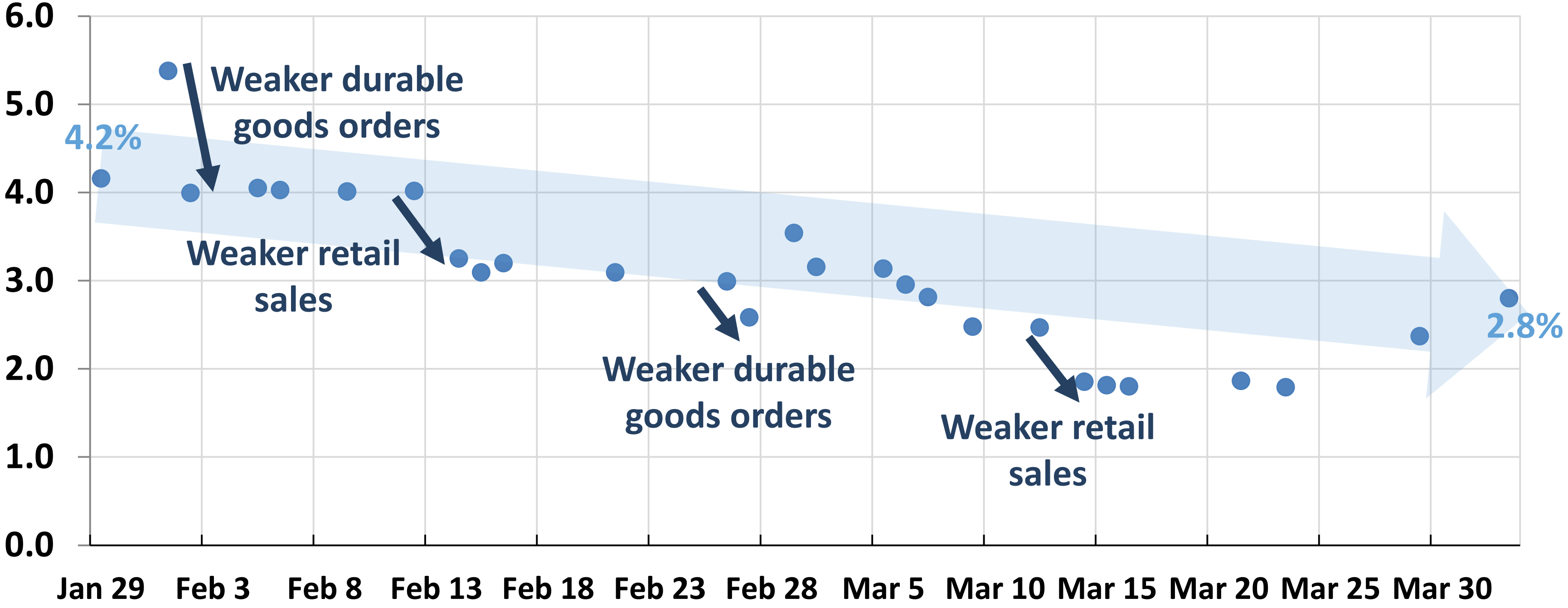
Weak Q1 Growth Expected to Fade

First quarter growth indicators, specifically those related to the consumer, have been weaker than expected. However, that's after a stellar 4Q for final sales and could also reflect residual seasonality.



Sources: Federal Reserve Bank of Atlanta, Vining Sparks

Almost All Economic Engines Firing

A strong consumer and more favorable business climate created a positive outlook for growth. Global growth also synchronized providing three engines of economic growth.

CONSUMPTION

Low Unemployment
Decent Wage Growth
Low Household Debt
Low Gas Prices
Record-High Stocks
Low Interest Rates
Booming Confidence

Tax Reform

INVESTMENT

Booming Confidence
Deregulation
Expectations for Sales
Record-High Stocks
Low Interest Rates
Weaker Dollar
Housing Momentum

Tax Reform

GLOBAL GROWTH

Unprecedented Monetary Stimulus
Low Interest Rates
Record-High Stocks
Synchronized Growth
Strong U.S. Economy

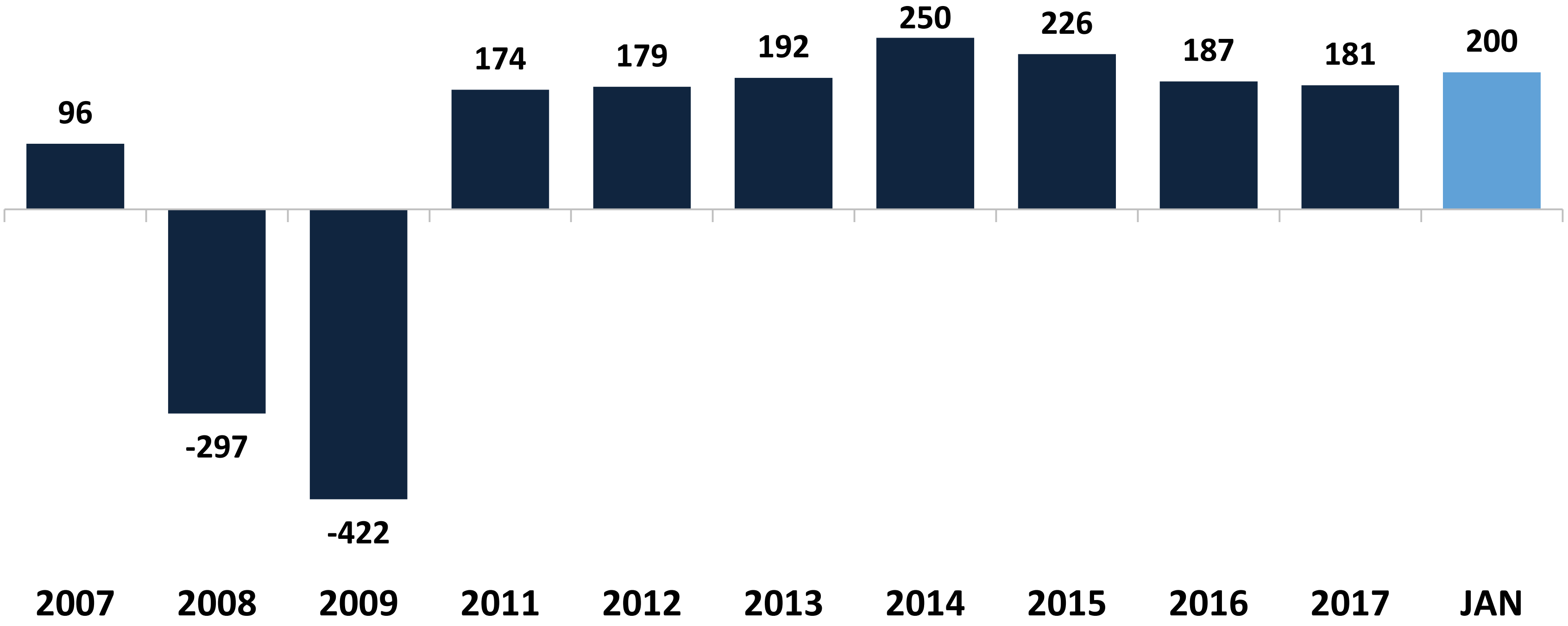
GOVERNMENT

Federal:
2011 Budget Caps
State and Local:
Improved Tax Receipts, Property Values

= Stable Outlook / Low Inflation / Patient Fed / Low Rates

Job Growth Continues to Beat Forecasts

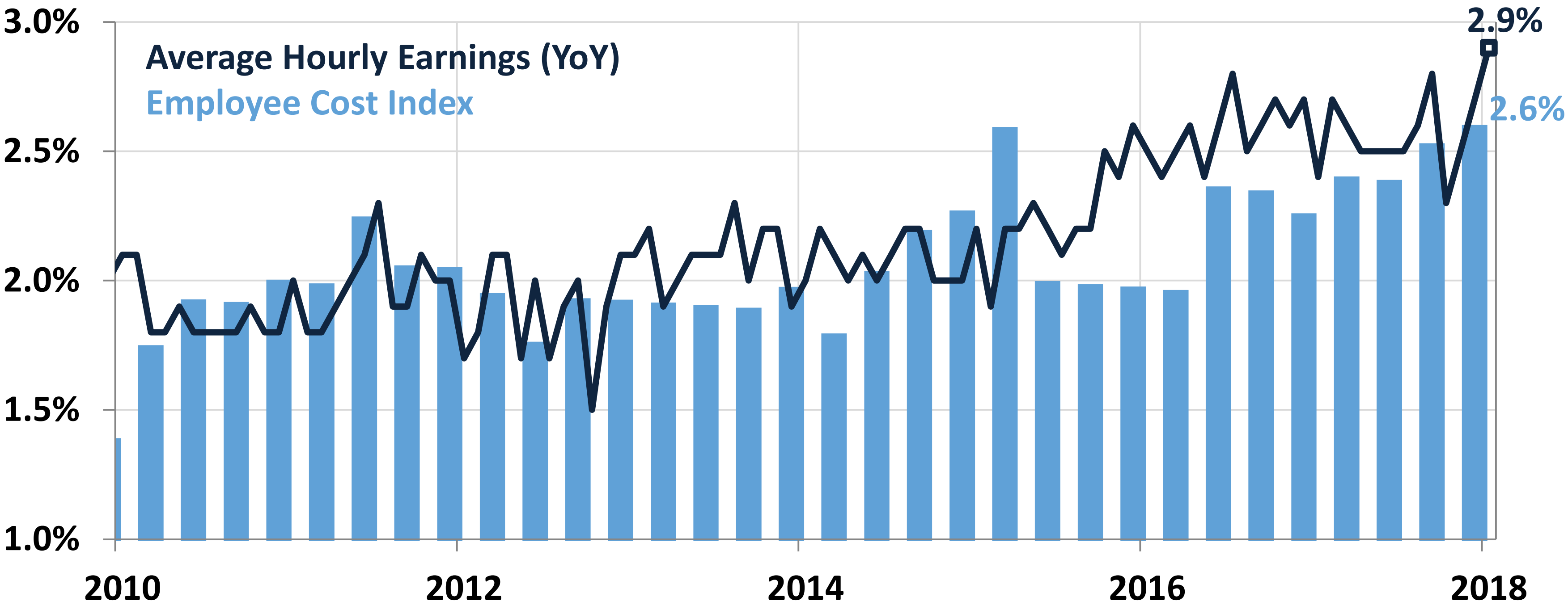
Total nonfarm payroll growth beat expectations again, initially rising 200k in January. The labor market has shown very few signs of slowing despite being almost nine years into the cycle.



Sources: BLS, Vining Sparks

Earnings Growth Shows Traction

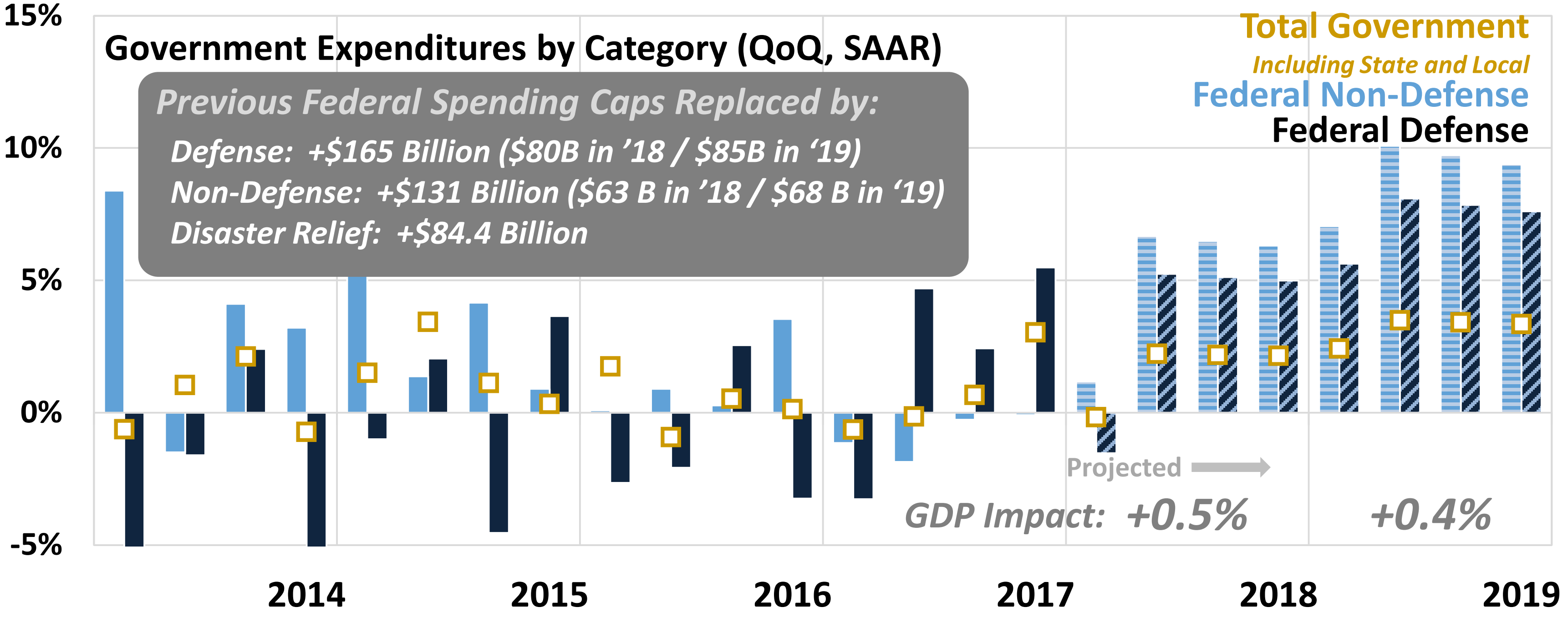
Three separate measures of wage growth showed traction in late January. While the average hourly earnings data were likely distorted by the weather, inflation fears gripped investors.



Sources: BLS, Vining Sparks

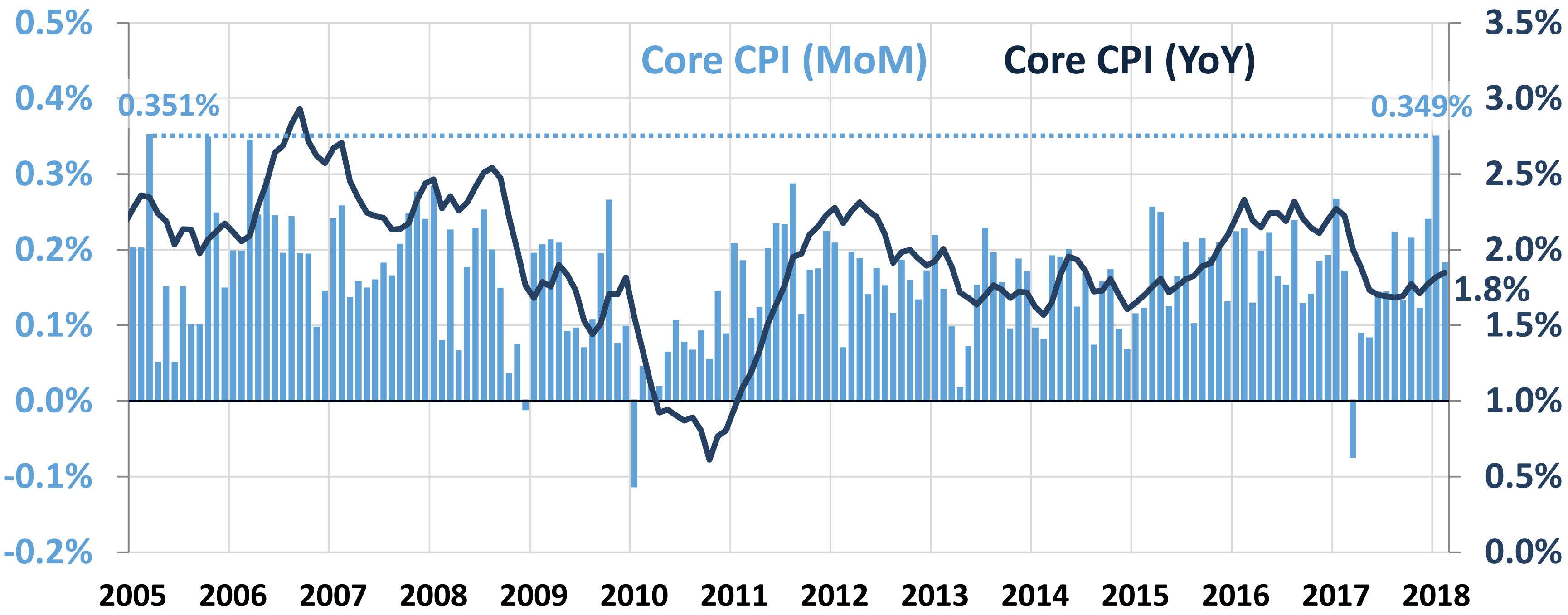
Fiscal Stimulus Added to Tailwinds

Washington agreed to lift spending caps, increasing defense spending by 24% and non-defense spending by 29% over the next two years. This will be another deficit-financed boost to GDP.



Core CPI Inflation Rises 0.35% MoM

Core CPI inflation showed the strongest monthly gain in prices since 2005, rising 0.35% MoM. While some of the increase should prove temporary, it exacerbated investors' fears.



Sources: BLS, Vining Sparks

All Economic Engines Firing

Add the boost from tax reform and more fiscal stimulus (deficit spending) to an already stable backdrop, and markets began to fear the economy over-heating.

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- Low Gas Prices
- Record-High Stocks
- Low Interest Rates
- Booming Confidence

Tax Reform

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- Unprecedented Monetary Stimulus
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GOVERNMENT

Federal:
Raised Budget Caps

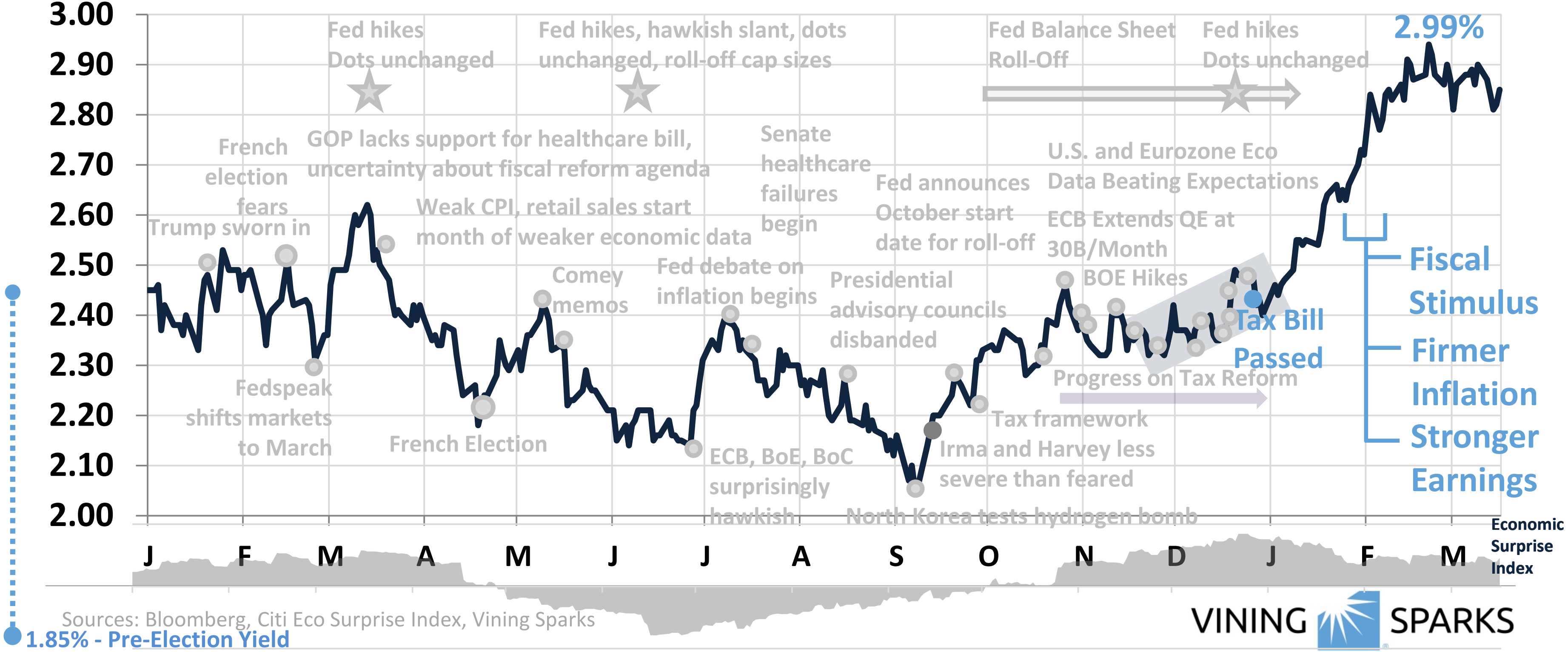
State and Local:
Improved Tax Receipts, Property Values

Fiscal Stimulus

= Hot Outlook / Risks to Inflation / Reactive Fed / Higher Rates

Investors Fear Economy Over-Heating

Driving longer interest rates have been 1) U.S. fiscal policy developments, 2) central bank actions, 3) geopolitical concerns, and 4) decent economic data.



Sources: Bloomberg, Citi Eco Surprise Index, Vining Sparks

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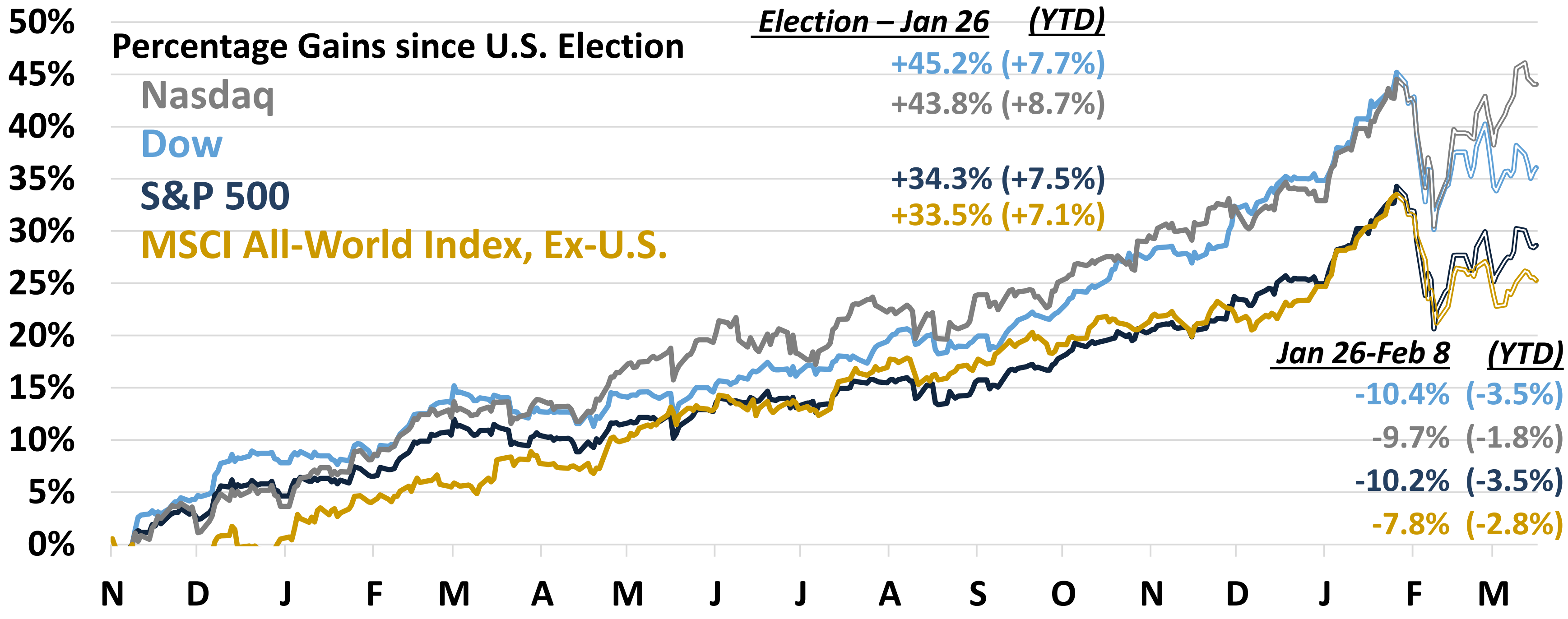
And Higher Rates Spooked Stocks

Despite the sensational news headlines, stocks have recovered and remain well above pre-election levels. As a result, the risk of frothy asset prices remains.



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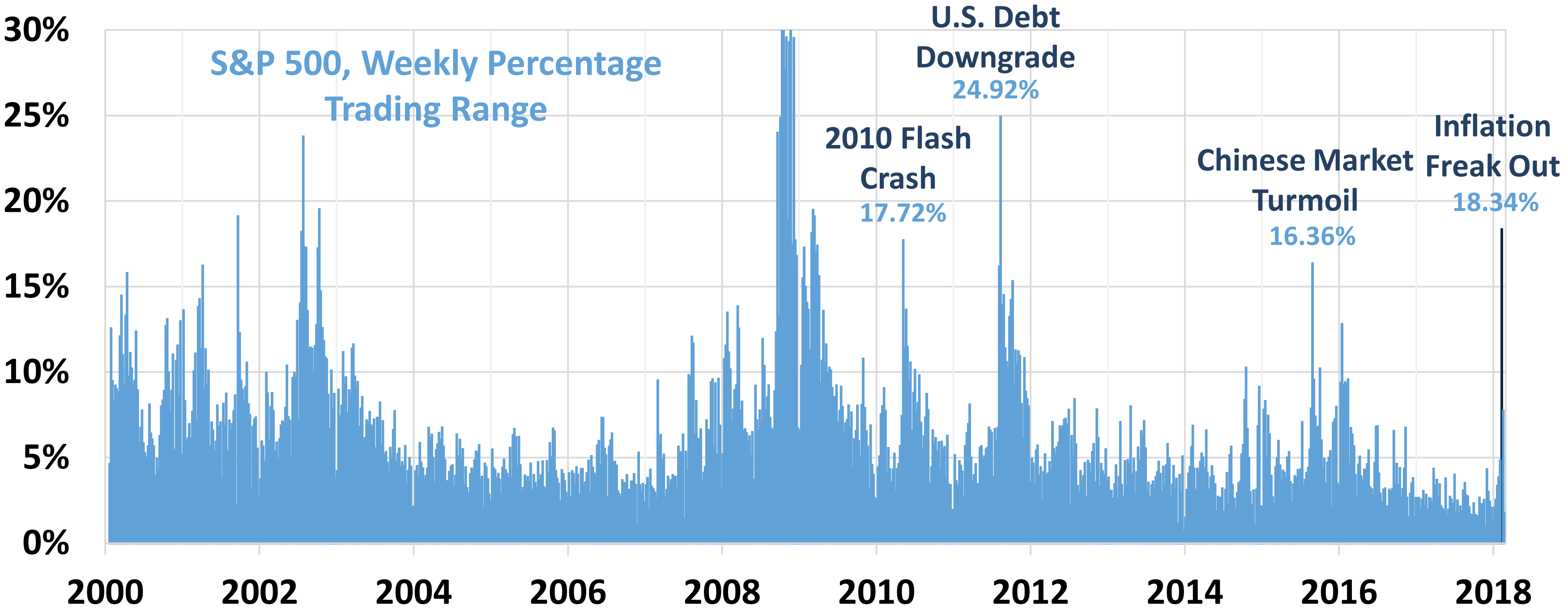
Second Wildest Week of the Cycle

Combining the intraday percentage trading ranges, those swings ultimately added up to the second wildest week for stocks since the Great Recession.



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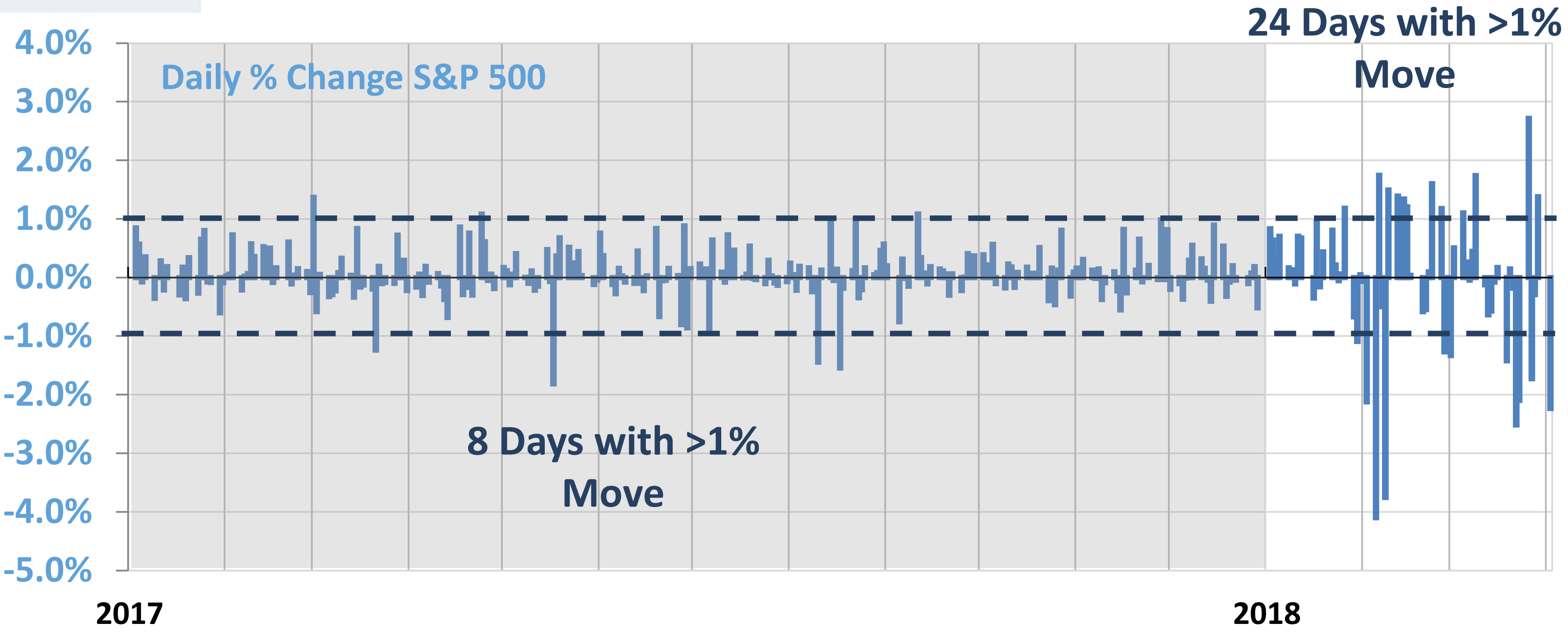


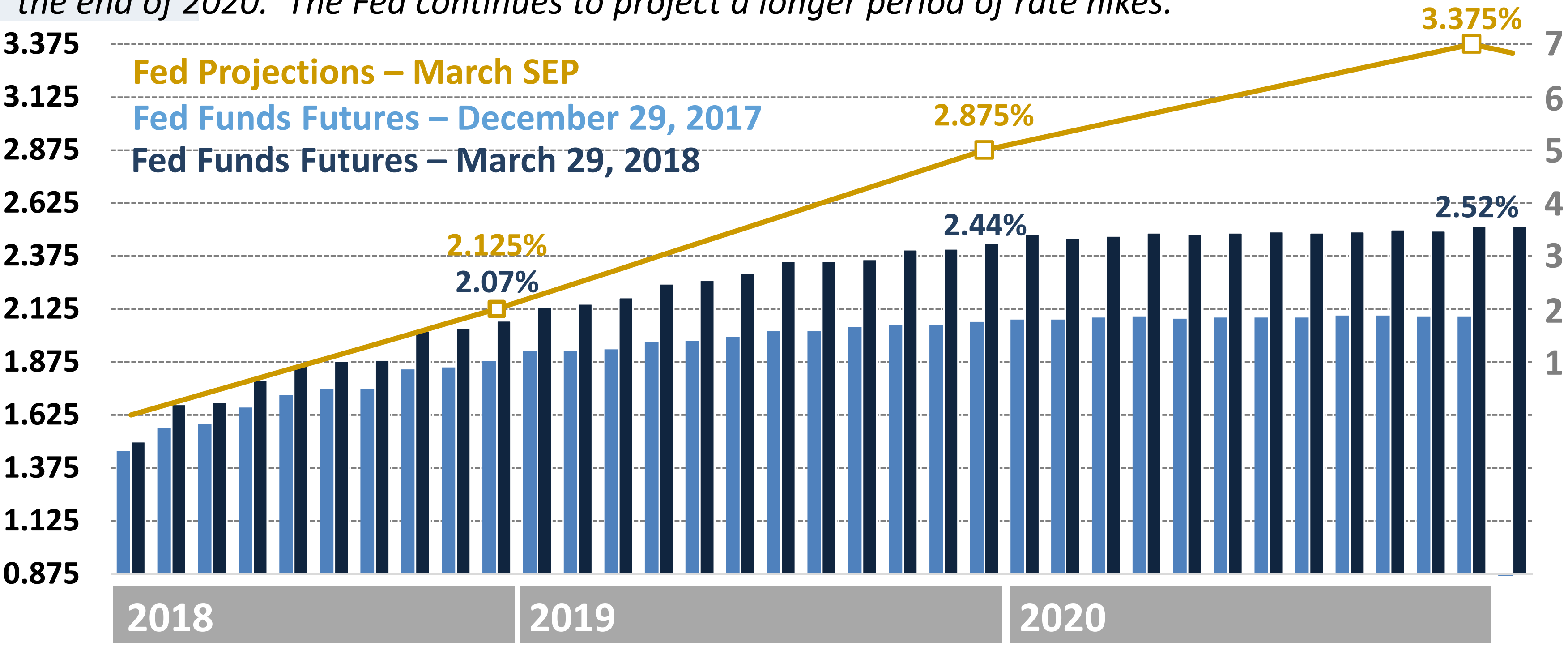
Growing Risks to Stability in 2018

The risks to economic stability are growing. As the economy begins to heat up, imbalances are likely to become more pronounced with the largest risk coming from an asset price correction.

- **Inflation** runs hotter-than-expected
- **Fed** feels they're behind the curve, leading to more a aggressive policy
- **Asset price recalibration** – stock prices, bond yields, credit spreads, cap rates
- **Volatility** excessively suppressed in financial markets, exacerbating future moves
- **Global central banks** simultaneously shift to less accommodative posture
- **Geopolitical** tensions and trade tensions
- **Mid-term elections** creating more political uncertainty
- **Longer-term obstacles** – Aging population, Federal debt, Weak productivity

Expectations for Fed Rate Hikes

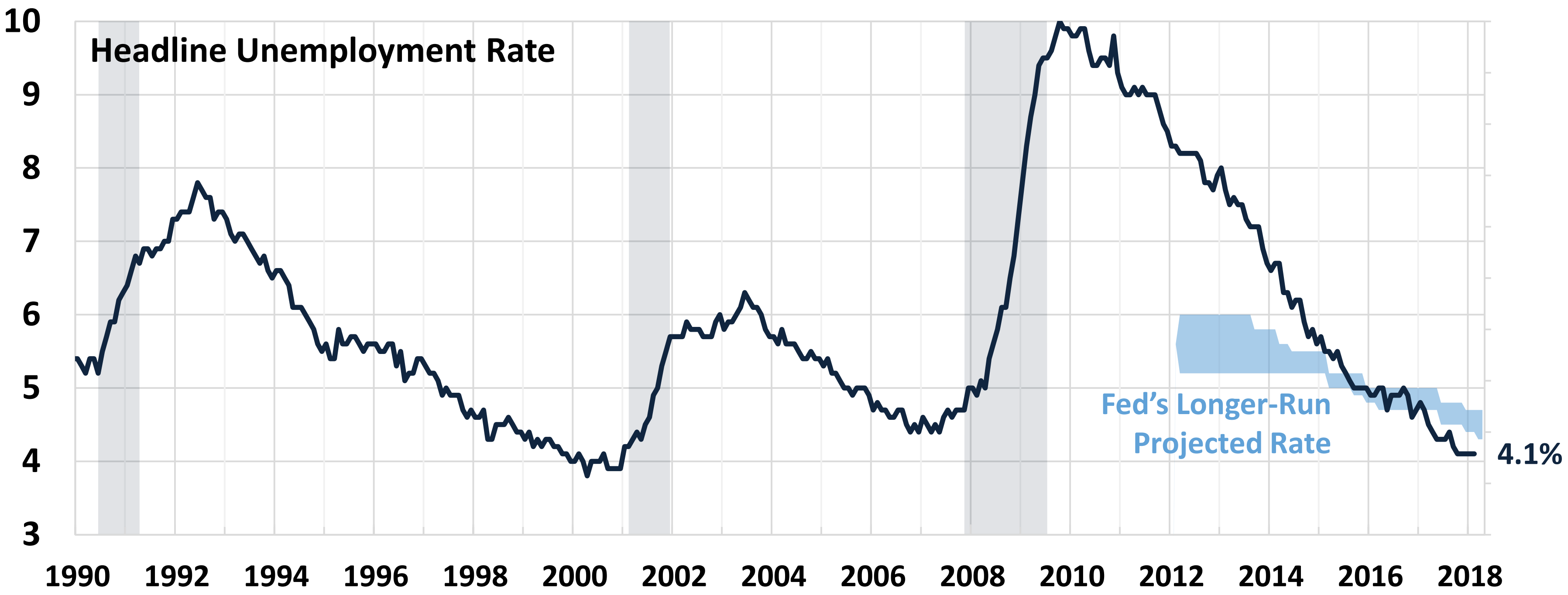
The markets are now pricing in three hikes in 2018, but only one or two additional hikes through the end of 2020. The Fed continues to project a longer period of rate hikes.



Sources: Fed Funds Futures Contracts, March 2018 Fed SEP Projections, Vining Sparks

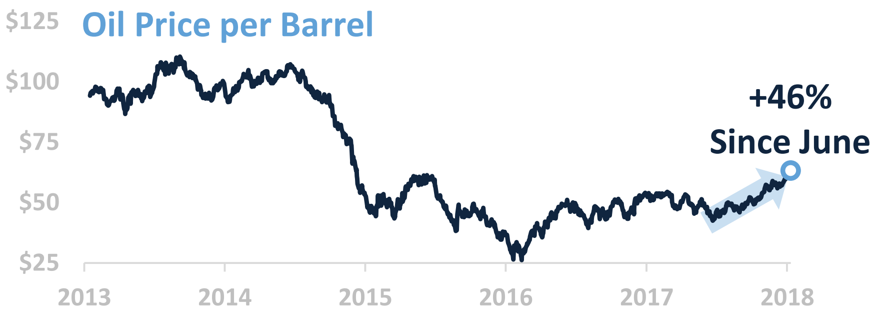
Unemployment Rate Below Target

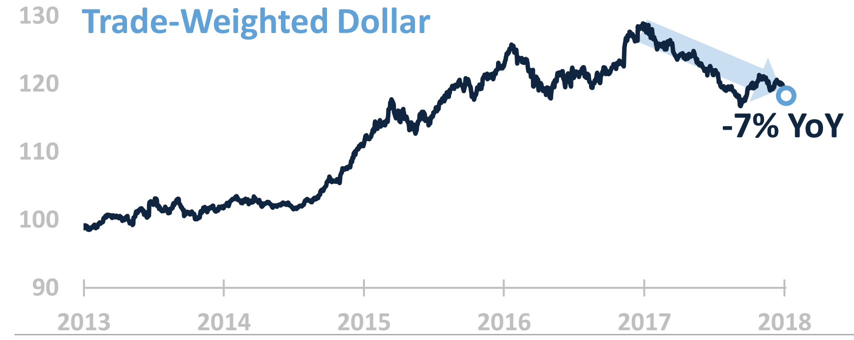
The Fed is likely to remain hawkish so long as unemployment rate 1) remains below their longer-run sustainable rate, 2) is not rising, and 3) financial conditions do not deteriorate dramatically.

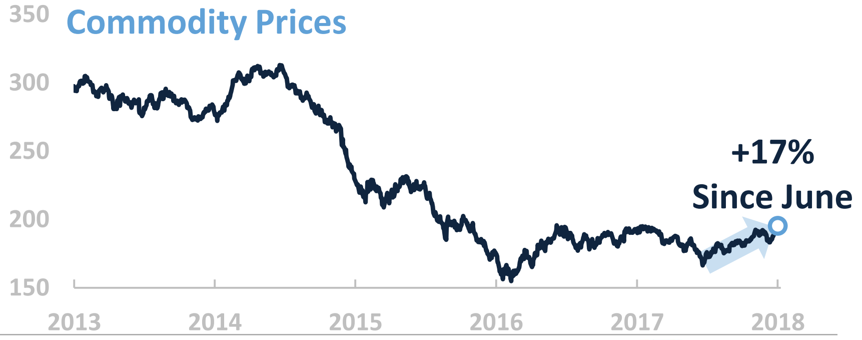


Less Risk of Disinflation in 2018

There appear to be more risks to a modest acceleration in price gains in 2018 than deceleration. Rising commodity prices, possible wage growth, and a weaker Dollar should push prices higher.







Sources: Bloomberg, CRB Core Commodity Index, NFIB, Federal Reserve, Vining Sparks

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FOMC Tilting More Hawkish

1) A strong assessment of future activity, 2) increased expectations for future growth and lower unemployment, and 3) more confidence in inflation stabilizing show a more confident Fed.

- FOMC Statement
  - **Labor Market:** "Job gains have been strong"
  - **Economic Activity:** rising at a "~~solid~~ moderate rate"
  - **Economic Outlook:** "The economic outlook has strengthened in recent months"
  - **Inflation:** "to move up ~~this year~~ in coming months"
- Powell Press Conference
  - "no sense in the data we're on the cusp" of inflation accelerating
  - Because of "the flatness of the Phillips curve"

FOMC Tilting More Hawkish

The FOMC's March SEP reflects expectations for faster growth in the short- to medium-term. However, the longer run outlook remains just 1.8%.

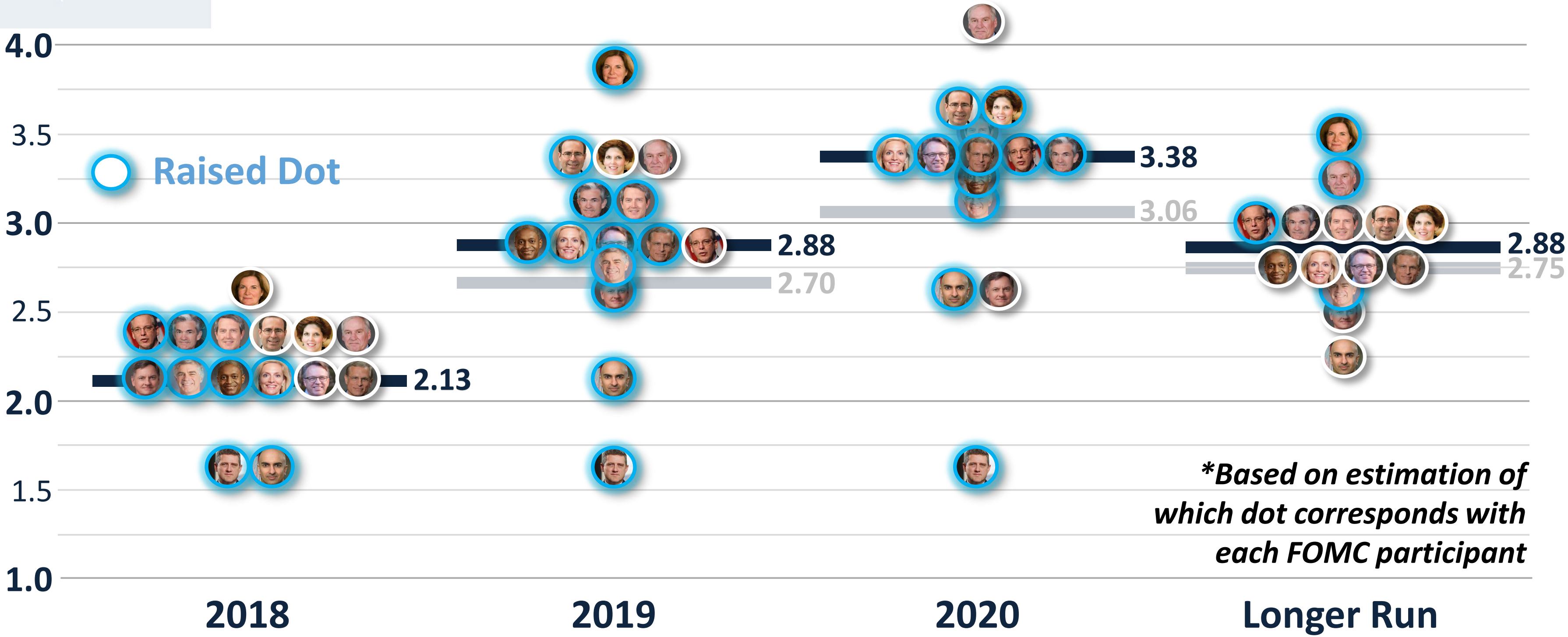
GDP Projections	2018	2019	2020	Longer Run
MARCH	2.7%	2.4%	2.0%	1.8%
	+0.2	+0.3		
DECEMBER	2.5%	2.1%	2.0%	1.8%

U.R. Projections	2018	2019	2020	Longer Run
MARCH	3.8%	3.6%	3.6%	4.5%
	-0.1	-0.3	-0.4	-0.1
DECEMBER	3.9%	3.9%	4.0%	4.6%

Sources: FOMC Summary of Economic Projections, Vining Sparks

March FOMC Dot Plot Projections

Thirty-four of forty-five dots through 2020 were raised in the March SEP.



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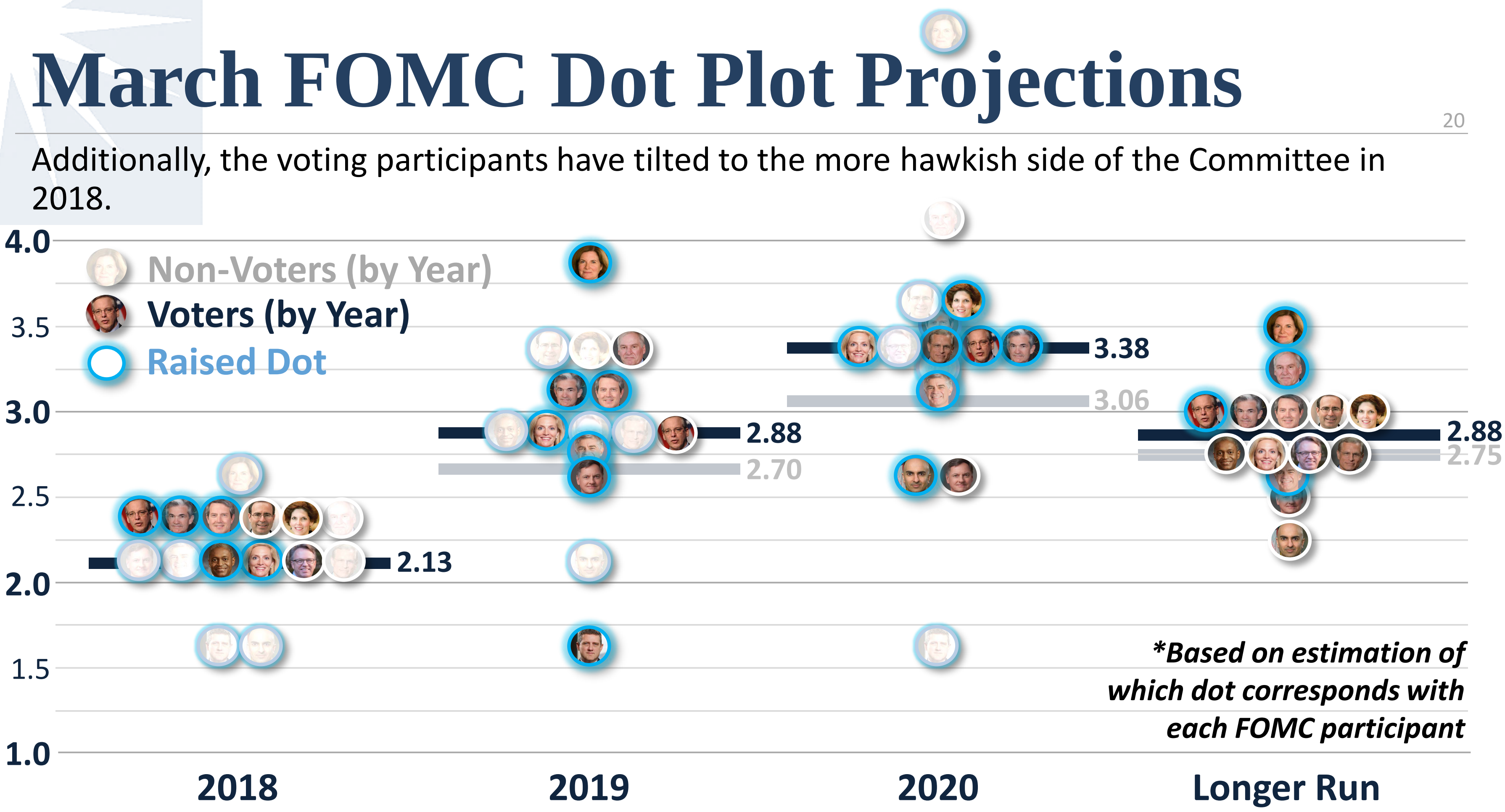
March FOMC Dot Plot Projections

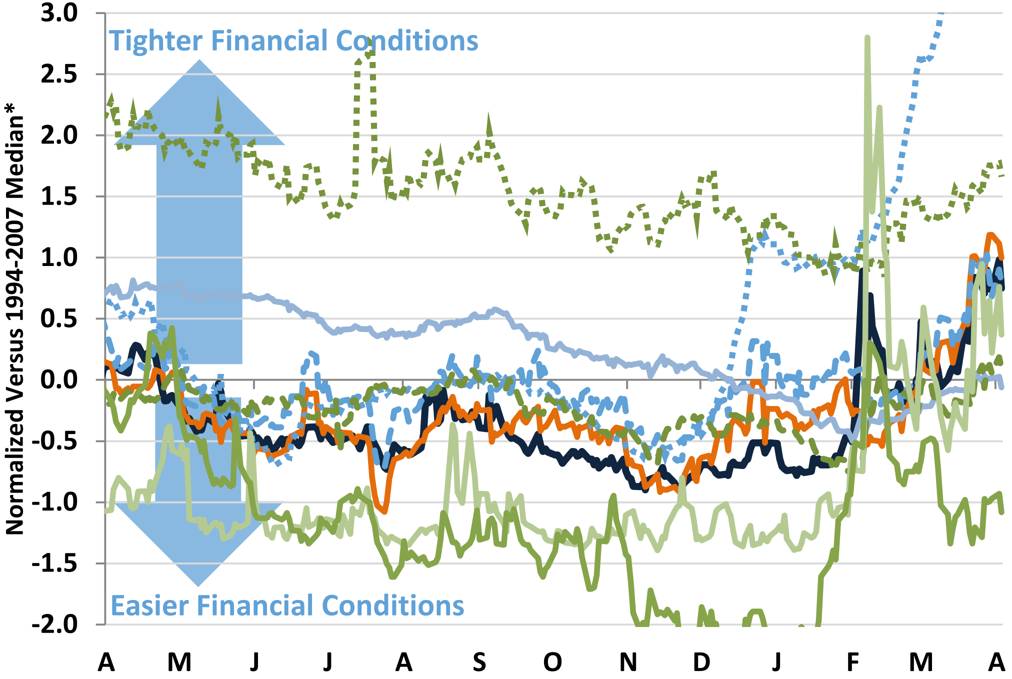
Additionally, the voting participants have tilted to the more hawkish side of the Committee in 2018.

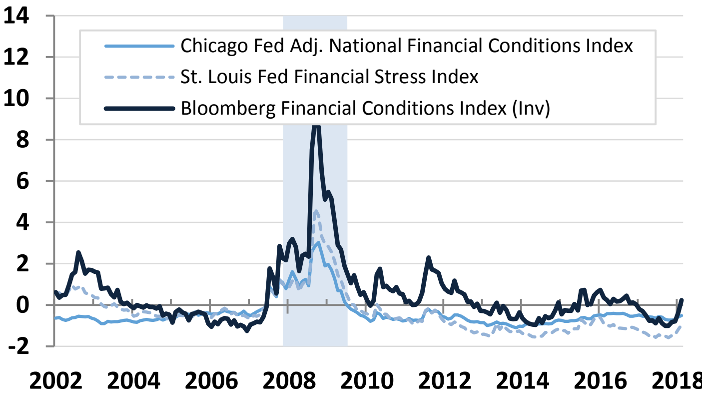


**Based on estimation of which dot corresponds with each FOMC participant*

Financial Conditions Tightening

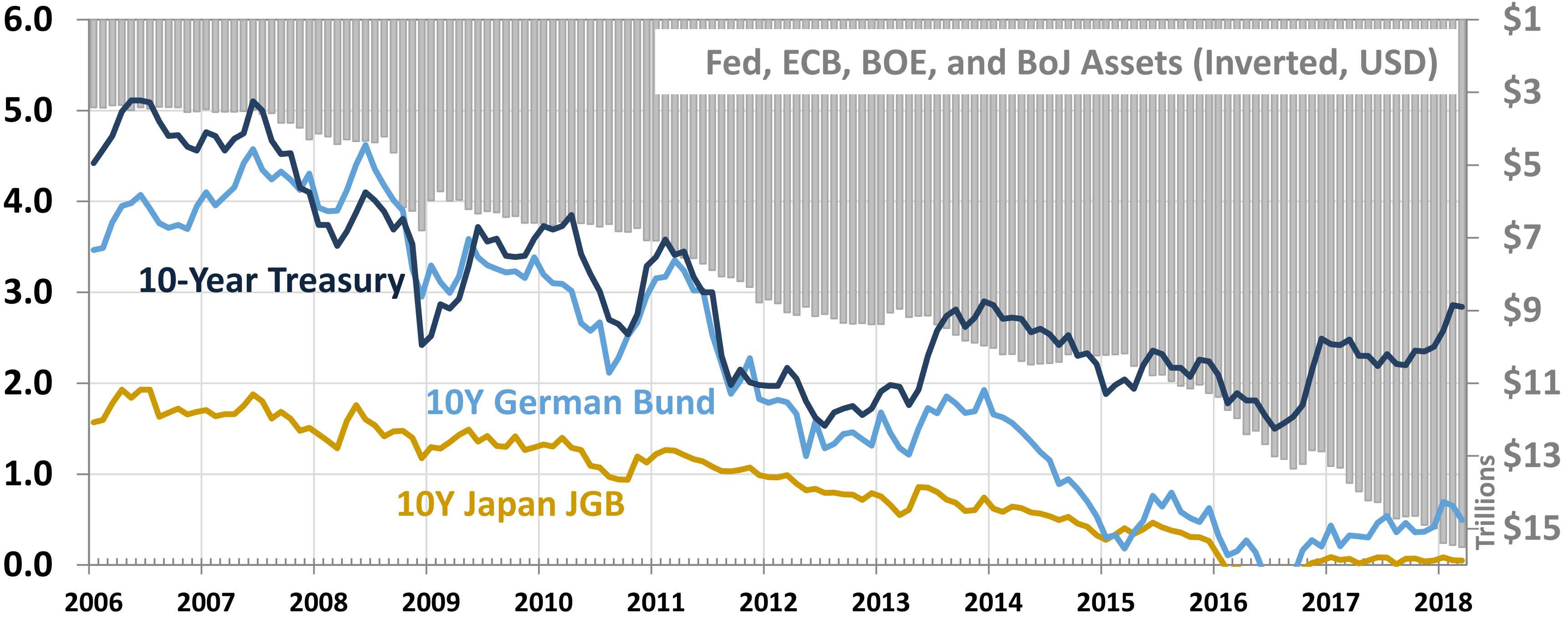
Financial conditions have tightened in 2018 as fears of inflation and higher interest rates have roiled markets. This will be key to watch and is the most likely factor to limit Fed hikes.





Longer Yields Remain Anchored

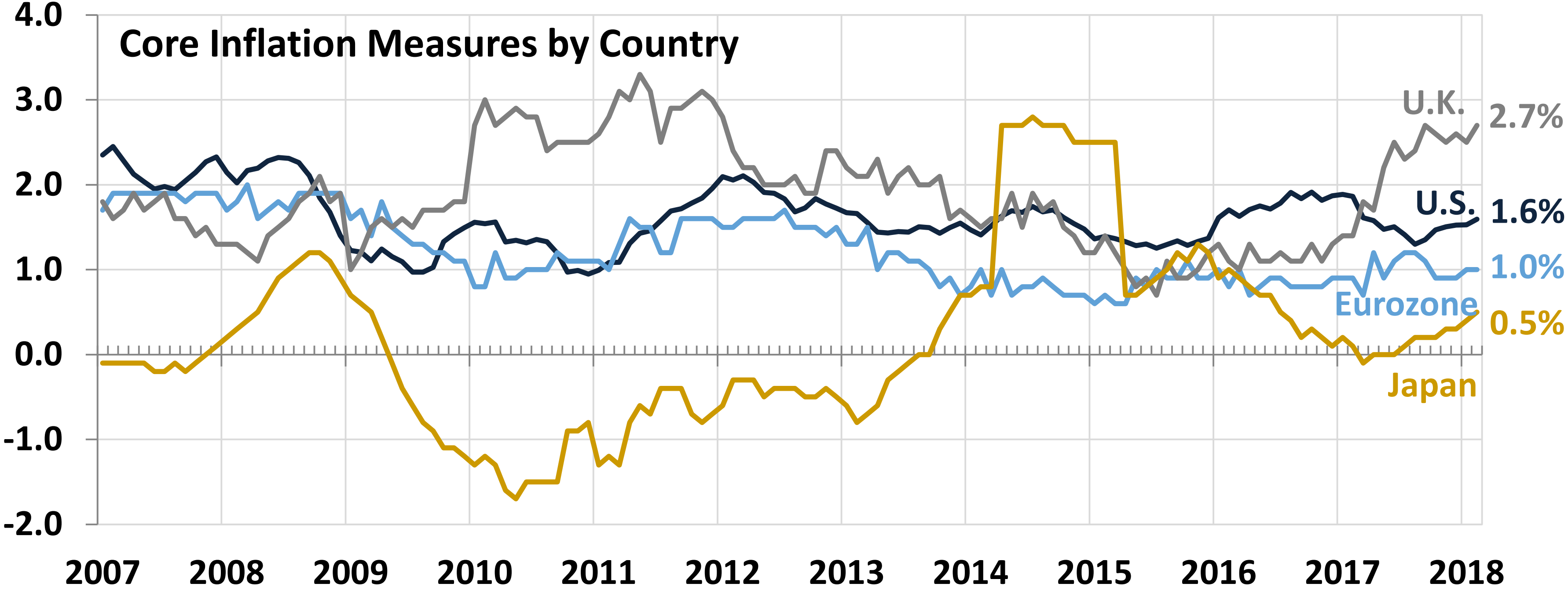
Treasury yields continue to we weighed down by global yields, generally, and the impact of still-easy monetary policy from the ECB and BoJ.



Sources: Federal Reserve, BOE, ECB, BoJ, Bloomberg, Vining Sparks

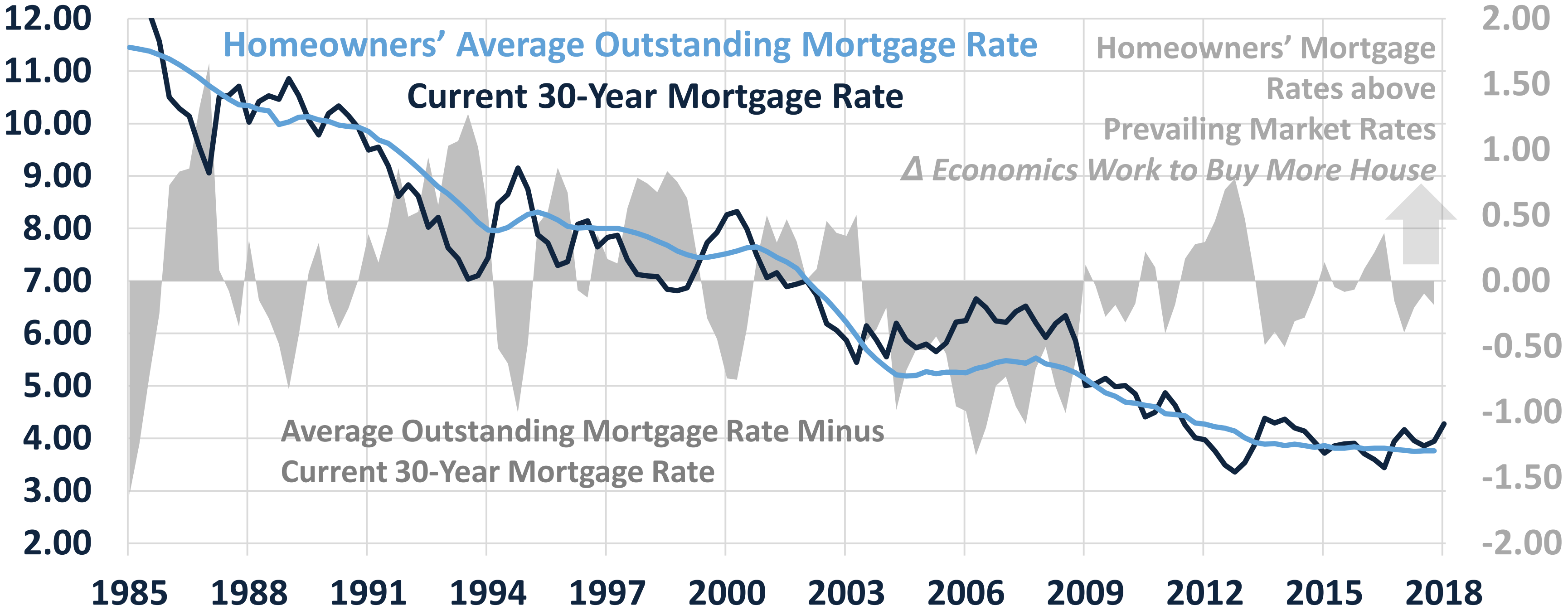
Inflation Firming, but Remains Low

Inflation in Japan and the Eurozone continue to run below-target despite the improving economic data and financial asset prices. This is likely to limit adjustments to monetary policy.



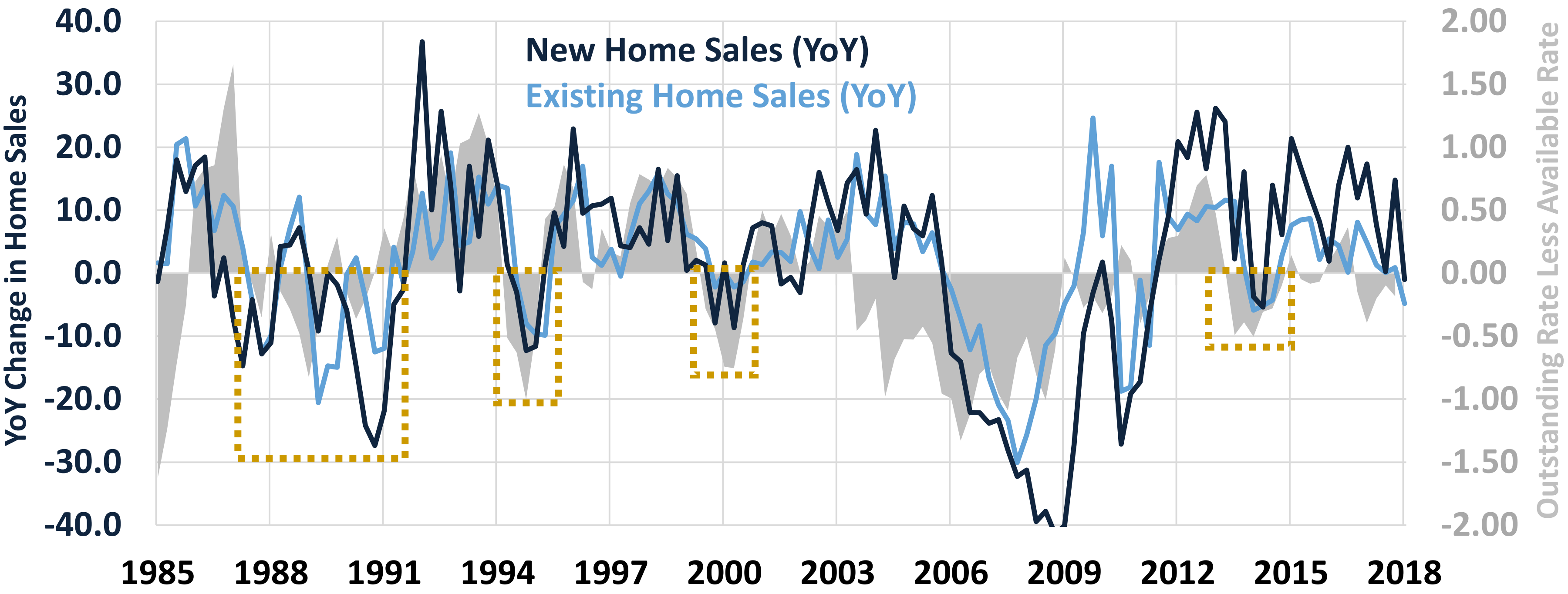
Housing Proven to Be Rate Sensitive

Home sales have proven historically to be very rate-sensitive. The higher the 10-year yield rises above 3.00% (mortgage rates above 4.75%), residential investment is likely to weaken.



Home Sales Prove to Be Rate Sensitive

Home sales have proven historically to be very rate-sensitive. The higher the 10-year yield rises above 3.00% (mortgage rates above 4.50%), residential investment is likely to weaken.



Sources: Census Bureau, NAR, Freddie Mac MMS 30-Year Mortgage Rate, Vining Sparks

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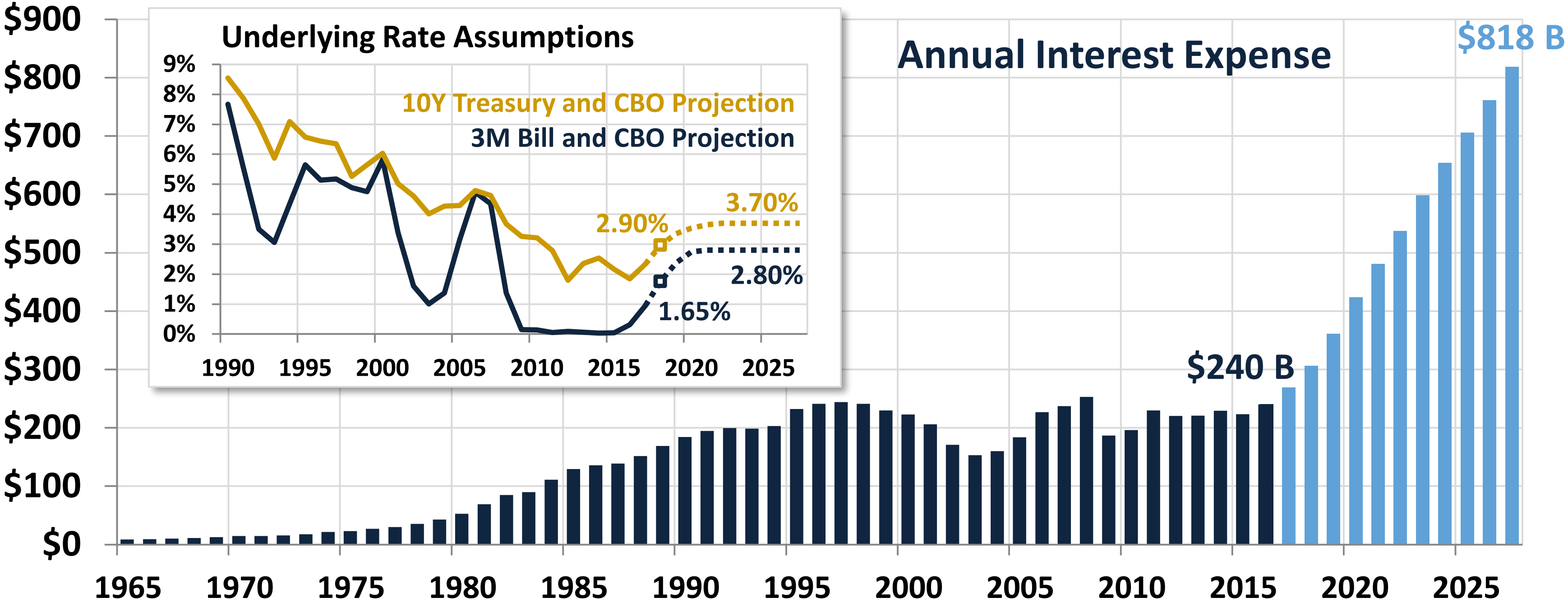
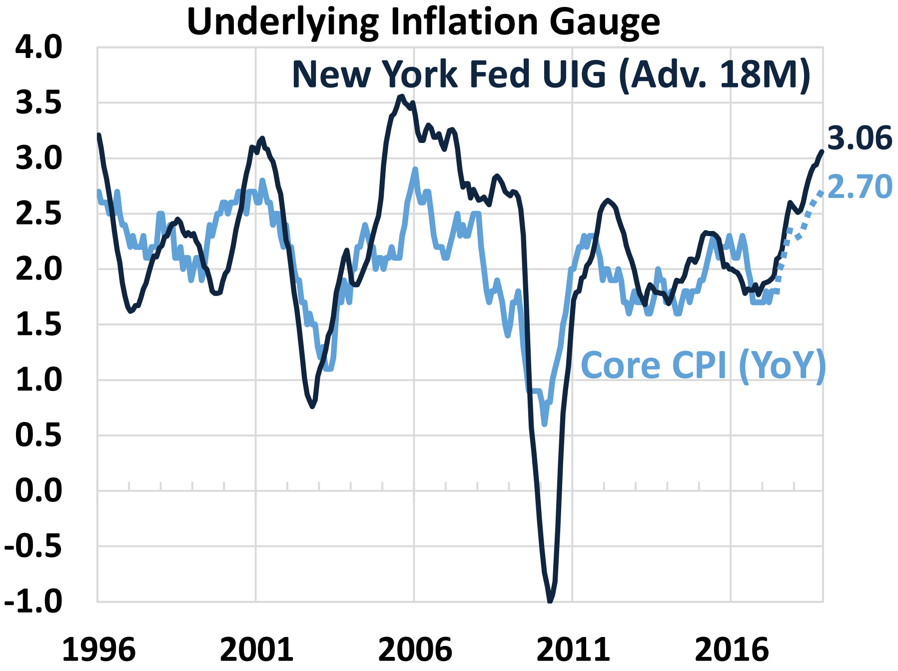
Federal Interest Expense

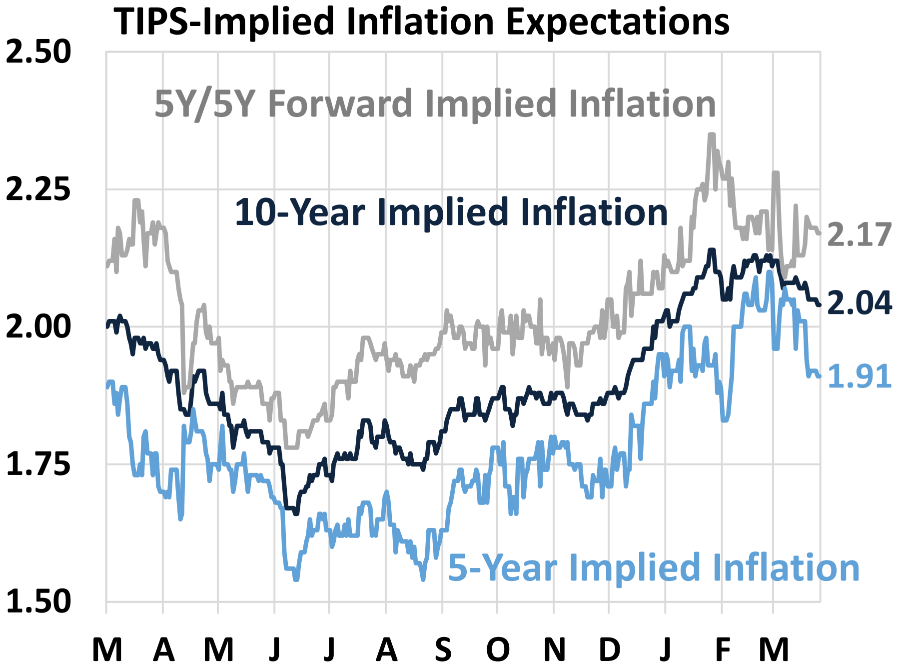
Politicians have significant incentive to keep interest rates anchored now more than ever. Using modest projections, annual interest expense is expected to rise $580 billion by 2028.



Inflation Outlook Remains Anchored

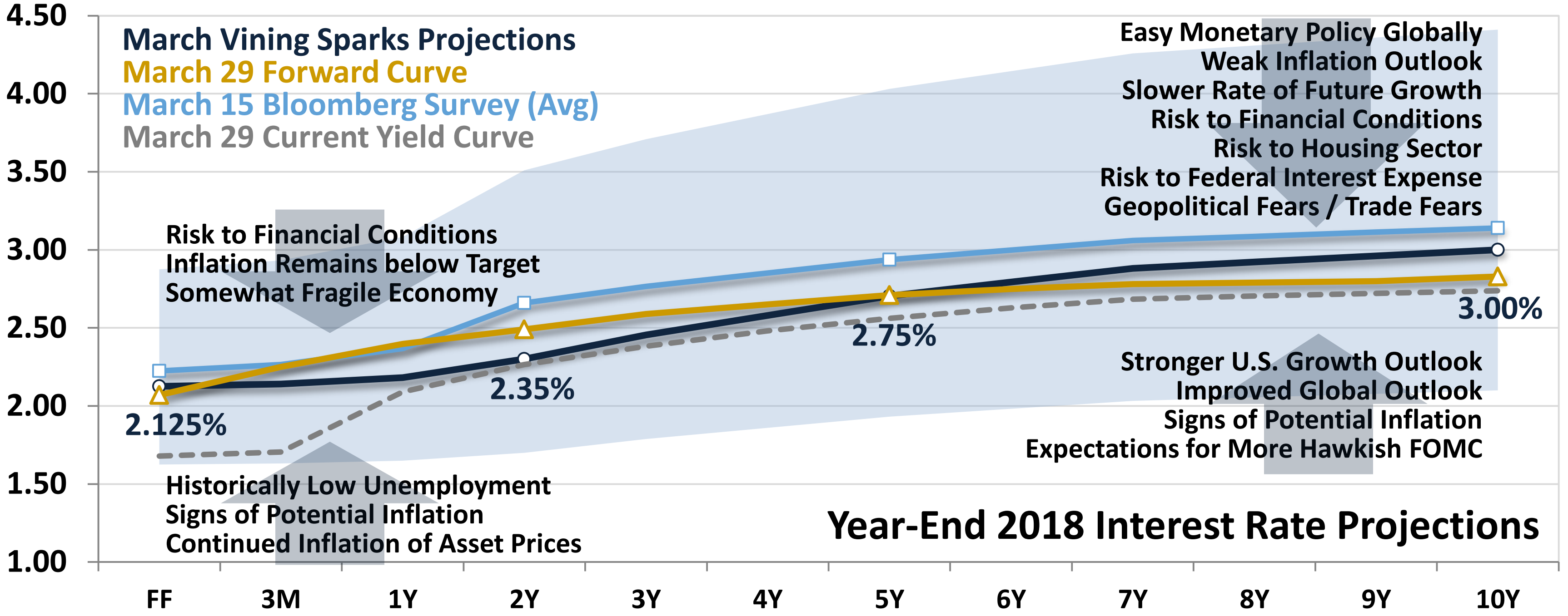
The biggest risk to longer yields rising more than expected appears to be an increase in inflation. While the New York Fed's UIG points to an imminent increase, market expectations remain tame.





Interest Rate Projections

Short-end of yield curve likely to be pressured higher from Fed hikes while longer-end responds to inflation expectations, supply/demand, global yields, and other limiting factors.



2018 Economic Outlook

- **Consumer** – Firmer wages, stronger labor market, and $140 billion boost from tax cuts
- **Business Investment** – Improved capex as a result of tax reform, particularly structures
- **Housing** – Tax reform diminishes some incentives to homeownership; however, housing should see another year of growth in 2018 - *presuming mortgage rates remain anchored*
- **Government Spending** – More deficit spending will yield better growth in the near-term but may tip the inflation scale; adds to the already excessive debt burden

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- **Risks to Growth** –
  - Rising inflation biggest risk to outlook (higher interest rates, asset price correction, etc…)
  - Too much of a good thing leads to correction-inducing imbalances
  - Fed walking tightrope in removing support without roiling markets

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- **Interest Rates (Short Maturities)** – Fed likely to remain hawkish so long as financial conditions remain easy, particularly with unemployment below-target
- **Interest Rates (Longer Maturities)** - Longer yields likely to rise moderately on tug-of-war between stabilizing inflation, improving growth, and global supply/demand

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- **Longer Term Outlook** – Aging population ▪ Weak productivity ▪ Excessive debt

Vining Sparks Projections

March 2018

	Q118	Q218	Q318	Q418	Q119	Q219	2018	2019
GDP (QoQ, SAAR)	2.4	3.0	2.9	2.7	2.3	2.7	2.9	2.3
Headline CPI (YoY)	1.9	2.2	2.2	2.2	2.0	1.9	2.2	2.1
Core PCE (YoY)	1.6	2.0	2.1	2.1	1.9	1.7	1.7	1.9
Unemployment Rate	4.0	3.9	3.8	3.8	3.9	4.1	3.9	3.9
Nonfarm Payrolls (Monthly)	234	170	190	170	160	160	190	165

Fed Funds Target	Q118	Q218	Q318	Q418	Q119	Q219	Q319	Q419
Fed Funds Target	1.63	1.63	1.88	2.13	2.13	2.13	2.13	2.13
2-Year Treasury Yield	2.30	2.35	2.30	2.30	2.30	2.35	2.35	2.35
10-Year Treasury Yield	2.85	2.85	2.90	3.00	3.00	3.00	3.00	3.00
30-Year Treasury Yield	3.04	3.02	3.10	3.24	3.24	3.22	3.22	3.22
Prime Rate	4.75	4.75	5.00	5.25	5.25	5.25	5.25	5.25
30-Year Mortgage Rate	4.50	4.50	4.55	4.65	4.65	4.65	4.65	4.65

Bloomberg March Survey

Survey Date: 3/15/2018

	Q118	Q218	Q318	Q418	Q119	Q219	2018	2019
GDP (QoQ, SAAR)	2.5	3.0	2.9	2.6	2.4	2.4	2.8	2.4
Headline CPI (YoY)	2.3	2.6	2.6	2.3	2.2	2.3	2.4	2.2
Core PCE (YoY)	1.6	1.8	2.0	2.0	2.0	2.0	1.8	2.0
Unemployment Rate	4.1	4.0	3.9	3.8	3.8	3.7	3.9	3.7
Nonfarm Payrolls (Monthly)	234	180	175	170	151	150	190	153

Fed Funds Target	Q118	Q218	Q318	Q418	Q119	Q219	Q319	Q419
Fed Funds Target	1.58	1.83	2.03	2.23	2.43	2.58	2.73	2.83
2-Year Treasury Yield	2.32	2.39	2.53	2.66	2.80	2.91	3.01	3.07
10-Year Treasury Yield	2.92	2.95	3.05	3.14	3.23	3.33	3.43	3.48

**Sources: Bloomberg Survey of Economists, Economists' Real-Time Updates, Vining Sparks*