December 2017
Vining Sparks' 2018 Forecast—Policy Makers Key to Delivering Accelerated Growth

Heading into 2018, we now expect the economy to match its fastest pace of growth of this cycle, expanding 2.7% for the full year. This is the outworking of 1) a solid consumer, 2) record-high business confidence and the subsequent expectation for improving business investment, 3) tepid growth—albeit growth—in the housing market, 4) little-to-no drag from government expenditures, 5) improving U.S. exports from the synchronization of growth globally, 6) still-easy financial conditions and the resulting economic effects, and 7) the passage of tax reform boosting consumer and business confidence and activity. While there remain very few indications of the economy overheating at this point in the cycle, we see risks beginning to emerge as growth accelerates and financial market valuations remain high.

Business Investment

While Congress has seen more gridlock than expected this past year, the President and his Cabinet have already boosted business confidence through a variety of regulatory rollbacks. Those are likely to continue in 2018. Perhaps more importantly, modernizing the U.S. tax code should continue to boost the confidence of business leaders, much as it has done this past year. Presuming passage of a tax bill similar to the current working documents, the expensing benefits should be a catalyst for business investment while a one-time deemed repatriation would bring large amounts of Dollars back to the country, potentially facilitating even more business investment. Against a backdrop of a stable consumer and better growth indicators globally, business investment is likely to be an even-more positive engine of growth for the economy in 2018. Moreover, a boon in investment is likely the best opportunity to improve productivity—which could then lead to better wage growth and firmer inflation.

Personal Consumption

Consumers are once again poised to be a steady engine of growth for the economy. As discussed below, the labor market continues to improve boosting the spending power of consumers. Financial markets ran wild in 2017 with the Dow, S&P, and Nasdaq hitting a combined 199 new record-high closes through mid-December. The ever-lower unemployment rate and record-high stock prices have boosted consumer confidence to the highest level since 2000. Additionally, the prospects of tax reform could put even more wind behind consumers' sails in 2018. Thus far, gains in consumption have not been driven by an accelerated leveraging cycle as seen in the early 2000s. Overall debt levels remain well contained. However, younger generations are facing elevated debt from burgeoning student loans which are creating, and will continue to, challenges for that demographic. Nonetheless, with an improving labor market, modest wage growth, high confidence, and contained debt; the consumer is poised to continue driving the economy at a stable rate in 2018. The biggest risk to the consumer, at this time, appears to be a drop in asset valuations as the Fed continues its tightening cycle.

Government Spending

Government spending was, once again, a non-issue for overall economic growth in 2017. In 2010, as the A.R.R.A. wound down, government spending proved to be a constant drag on overall growth. That reversed in 2014 with government becoming fractionally accretive to growth. Heading in 2018, President Trump has indicated that he will lay out his infrastructure spending plans prior to the January 30 State of the Union speech. A large, deficit-funded plan is highly unlikely to be approved given the likely increase to deficit projections in the tax reform proposals. However, a small deal is more likely and government spending could become minimally accretive to growth once again. One item worth noting is the impact of rising interest rates on the government's interest expense. This will increasingly begin to crowd out productive government investment as the Fed pushes rates higher.

Labor market

The unemployment rate fell more than Fed officials and private economists expected in 2017, dropping from 4.6% to 4.1%. The Fed now estimates that 4.6% is a sustainable rate longer term; thus, the rate is currently 0.5% below what they see as sustainable. Going into 2018, there are no signs that the drop in the headline rate will stop. The Fed now projects the unemployment rate will end 2018 at 3.9% while we project 3.8%. In addition to the drop in the headline rate, measures of labor slack continued to decline and nonfarm payroll growth beat economists' expectations for the year (exp. +154k per month / act. +174k per month). The most confounding aspect of the tightening labor market has been the continued lack of wage growth. Given the historical relationship between unemployment and wage growth, one would expect average hourly earnings to be growing over 4.0% year-over-year. However, earnings remains stuck at 2.5%. Heading into 2018, one of the biggest questions for Fed officials, and therefore the markets, is if wage growth will finally gain traction as all the indicators suggest. If so, it would likely cause the Fed to hike more assertively. If not, the Fed is likely to begin questioning their slow-and-steady approach. We continue to expect more modest wage growth.

Housing

The housing market will continue to be affected by cross currents in coming years. While residential activity managed minimal growth in 2017, it was a rocky path. New home sales rose 19% YoY but existing home sales fell 1%. Building permits rose 2% but new housing starts fell 3%. But while the sales and construction data were mixed, home prices continued to rise at a 6% YoY rate. Herein lies one of the cross currents heading into 2018—lower affordability. Home prices steadily rising twice as fast as income growth is weighing on affordability for many homebuyers. Going forward, any meaningful increase in mortgage rates will exacerbate the affordability problem. For now, mortgage rates have remained low. The 30-year mortgage rate rose from 3.47% just prior to the 2016 election to 4.32% by the end of 2016. It has since dropped back to 3.93% and remains a tailwind for the time being. Overall residential investment dragged 0.1% cumulatively from the first three quarters of economic growth in 2017; and, we expect this flat trend to continue in 2018.

Forecast Implications

GDP Growth

Given the backdrop of improving business investment, a strong consumer, positive global growth, a flat housing market, and no drag from government spending (with the potential for a small uptick); we expect the economy to expand 2.7% in 2018. Additionally, if the full tax reform proposals are implemented and an infrastructure spending package is approved, there appear to be upside risks to our projection. Nonetheless, there will continue to be structural headwinds to sustaining a growth rate of 3% or higher.

Interest Rates

Longer-maturity interest rates are poised to end 2017 very near our expectations coming into the year. The 10-year Treasury yield is currently trading at 2.36% (forecast 2.40%) and has been largely range-bound for the majority of the year. We expect the yield will continue to be weighed down in 2018 by global demand for safe, positive-yielding assets. Additionally, investors are likely to look through the short-term bump in growth to economists' longer-run expectation of 2.0% GDP growth. Slightly firmer inflation expectations and slightly higher global interest rates are likely to lead the 10-year yield higher as the year progresses. We project the 10-year Treasury will end 2018 near 2.75%.

The rise in the 2-year Treasury yield this past year was larger-than-expected (current 1.80%, forecast 1.30%). The increase came as the Fed surprised investors with three rates hikes in 2017 (forecast 2 hikes) despite weaker-than-target inflation. The combination of a tighter-than-expected labor market and ultra-easy financial conditions apparently outweighed below-target inflation. The Fed is, once again, projecting three rate hikes for the upcoming year. And, once again, we expect there will be two hikes as we expect inflation will remain benign and stock prices will begin to level off. As such, we expect the 2-year Treasury yield to end 2018 at 2.10%, up 30 basis points from the current level.

Risks to Forecast

The biggest risks to the forecast appear to be 1) failure to pass tax reform, 2) a marked downturn in the stock markets, 3) a rapid or larger-than-expected increase in interest rates, 4) meaningfully faster wage growth, and 5) exogenous geopolitical events. The presumption of tax reform passing, in some form, underlies our overall growth expectations for 2018. If this does not materialize, it is likely that stock prices would correct, business confidence would fall, consumer confidence would fall, and economic activity would slow. If wage growth were to finally take hold, the Fed would be much more likely to increase the pace of rate hikes. If they were to hike too aggressively, it would necessarily change the calculus for asset valuations and likely lead to a material drop in stock valuations. Given the importance of high equity prices to consumer and business confidence, such an event would likely affect consumption and investment trends quickly. Another threat, in the same vane, is a change in direction from the European Central Bank. With their overnight rate currently targeted at –0.4%, there remains significant demand globally for high-grade sovereign debt at positive yields. This has been one factor anchoring longer-maturity Treasury yields. If the ECB were to unexpectedly begin raising their target rate, it could lift one of the lids from longer Treasury yields, having an immediately deleterious impact on the U.S. economy. Finally, there are at any given time geopolitical risks present and 2018 will be no different. Top of the list for the coming year are potential conflicts with North Korea, unrest in the Middle East, and international trade negotiations gone awry. However, the risks heading into 2018 appear to be less acute than they were at the beginning of 2017.

BLOOMBERG SURVEY OF ECONOMISTS (Economic Projections)

December 2017 Survey Results

	Q4 2017	Q1 2018	Q2 2018	Q3 2018	Avg. 2017	Avg. 2018
GDP						
Bloomberg Forecast (December)	**2.6%**	**2.3%**	**2.5%**	**2.3%**	**2.3%**	**2.5%**
Vining Forecast (December)	*2.6%*	*2.2%*	*3.1%*	*2.8%*	*2.4%*	*2.7%*
Bloomberg Forecast (November)	2.7%	2.2%	2.5%	2.2%	2.2%	2.4%
Bloomberg Forecast (October)	2.7%	2.2%	2.4%	2.2%	2.2%	2.4%
Bloomberg Forecast (September)	2.4%	2.1%	2.3%	2.2%	2.2%	2.3%
CPI YoY%						
Bloomberg Forecast (December)	**2.1%**	**1.9%**	**2.3%**	**2.3%**	**2.1%**	**2.1%**
Vining Forecast (December)	*2.1%*	*1.7%*	*2.0%*	*2.0%*	*2.1%*	*2.0%*
Bloomberg Forecast (November)	2.0%	1.7%	2.2%	2.2%	2.1%	2.1%
Bloomberg Forecast (October)	1.9%	1.6%	2.2%	2.2%	2.1%	2.1%
Bloomberg Forecast (September)	1.7%	1.5%	2.0%	2.1%	2.0%	1.9%
Unemployment Rate						
Bloomberg Forecast (December)	**4.1%**	**4.0%**	**4.0%**	**3.9%**	**4.4%**	**4.0%**
Vining Forecast (December)	*4.2%*	*4.0%*	*3.9%*	*3.8%*	*4.3%*	*3.9%*
Bloomberg Forecast (November)	4.2%	4.1%	4.1%	4.1%	4.4%	4.1%
Bloomberg Forecast (October)	4.3%	4.2%	4.1%	4.1%	4.4%	4.2%
Bloomberg Forecast (September)	4.3%	4.2%	4.2%	4.2%	4.4%	4.2%
Average Monthly Payrolls (000s)						
Bloomberg Forecast (December)	**211**	**175**	**169**	**160**	**175**	**163**
Vining Forecast (December)	*190*	*170*	*165*	*160*	*174*	*163*
Bloomberg Forecast (November)	200	168	160	151	170	158
Bloomberg Forecast (October)	184	167	158	152	166	158
Bloomberg Forecast (September)	167	165	155	150	175	156

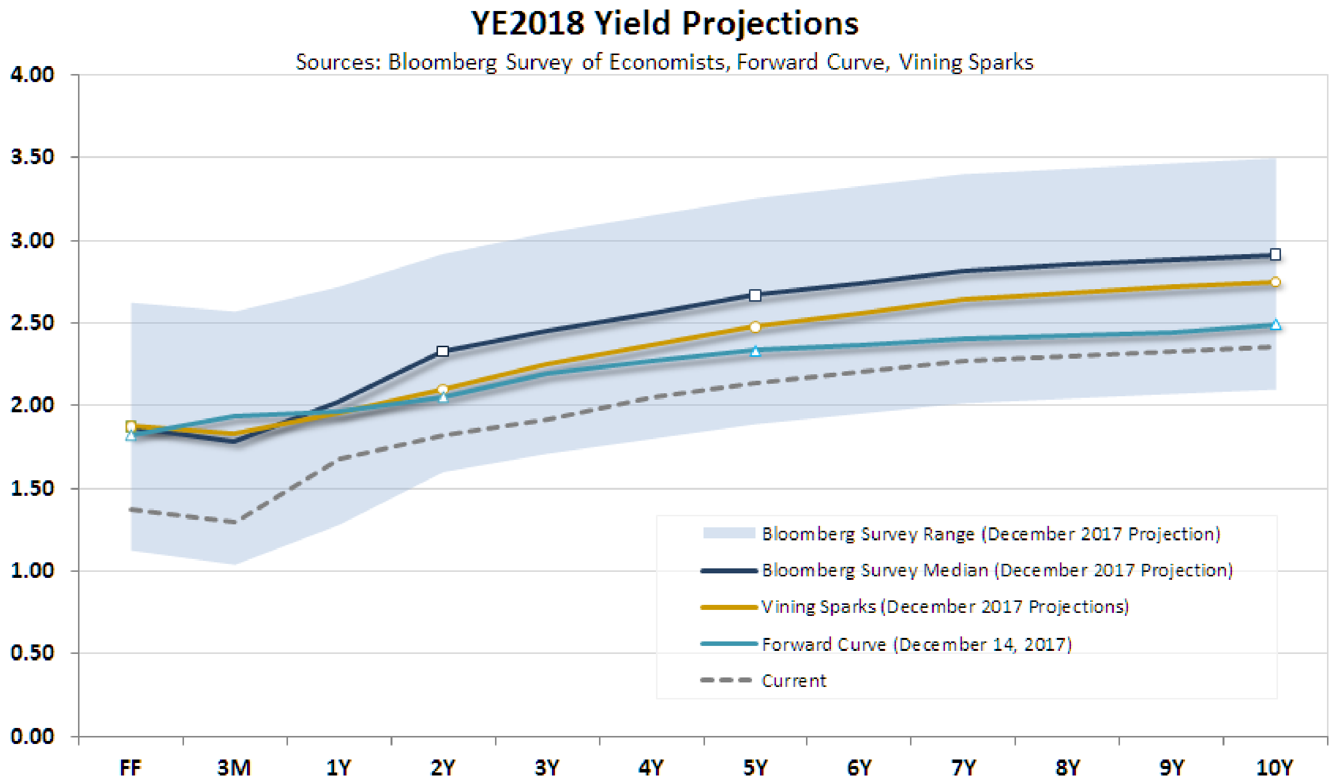
BLOOMBERG SURVEY OF ECONOMISTS (Interest Rate Projections)

December 2017 Survey Results

	Q4 2017	Q1 2018	Q2 2018	Q3 2018	Q4 2018	Q1 2019
Federal Funds Target Rate (Median of Upper and Lower Bounds)*						
Bloomberg Forecast (December)	**1.375%**	**1.625%**	**1.625%**	**1.875%**	**2.125%**	**2.125%**
Vining Forecast (December)	*1.375%*	*1.625%*	*1.625%*	*1.875%*	*1.875%*	*1.875%*
Bloomberg Forecast (November)	1.375%	1.375%	1.625%	1.875%	1.875%	2.125%
Bloomberg Forecast (October)	1.375%	1.375%	1.625%	1.875%	1.875%	2.125%
Bloomberg Forecast (September)	1.375%	1.375%	1.625%	1.875%	1.875%	2.125%
2-Year Treasury Rate						
Bloomberg Forecast (December)	**1.80%**	**1.90%**	**2.09%**	**2.20%**	**2.33%**	**2.50%**
Vining Forecast (December)	*1.80%*	*1.90%*	*1.95%*	*2.05%*	*2.10%*	*2.15%*
Bloomberg Forecast (November)	1.65%	1.81%	2.01%	2.18%	2.31%	2.49%
Bloomberg Forecast (October)	1.60%	1.79%	1.95%	2.12%	2.29%	2.44%
Bloomberg Forecast (September)	1.60%	1.80%	2.00%	2.15%	2.30%	2.53%
10-Year Treasury Rate						
Bloomberg Forecast (December)	**2.42%**	**2.57%**	**2.75%**	**2.82%**	**2.92%**	**3.03%**
Vining Forecast (December)	*2.45%*	*2.65%*	*2.60%*	*2.70%*	*2.75%*	*2.75%*
Bloomberg Forecast (November)	2.43%	2.59%	2.70%	2.85%	2.95%	3.04%
Bloomberg Forecast (October)	2.44%	2.58%	2.70%	2.80%	2.95%	3.03%
Bloomberg Forecast (September)	2.48%	2.60%	2.75%	2.90%	2.99%	3.14%

Source: Bloomberg; All figures are quarter-end. GDP and CPI are annualized.

*In the January 2014 Survey, Bloomberg began reporting economists' projections for the upper and lower bound for the Fed Funds Target Rate.



Maturities without published projections interpolated based on historical spread differentials

YE2018 Interest Rate Projections

Observation Date: December 14, 2017

	Fed Funds	3M T-Bill	1-Year	2-Year	3-Year	5-Year	7-Year	10-Year	30-Year
Bloomberg Survey									
Low Forecast	1.13			1.60		1.89		2.10	2.54
Median Forecast	1.88			2.33		2.67		2.92	3.40
High Forecast	2.63			2.92		3.26		3.50	4.20
Forward Curve	1.83	1.94	1.96	2.06	2.19	2.33	2.41	2.50	2.83
Vining Sparks Forecast	1.88	1.83	1.95	2.10	2.24	2.48	2.64	2.75	3.05
Current	***1.38***	***1.30***	***1.68***	***1.82***	***1.92***	***2.14***	***2.27***	***2.36***	***2.78***
Projected Δ by Year-End									
Bloomberg Survey									
Low Forecast	-0.25			-0.22		-0.25		-0.26	-0.24
Median Forecast	0.50			0.51		0.53		0.56	0.62
High Forecast	1.25			1.10		1.12		1.14	1.42
Forward Curve	0.45	0.64	0.28	0.24	0.27	0.20	0.14	0.14	0.05
Vining Sparks Forecast	0.50	0.54	0.27	0.28	0.32	0.34	0.37	0.39	0.27