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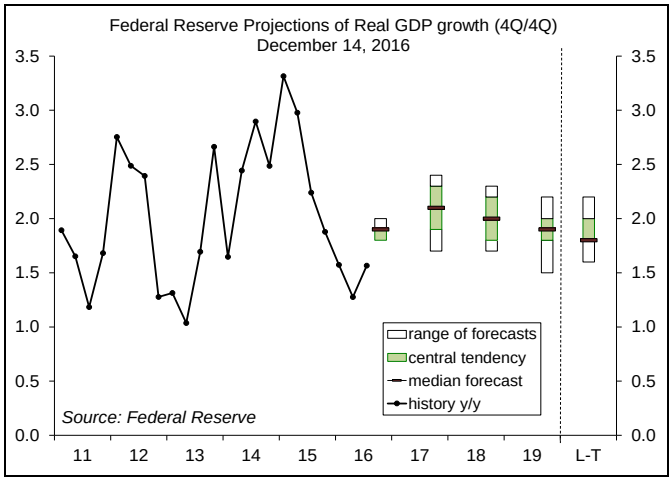
Weekly Economic Monitor

An Uncertain Outlook, But For Whom?

The outlook for 2017 is now shaping up as a battle of ideas, though few seem to be realizing it yet. The stock market has risen since the election. Consumers, small businesses owners, homebuilders, and manufacturers are all more optimistic. Many expect that a rollback in regulation, increased infrastructure spending, and lower taxes will spur growth. Yet, most economists, including those at the Fed, have raised their GDP forecasts for 2017 and 2018 only slightly at best. At the center of the discussion are differing views of how much stimulus we may get, how much slack remains in the labor market, and whether increased optimism can be self-fulfilling.

In the Fed's revised Summary of Economic Projections, the median forecast for 2017 edged slightly higher, to 2.1% (from 2.0%), while the median forecast for 2018 GDP growth remained at 2.0%. In her post-FOMC press conference, Fed Chair Janet Yellen emphasized that the economic outlook is *"highly uncertain."* Some, but not all, of the Fed governors and district bank presidents adjusted their forecasts for possible changes in fiscal policy (government spending and taxation) and other policies (deregulation) that might affect growth. Surveys of private-sector economists also showed only a mild increase in GDP growth expectations since the election.



Changes to the regulatory outlook are often difficult to gauge as a new administration takes charge. Laws may remain on the books, but they may be ignored. Just about everybody agrees that the country needs infrastructure investment, but it will likely be difficult to achieve through deficit spending. The House of Representatives no longer has earmarks (specific allocations in spending bills). Without the ability to do any "horse trading" for votes, it will be hard to reach a broad spending agreement. Funding infrastructure through the private sector would mean privatization. That may make some sense for airports, ports, or major bridges, but most Americans would bristle at the thought of having to pay simply to drive down the road. Privatization would also be unlikely to funnel infrastructure investment to where it is most needed.

Tax cuts should be easily achievable. It's what Republicans do. However, it's unclear how much of a reduction we'll see. Reducing deductions could offset the impact of lower rates, but nobody is going to want to give up their current tax breaks.

The bigger question for economists is what happens when fiscal stimulus faces constraints in the job market. As the job market tightens, wages ought to rise more rapidly. Can firms pass the added labor costs along? If not, they will eat into corporate profits. Higher wages could lead to increased labor force participation and to reallocations of labor, putting workers into positions where they are more productive, and creating more room for more inexperienced workers to move up. This could certainly be accomplished through increased (labor-saving) capital investment. However, none of that is quick and easy. In her press conference, Chair Yellen said that fiscal policy could be effective if concentrated on efforts to boost productivity, but this takes time. Over the next year or two, GDP growth is likely to be constrained by a tight job market.

The effectiveness of fiscal stimulus may also be constrained by market reactions to it. That is, higher long-term interest rates would likely restrain the improvement in the housing market and limit business borrowing. A strong dollar would make U.S. exports more expense for the rest of the world (and also make foreign goods and services cheaper here). Indeed, we ought to see somewhat better growth in underlying domestic demand next year, but a wider trade deficit will likely keep GDP growth from picking up significantly. In an open economy, some fiscal stimulus leaks away to other countries (which is why it important to have coordinated fiscal stimulus in a global recession). One might expect restrictions on global trade to reduce that leakage, but trade disruptions could destabilize supply chains in a number of industries.

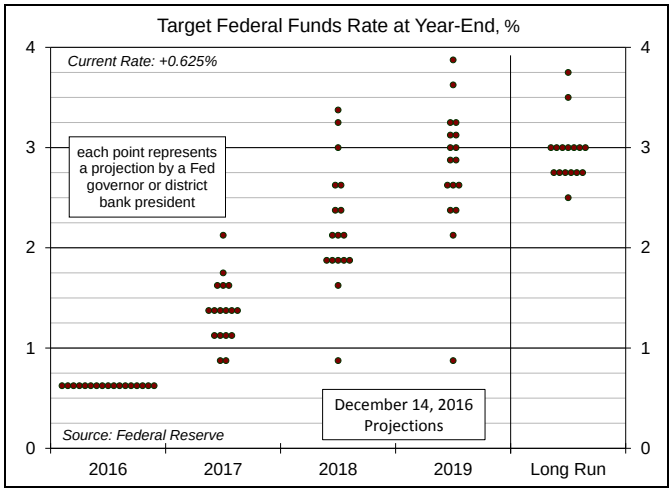
Might the increased optimism about growth be self-fulfilling? In the short term, perhaps. Firms have faced low borrowing costs and are generally flush with cash, but are unlikely to expand unless they expect increased demand for the goods and services that they produce. This has been the "chicken or egg" question for much of the recovery. However, if demand fails to materialize, there would be a clear downside to follow.

To be sure, the stock market's recent rise is consistent with the renewed sense of optimism we're seeing in many areas of the economy. However, there ought to be more uncertainty in the outlook for the next few years. There are many moving parts here, including Fed policy, long-term interest rates, and exchange rates, and they may not mesh all that well in 2017.

	Treasury Yields								Dollar				Equities		
	13-wk	26-wk	52-wk	2-yr	3-yr	5-yr	10-yr	30-yr	$/Euro	$/BP	JY/$	CD/$	NASD	SPX	DJIA
11/18/16	0.44	0.60	0.77	1.07	1.36	1.80	2.34	3.01	1.060	1.233	110.51	1.352	5321.51	2181.90	18867.93
12/09/16	0.54	0.64	0.85	1.15	1.43	1.89	2.47	3.16	1.054	1.259	115.17	1.316	5444.50	2259.53	19756.85
12/16/16	0.51	0.65	0.90	1.26	1.60	2.07	2.60	3.18	1.044	1.248	117.91	1.334	5432.58	2258.07	19842.55

Recent Economic Data and Outlook

Optimism that a rollback in regulation, increased infrastructure spending, and lower taxes will fuel growth continued to drive the stock market. However, Fed officials do not appear to share that view, judging by officials revised projections of growth. The FOMC raised the federal funds target range. Some of the dots in the dot plot shifted higher for a change, spooking the bond market and driving the dollar higher.



The **Federal Open Market Committee** raised the federal funds target range by 25 basis points, to 0.50-0.75%, citing realized and expected improvement in the job market. The Board of Governors approved a 25-bp rise in the discount rate (to 1.25%).

In its **Summary of Economic Projections**, senior Fed officials raised their forecasts of GDP growth slightly for 2017 (2.1%) and left the 2018 forecast unchanged (at 2.0%). The median expectation was for three rate increases in 2017 (up from two seen in September), but there is still considerable uncertainty about the path of Fed tightening (there is uncertainty in each of the dots in the dot plot and not all of the officials vote on policy.

In her post-FOMC press conference, **Fed Chair Janet Yellen** suggested that, with the degree of labor market slack diminished, *"fiscal policy is obviously not needed to provide stimulus to help us get back to full employment."*

The **Consumer Price Index** rose 0.2% in November (+1.7%). Food was flat (lower at home, higher away from home). Gasoline rose 2.7% (-2.4% before seasonal adjustment, +1.0% y/y). Ex-food & energy, the CPI rose 0.2% (+2.1% y/y). Shelter costs continued to outpace overall inflation, while the price of goods, ex-food & energy, was down 0.3% (-0.7% y/y).

Real Hourly Earnings fell 0.4% in November (+0.8% y/y). The three-month average was up 1.0% y/y (vs. +2.3% a year ago).

The **Producer Price Index** rose 0.4% (+1.3% y/y), reflecting a 0.6% rise in food and a 1.3% rise in trade services. Ex-food, energy, and trade services, the PPI rose 0.2% (+1.8% y/y).

Import Prices fell 0.3% in November (-0.1% y/y), down 0.1% ex-food & fuels (-0.6% y/y). The index for imported food, feeds, and beverages rose 1.5% (+5.6% y/y).

Retail Sales edged up 0.1% in the initial estimate for November (+3.8% y/y), up 0.2% excluding autos (+3.9% y/y). Ex-autos, building materials, and gasoline, sales rose 0.2% (+3.7% y/y) – still a relatively good quarter (vs. 3Q16).

Business Inventories fell 0.2% in October, a slow start to 4Q16.

Industrial Production fell 0.4% in November (-0.6% y/y), reflecting above-normal temperatures (lower output of utilities). Manufacturing output was flat (+0.4% y/y), mixed across sectors.

Building Permits fell 4.7% in November, to a 1.201 million seasonally adjusted annual rate (-6.6 % y/y). Single-family permits edged up 0.5% (three-month average up 5.9% y/y). **Housing Starts** sank 18.7%, following a 27.4% spike in October (reflecting the usual noise in the multi-family sector).

Homebuilder Sentiment jumped to 70 in December, vs. 63 in November, as optimism about reduced regulation offset concerns about higher mortgage rates and labor constraints.

The **Index of Small Business Optimism** rose to 98.4 in November, vs. 94.9 in October. The general business outlook improved sharply, likely reflecting the election results. The earnings trend remained weak. Sales expectations improved. Hiring plans, moderately strong in recent years, picked up further. Capital spending plans remained moderate.

The **Bank of England** left short-term interest rates unchanged and did not alter its asset purchase program.

Economic Outlook (4Q16): GDP growth near a 2.0% annual rate.

Employment: The pace of job growth slowed in 2016, but remains relatively strong (restrained by a tight job market).

Consumers: Some loss of spending due to bad October weather, but generally in good shape. Wage growth is trending moderately higher, but the benefit of low gasoline prices is fading. Attitudes are generally more positive.

Manufacturing: Mixed across sectors, but relatively soft overall. A strong dollar makes it more difficult for U.S. exporters, but helps firms that import raw materials.

Housing/Construction: Job growth has remained supportive, but higher home prices and rising mortgage rates are a restraint for first-time buyers. Tax cuts are expected to help fuel the demand for vacation homes and second homes in 2017.

Prices: Ex-food & energy, the PCE Price Index has continued to trend below the Fed's 2% target. There is little inflation in consumer goods. Inflation in consumer services has been boosted by higher rents. Wage gains are moderate, but rising.

Interest Rates: The Fed remains in tightening mode, but is expected to proceed cautiously as it normalizes policy.

This Week:					*forecast*	last	last –1	comments
Monday	12/19		Electoral College votes					37 defections needed to overturn
		1:30	Yellen Speaks					*"The State of the Job Market"*
Tuesday	12/20		no significant data					Médecins Sans Frontières (founded 1971)
Wednesday	12/21	10:00	Existing Home Sales, mln.	Nov	***5.46***	5.60	5.49	still strong
			% change		***-2.5***	+2.0	+3.6	mortgage rates not yet a constraint
Thursday	12/22	8:30	Jobless Claims, th.	12/17	***255***	254	258	still trending low
		8:30	Real GDP (3rd estimate)	3Q16	***+3.3%***	+1.4%	+0.8%	+3.2% in the 2nd estimate
		8:30	Personal Income	Nov	***+0.2%***	+0.6%	+0.4%	slower wage income (vs. strong October)
			Personal Spending		***+0.5%***	+0.3%	+0.7%	rebounding from Hurricane Matthew
			PCE Price Index		***+0.1%***	+0.1%	+0.1%	mild core inflation
		8:30	**Durable Goods Orders**	Nov	***-3.1%***	+4.6%	+0.3%	unwinding spike in aircraft orders
			ex-transportation		***+0.4%***	+0.8%	+0.1%	choppy, but a moderate trend
			nondef cap gds ex-aircraft		***+0.4%***	+0.2%	-1.5%	noisy, but likely to trend higher
		10:00	Leading Econ Indicators	Nov	***0.0%***	+0.1%	+0.2%	mixed components
Friday	12/23	10:00	New Home Sales, th.	Nov	***570***	563	574	choppy, but likely to have stayed strong
			% change		***+1.2***	-1.9	+1.2	watch for revisions
			UM Consumer Sentiment	Dec	***98.8***	93.8	87.2	98.0 at mid-month (Trump sizzle)
			Christmas Eve (observed)					bnd mkt closes early (not Scrooge McNYSE)
Next Week:								
Monday	12/26		Christmas Holiday (obs.)					markets closed
Tuesday	12/27	10:00	**Consumer Confidence**	Dec	***108.5***	107.1	100.8	feeling good
Wednesday	12/28	10:00	Pending Home Sales Index	Nov	***+1.4%***	+0.1%	+1.4%	rising mortgage rates are motivating
Thursday	12/29	8:30	Jobless Claims, th.	12/24	***255***	***255***	254	still trending low
		8:30	Adv. Econ Indicators	Nov				filling in the picture of 4Q16 GDP
Friday	12/30	9:45	Chicago PM Index	Dec	***58.2***	57.6	50.6	sentiment improving
Beyond:								
Monday	1/02		New Year's Day (obs.)					markets closed
Tuesday	1/03	10:00	**ISM Manf Index**	Dec	***54.4***	53.2	51.9	sentiment improving
Wednesday	1/04	2:00	**FOMC Minutes**	12/14				might some officials have wanted 50 bps?
Thursday	1/05	8:15	**ADP Payroll Est., th.**	Dec	***+160***	+216	+119	moderately strong
		8:30	Jobless Claims, th.	12/31	***255***	***255***	255	still trending low
		10:00	**ISM Non-Manf. Index**	Dec	***58.0***	57.2	54.8	sentiment improving
Friday	1/06	8:30	**Nonfarm Payrolls, th.**	Dec	***+155***	+178	+142	subject to seasonal noise
			private-sector		***+165***	+156	+135	a moderately strong trend
			Unemployment Rate		***4.7%***	4.6%	4.9%	noisy, but trending at a low level
			employment/population		***59.8%***	59.7%	59.7%	likely to edge higher
			Avg. Weekly Hours		***34.4***	34.4	34.4	steady
			Avg. Hourly Earnings		***+0.3%***	-0.1%	+0.4%	choppy, but a moderate trend higher

This Week…

The important economic data reports bunch up on Thursday, with another look back at 3Q16 GDP growth and some of the missing pieces for 4Q16. However, investors have already been looking ahead to 2017. Yellen speaks about the job market on Monday, but we aren't likely to learn much new.

Monday

The Electoral College Votes – After the strangest election in years, nothing should surprise us anymore. Many electors have requested an intelligence briefing on Russian interference. However, it seems extremely unlikely that we'll get 37 or more "unfaithful" electors to overturn the November 8 results.

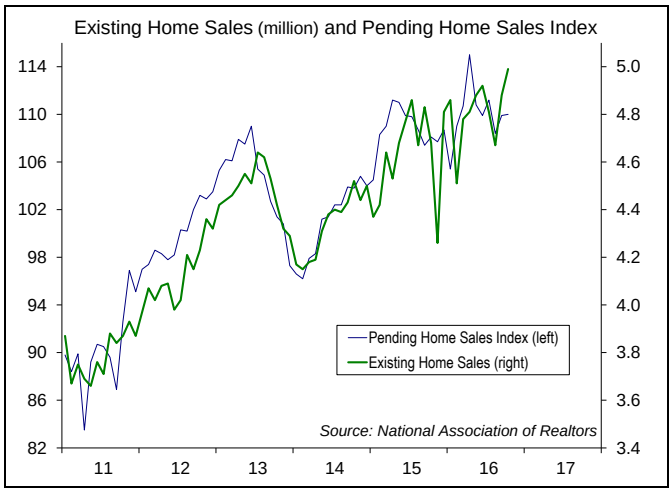
Fed Chair Yellen Speaks – Janet Yellen will deliver remarks at the University of Baltimore's Midyear Commencement (hence, no Q&A). The Federal Reserve's website lists the title of the speech as "the state of the job market." The labor market is the key driver of Fed policy decisions. Yellen is expected to note that while job conditions have tightened considerably in recent quarters, there is still some slack remaining.

Tuesday

No significant economic data. You have five days to finish your holiday shopping (no pressure).

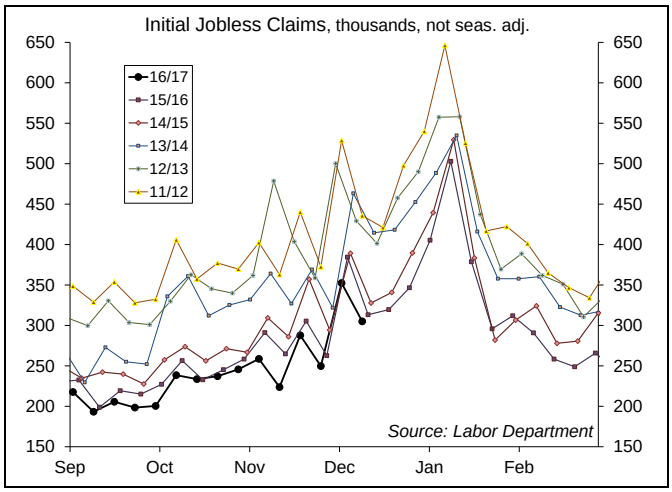
Wednesday

Existing Home Sales (November) – The National Association of Realtors figure measures closings. November figures ought to be reflective of the election uncertainty in October. Higher mortgage rates since the election may not be much of restraint in November, although some buyers may have been frozen out due to affordability issues heading into December. Rising mortgage rates are a strong motivator for those on the fence. There's normally a pickup in the sales pace as potential buyers fear missing out on low mortgage rates and rush in.



Thursday

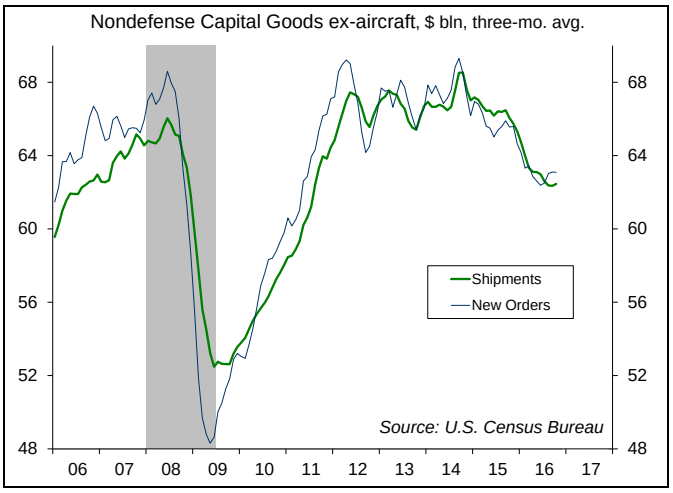
Jobless Claims (week ending December 17) – Figures will remain subject to seasonal distortions, but the underlying trend should remain very low by historical standards.



Real GDP (3Q16) – The headline figure is expected to be revised slightly higher in the 3rd estimate. The story won't change.

Personal Income and Spending (November) – Consumer spending accounts for 69% of GDP and these figures are direct inputs into the GDP accounts. November income is likely to be a bit soft, reflecting a correction from a strong October. Retail sales were disappointing in the initial estimate for October, but spending appears to have been strong for the quarter as a whole. The core CPI rose 0.151% last month.

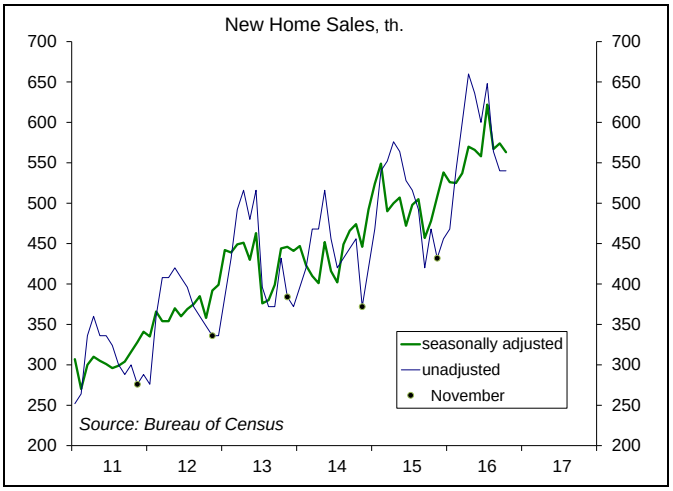
Durable Goods Orders (November) – Aircraft orders popped higher in October. Boeing reported a decline in aircraft orders, which should translate to a drop in the headline figure on durable goods orders. Prior to the election, orders for nondefense capital goods ex-aircraft, a rough proxy for business fixed investment, had shown signs of firming. It's too soon to see much of a post-election bounce or whether the improvement in business sentiment will actually lead firms to expand. The contraction in oil and gas extraction is behind us, so energy is not going to be the drag on overall capital spending that it was (although it may not be a big positive either).



Leading Economic Indicators (November) – Components were mixed. A drop in the factory workweek and a decline in building permits will subtract. The yield curve continues to add.

Friday

New Home Sales (November) – Government figures on new home sales (which measure initial transactions) are reported with a huge amount of uncertainty, which makes the headline numbers quirky. Take any large swings with a grain of salt.



Next Week …

Market activity ought to be lethargic during the holiday week, but the first week of January will be more eventful (including the ISM surveys and the Employment Report).

Coming Events and Data Releases

January 16	MLK, Jr. Holiday (markets closed)
January 20	Inauguration Day
January 27	Real GDP (4Q16, advance estimate)
February 1	FOMC Policy Decision (no press conference)
March 15	FOMC Policy Decision, Yellen press conference
May 3	FOMC Policy Decision (no press conference)
June 14	FOMC Policy Decision, Yellen press conference