LH|M MONETARY POLICY ANALYTICS

Macro Views

September 20, 2018

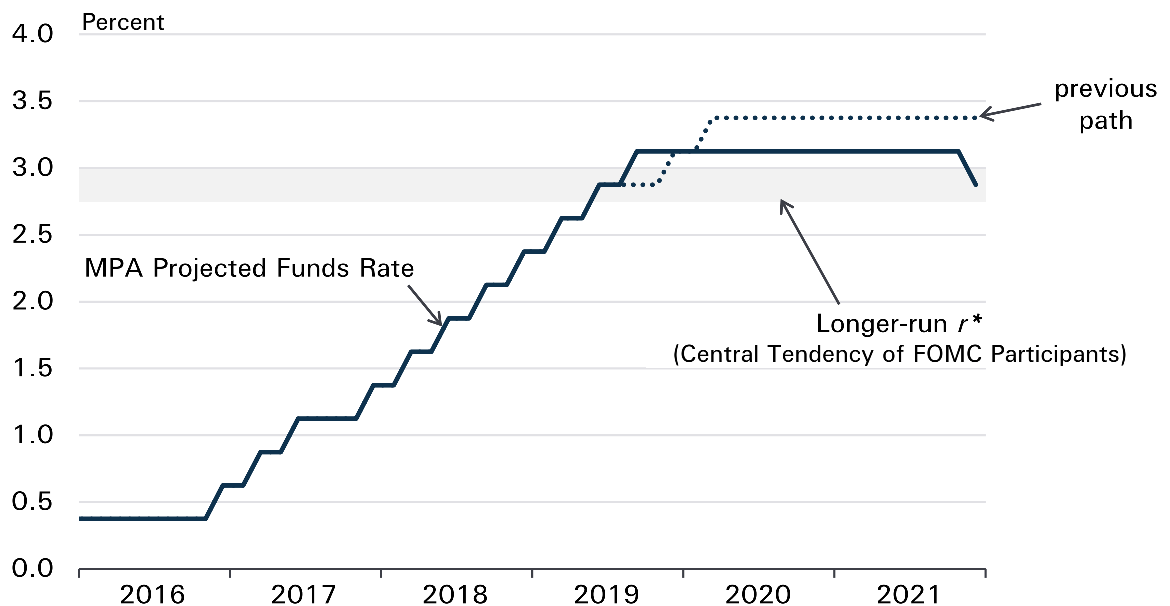
Now Expecting Rate Hikes to Continue Only Through 2019:Q3

In this forecast, our first update since June, the broad contours of the outlook remain intact. However, we have reconsidered our monetary policy call in light of some subtle changes in the macro picture, including slightly softer core inflation, as well as insights from FOMC participants' public remarks.

The outlook for real GDP growth is strong, and we expect growth to continue at a pace well above trend. While the ongoing drama around trade continues to cause a good deal of consternation, and business leaders have suggested that trade actions could lead to reduced investment, we have yet to see an impact in the data warranting a meaningful change in the forecast. Elevated equity prices and stubbornly low long-term rates are supportive of growth, but a stronger dollar means that financial conditions are, on net, somewhat tighter than in our previous forecast. Still, we have marked up the near-term outlook because there appears to be greater momentum in growth than we had anticipated.

We now assume rate hikes at every other meeting through September 2019, which would bring the funds rate just slightly to the restrictive side of where FOMC participants estimate its neutral level is. Such a path is justified by a well-above-trend pace of growth, an unemployment rate projected to fall to 3½%, and core inflation near its objective. At that point, we expect the FOMC to stop rate hikes as one of the most striking features of our forecast begins to materialize in the data: a pronounced slowing in growth toward—and then slightly below—trend supported by the fading of fiscal stimulus and the tightening of monetary policy. This will make the FOMC comfortable that policy is leaning in the appropriate direction, but gently.

Funds Rate Brought Just Above Neutral by September 2019, Next Move After That Is a Cut in 2021



Source: MPA, Federal Reserve.

We no longer assume a pause at neutral followed by a couple further hikes into restrictive territory, a strategy that would be more complicated and difficult to communicate. Supporting this slightly less restrictive path of monetary policy is a modestly softer inflation outlook. Recent readings on core inflation have come in softer than we assumed in our previous forecast. In addition, the dollar has appreciated, which will weigh on import prices. We have marked down core PCE inflation to 1.9% this year and have marked it down a tenth per year in 2019 and 2020. The story is much the same, however: a gradual rise in core inflation to about 2¼%. This forecast of a modest overshoot of the 2% inflation objective continues to be supported by our expectation that the unemployment rate, already well below the NAIRU, will reach 3.4% in 2019.

Once policy is modestly restrictive, with growth dipping slightly below potential and core inflation showing no sign of breaking higher, the FOMC's primary concern will be keeping the expansion going. Payroll gains will slow, and we have included in our forecast a very modest rise in the unemployment rate beginning in late 2020 back toward the NAIRU. Gradual rises in the unemployment rate have not been a historical regularity, and the FOMC will be concerned about recession risk. Accordingly, in our forecast we assume that the next funds rate action following the September 2019 hike will be a rate cut in 2021.

Larry Meyer **David Stockton**

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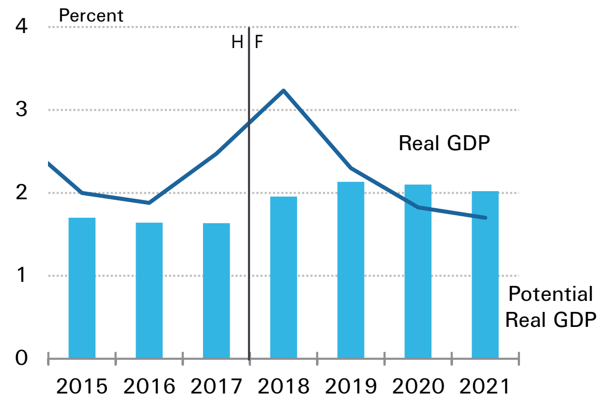
Forecast Overview

	2017	2018	2019	2020	2021
Real GDP	**2.5**	**3.2**	**2.3**	**1.8**	**1.7**
	2.6	3.0	2.3	1.8	-
Unemployment Rate *	**4.1**	**3.7**	**3.4**	**3.5**	**3.6**
	4.1	3.6	3.4	3.4	-
Core PCE Inflation	**1.6**	**1.9**	**2.1**	**2.2**	**2.2**
	1.5	2.1	2.2	2.3	-

Note: Percent.
Lighter values are from our previous forecast.
* Q4 average.

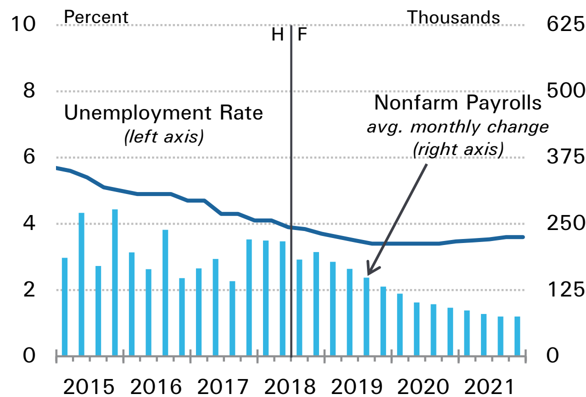
Source: MPA, BLS, BEA.

Growth Slows to Slightly Below Potential



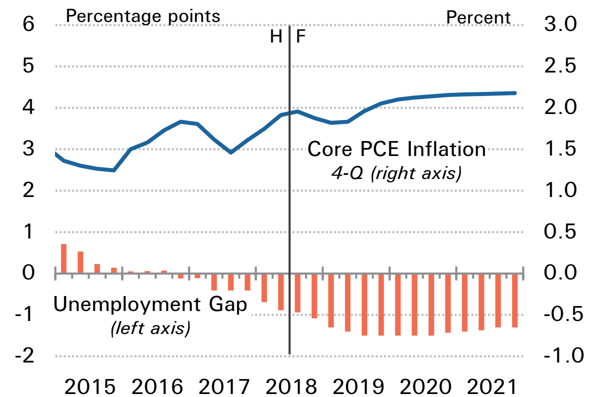
Source: MPA, BEA.

Growth Above Potential Supports Continuing Labor Market Improvement



Source: MPA, BLS.

With a Tightening Labor Market, Inflation Overshoots Objective by About ¼ pp



Source: MPA, BLS, BEA.

General Note: Unless otherwise indicated, quarterly growth rates are expressed as compound annual rates, expenditure components of GDP are chained 2009 dollars, and annual growth rates refer to growth from the fourth quarter of the previous year to the fourth quarter of the year indicated.

What’s New

- Real GDP advanced at a 4.2% pace in Q2 despite inventories subtracting a full percentage point from growth. Final private demand grew at a 4.3% pace, driven by robust consumer spending and business fixed investment, and net exports also contributed substantially to growth.
- The incoming data suggest that consumer spending growth is likely to maintain an above-3% pace in Q3.
- Business fixed investment likewise appears robust, with core capital goods data pointing to continued solid growth in equipment spending in Q3 despite businesses’ concerns about trade policy.
- The recent housing data have continued to be soft, pointing to a third consecutive quarterly decline in residential investment in Q3.
- Financial conditions remain accommodative but have tightened somewhat since June as the dollar has appreciated, despite longer-term rates remaining low and U.S. equity prices moving higher.
- The trade deficit is expected to reverse its Q2 decline in Q3, and we also expect net exports to subtract more from growth in subsequent quarters than in our previous forecast, owing to the stronger dollar.
- The labor market data have continued to be strong. The unemployment rate has been somewhat higher than we anticipated, but due to a higher-than-expected participation rate. Job growth has remained robust, pretty much expected, but there doesn’t appear to be any sign of the slowing that we had expected to commence around now. As such, we’ve marked up the near-term pace of job gains.
- The 12-month core PCE inflation rate was 2% in July, but core PCE prices are expected to post only a modest gain in August, and we expect the 12-month rate to edge down a tenth. Recent core inflation readings have been a bit softer than we anticipated, and we now anticipate core inflation will be 1.9% this year. That and a stronger dollar, which will weigh on import prices, led us to mark down our forecast for subsequent years by a tenth, but we still expect a gradual firming to about 2¼%.
- Finally, in part because of this slightly softer inflation outlook, we’ve adjusted our funds rate call. We now expect that the FOMC will raise rates once at every other meeting through September 2019, then stop. We now assume that the next action after that will be a rate cut later in 2021.

	17:Q3	17:Q4	18:Q1	18:Q2	18:Q3	18:Q4	2018	2019	2020	2021
Real GDP	2.8	2.3	2.2	4.2	3.5	3.0	3.2	2.3	1.8	1.7
	-0.4	-0.6		+0.4	+0.4	+0.1	+0.2			--
PCE	2.2	3.9	0.5	3.8	3.2	2.5	2.5	2.3	1.9	1.6
		-0.1	-0.5	+0.4	+0.8	+0.3	+0.2	+0.2	+0.2	--
Business Fixed Inv.	3.4	4.8	11.5	8.5	4.6	4.9	7.4	4.0	2.5	2.2
	-1.3	-2.0	+2.3	+3.7	-0.3	+0.4	+1.6		-0.1	--
Residential Inv.	-0.5	11.1	-3.4	-1.6	-3.7	1.2	-1.9	1.3	1.5	1.3
	+4.2	-1.7	-1.4	-2.7	-6.2	-1.3	-2.9	-0.7	-0.4	--
Chg. in Pvt. Inventories *	1.0	-0.9	0.3	-1.0	1.5	0.0	0.2	0.1	0.0	0.0
	+0.2	-0.4	+0.2	-1.3	+1.5		+0.1			--
Net Exports *	0.0	-0.9	0.0	1.2	-1.2	-0.2	-0.1	-0.3	-0.1	0.0
	-0.4	+0.3	-0.1	+0.8	-1.1	-0.1	-0.2	-0.1	-0.1	--

Note: Percent. Values in red or green are pp revisions from our previous forecast.

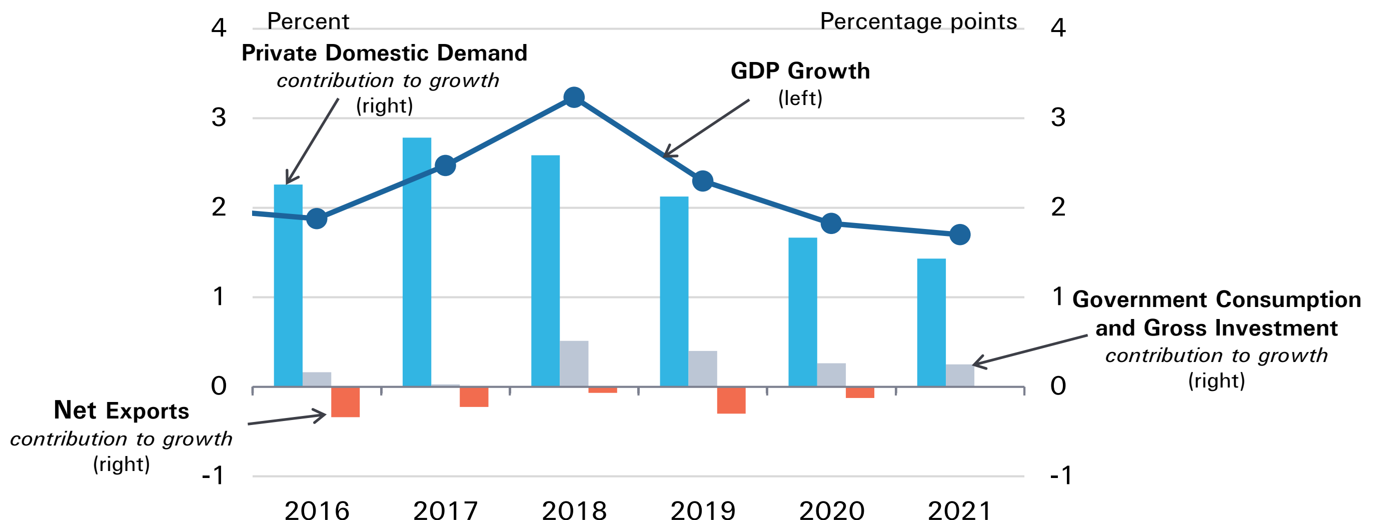
* percentage-point contribution to growth

Sources: MPA, BEA.

Stronger Momentum, But a Slowdown to Come in 2019

The recent incoming data have continued to indicate that there is strong momentum in growth, indeed more than we had anticipated. Consumer spending looks particularly strong, likely reflecting in part the recent tax cuts. Stronger consumer spending accounts for much of the upward revision to growth in the second half in this forecast, from 3% to 3¼%. While there has been concern that investment plans might be delayed or canceled because of trade policy uncertainty, the data show no sign of such a shift. As such, we assume that business fixed investment maintains a solid pace of growth. One of area of weakness has been housing, and we've marked down our forecast somewhat. Home builder sentiment remains strong and prices are rising, however, suggesting that there hasn't been a serious softening in demand. So we expect growth in residential to resume, albeit at a meager pace because of supply constraints and past and prospective increases in mortgage rates. While the data led us to mark up real GDP growth in the near term, our forecast beyond the next couple of quarters is little changed, because the dollar has strengthened, resulting in tighter financial conditions and slightly greater projected drag from net exports. Our expectation continues to be that growth will slow substantially in 2019 as the boost from fiscal stimulus fades. Growth will remain above potential, however, sufficient for the unemployment rate to decline to 3.4% and for the FOMC to be comfortable bringing the funds rate just barely into restrictive territory by September 2019. At that point, with policy restrictive, we expect growth to fall slightly below potential and for the FOMC to stop raising rates. As growth slows, so do payroll gains, eventually to a point where the unemployment drifts up marginally late in 2020.

Growth Expected to Be Faster in 2018 As Boost from Government Spending More than Offsets Moderation in Final Private Domestic Demand

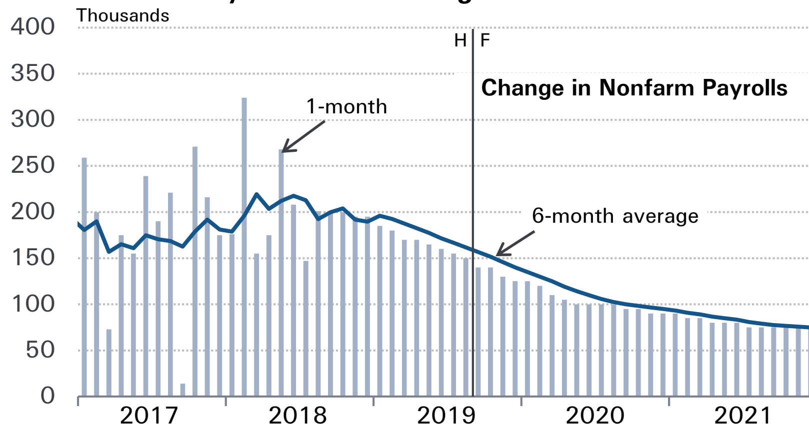


Source: LHMeyer Inc, BEA.

Labor Market Tight, Getting Tighter

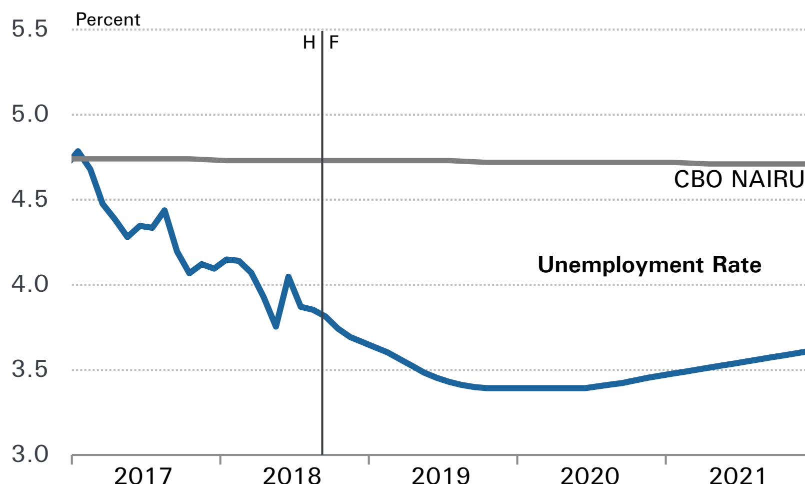
The labor market continues to look strong, with payroll gains averaging about 200K per month over the last six months. The recent pace has been about as expected in our last forecast, but we've marked up the near-term outlook because there's been no sign that the moderation we had been forecasting is imminent. Despite that, we've also marked up the unemployment rate in the near term, as the participation rate has been higher than expected. Beyond that, however, our forecast is little changed. We continue to expect that, with growth above trend, the unemployment rate will continue to fall through mid-2019, reaching as low as 3.4%, well below the estimated NAIRU. At that point, with growth having moderated to closer to trend, we expect the unemployment rate to stabilize. Eventually, as growth falls below trend, we expect the unemployment rate to drift upward beginning in late 2020. We expect that gradual drift upward to continue in 2021. Though in our forecast the slowing in payroll gains is gradual, as is the upward drift in the unemployment rate, the FOMC will naturally be focused on recession risk at this point, particularly with core inflation only modestly above the 2% objective. That is why we assume that the FOMC cuts the funds rate late in 2021.

Strong Payroll Pace of Payroll Gains Expected to Continue, Followed by Gradual Slowing as Growth Moderates



Source: LHMeyer Inc, BLS.

Unemployment Projected to Decline to 3½%, Level Off, then Drift Upward

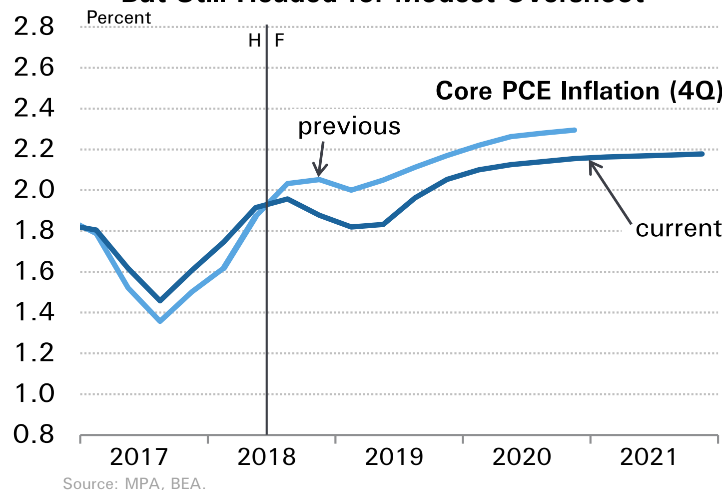


Source: MPA, BLS, CBO.

Inflation A Bit Softer, But Still Headed for a Slight Overshoot

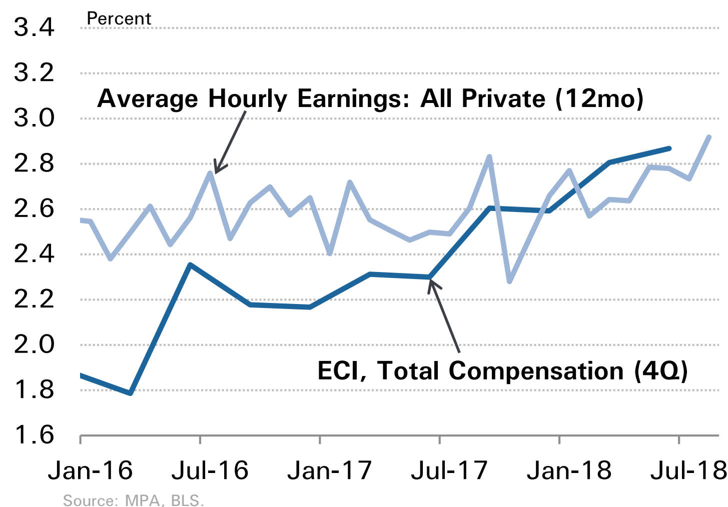
The data on core inflation have come in a bit softer than expected. The 12-month core PCE inflation rate is at 2.0%, and we expect that to edge down to 1.9% in August. The softer data warranted marking down our near-term inflation forecast somewhat, and a stronger dollar means lower import prices, which will weigh on core inflation. We now expect that core PCE inflation in 2018 will be 1.9%, down two tenths from our previous forecast, and we've also trimmed our forecast for subsequent years, but by only a tenth per year. Overall, however, the story with respect to inflation is little changed. Core inflation is currently close to its objective, and, with the labor market tight and only getting tighter, it will gradually rise. However, given the flatness of the Phillips curve, there is not much concern about a substantial overshoot. We still expect that core inflation will reach about 2¼% in 2020 and 2021. FOMC participants have generally indicated that they would be quite comfortable with such a modest overshoot. With growth having slowed to a below-trend rate at that point, and with the unemployment rate even edging up, the FOMC will be much more concerned about recession risk than above-target inflation. However, should the overshoot be more substantial, the FOMC will presented with an interesting dilemma.

Core PCE Inflation Forecast Marked Down Somewhat, But Still Headed for Modest Overshoot



Source: MPA, BEA.

Wage Inflation Has Picked Up Somewhat, and Is Expected to Gradually Firm Further



Source: MPA, BLS.

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Major Economic Indicators

	Quarterly 2018			Annual				
	I	II	III	2017	2018	2019	2020	2021
Real GDP	2.2	4.2	3.5	2.5	3.2	2.3	1.8	1.7
Major Components of Real GDP								
Personal Consumption Expenditures	0.5	3.8	3.2	2.7	2.5	2.3	1.9	1.6
Business Fixed Investment	11.5	8.5	4.6	6.3	7.4	4.0	2.5	2.2
Residential Investment	-3.4	-1.6	-3.7	3.8	-1.9	1.3	1.5	1.3
Gov. Consumption & Gross Investment	1.5	2.4	3.2	0.1	2.9	2.3	1.5	1.4
Net Exports (pp contribution to GDP)	0.0	1.2	-1.2	-0.2	-0.1	-0.3	-0.1	0.0
Private Inventories (pp contribution to GDP)	0.3	-1.0	1.5	-0.1	0.2	0.1	0.0	0.0
Unemployment Rate (%)	4.1	3.9	3.8	4.1	3.7	3.4	3.5	3.6
Change in Nonfarm Payrolls (avg. per month)	218	217	183	178	204	156	103	79
Core PCE Price Index	2.2	2.0	1.6	1.6	1.9	2.1	2.2	2.2
PCE Price Index	2.5	1.9	1.6	1.8	1.9	2.1	2.2	2.2
ECI - Total Compensation, Private	4.0	2.4	2.8	2.6	3.0	3.2	3.3	3.3
Fed Funds Rate (%)	1.42	1.67	1.92	1.17	2.18	3.13	3.13	3.06
2-yr Treasury Yield (%)	2.16	2.48	2.66	1.69	2.86	3.12	2.98	2.76
10-yr Treasury Yield (%)	2.76	2.92	2.91	2.37	3.07	3.03	2.99	2.95

Note on Units and Transformations

By default, values represent seasonally-adjusted, annualized growth rates (%) for the series indicated in the leftmost column. "Quarterly" values are q/q rates; "Annual" values are q4/q4 rates. For series followed by units in parentheses, "Quarterly" values are quarterly averages, and "Annual" values are q4 averages.

* "Quarterly" values are not compounded to annual rates.

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