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ECONOMIC UPDATE

SECOND QUARTER 2017

Quarterly Key Points

- U.S. GDP grew at a modest +1.4% annual pace in Q1 as consumers pulled back on spending.
- Most measures of inflation fell modestly during the quarter, marking a setback on the road to reaching the Fed's 2% inflation target.
- The Fed raised its policy rate by a further 25 basis points (0.25%) at its June meeting, and indicated a desire to begin reducing the size of its securities holdings later this year.

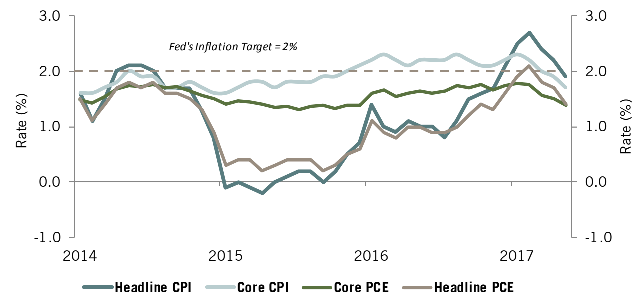
Our View

- Global economic conditions have improved and growth in Europe and developed Asia may outpace U.S. growth this year.
- The Fed has signaled the likelihood of one more hike in 2017 and perhaps 3-4 hikes in 2018. However, if current conditions persist, the Fed has plenty of room to slow the pace of hikes.
- Markets remain somewhat complacent despite what we judge to be elevated tail risks from U.S. policy uncertainty.

INFLATION DIPS LOWER – SPEED BUMP OR REALITY CHECK?

Following a persistent (if gradual) rise in inflation measures over the last 12-24 months, nearly every inflation gauge registered a pullback during the second quarter. While the decline in energy prices certainly played a role (West Texas Intermediate crude prices fell 9% in Q2), core inflation also experienced a meaningful decline. On a year-over-year basis, core CPI declined to 1.7% in May from 2.3% in January (*see Figure 1*). Notably, declines in the cost of housing, medical care goods and services, and used car prices all contributed to the pullback in recent inflation readings. The largest impact, however, was the result of the recent heavy competition in wireless services. A methodology change to quantify quality adjustments plus Verizon's re-introduction of unlimited data plans accounted for a nearly 20 basis point (0.20%) drop in core CPI since January.[2]

FIGURE 1 YOY CPI AND PCE INFLATION[1]



In its assessment of the outlook for inflation from the June policy statement, the Fed chose to emphasize the "one-off" nature of certain contributors to the recent decline in inflation measures (see "Fed Stays on Normalization Path with June Hike" on reverse page). However, market-based measures of inflation, such as Treasury Inflation Protected Securities (TIPS) breakeven inflation levels, also declined materially during the quarter. In addition, the yield curve flattened – with short rates rising while yields on longer maturities fell. Both of these moves suggest the market believes inflation is in check and may not reach the Fed's 2% target level anytime soon.

SLOW START TO 2017 U.S. GDP GROWTH AS CONSUMERS PAUSE

U.S. GDP growth registered +1.4% (annualized rate) in the first quarter of 2017, declining from the +2.1% pace of the final three months of 2016. The lackluster pace of Q1 growth was largely the result of a pullback in consumer spending. Personal consumption growth – which averaged nearly 3% over the last three years – rose at a lowly +1.1% pace in Q1. Spending on durable goods, including automobiles, was particularly soft.

As we've noted in the past, however, sluggish growth in the first quarter relative to subsequent quarters has become a well-established pattern. Over the last seven years (2010-16), the initial quarter's growth rate marked the weakest quarter of the year in four of those seven years (*see Figure 2 on reverse page*). As for 2017, we will have to wait and see.

However, three factors give us reason for optimism. First, business investment in structures and equipment rose substantially after a prolonged period of little or no growth. The jump in business investment – if sustained – is both a signal of business's outlook for demand growth and a necessary ingredient to prolong the economic expansion, which is already entering its ninth year. Second, the job market remains solid and wage gains continue to outpace inflation.

1, 2 Endnotes are located on reverse page

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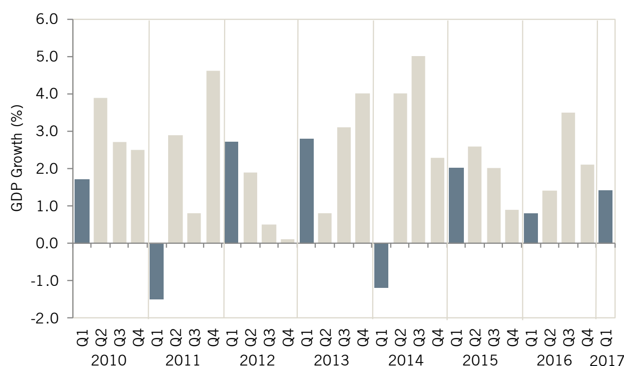
We would therefore not be surprised if Q1's consumer retrenchment proves temporary and consumers return to a more normal consumption pattern for the rest of 2017. And finally, inventory drawdowns detracted over 1.1 points from Q1's growth rate. In an expansion, such events are usually transitory; after a drawdown, businesses subsequently need to ramp production to rebuild depleted stocks.

FIGURE 2 U.S. GDP GROWTH BY QUARTER (ANNUALIZED RATES)[3]

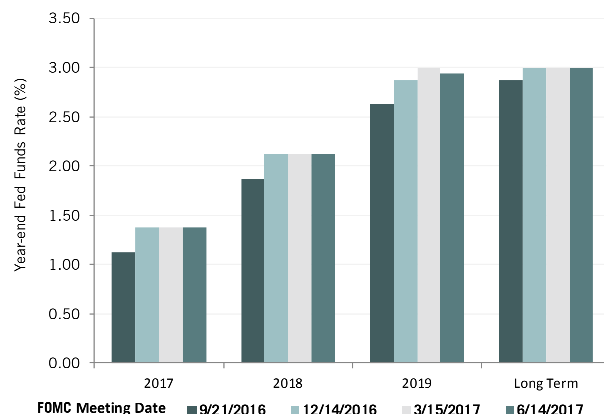


FED STAYS ON NORMALIZATION PATH WITH JUNE HIKE

In a widely expected move, the Federal Reserve (Fed) raised its policy rate by a further 25 basis points (0.25%) at its June Federal Open Market Committee (FOMC) meeting. The Fed's policy rate range now stands at 1.00% to 1.25%. The Fed's statement and post-meeting press conference suggest that the Fed is broadly comfortable with the pace of growth and continued gradual improvements in the labor market.

The Fed acknowledged recent softness in inflation data relative to its 2% inflation target, but chalked up most of the decline in core inflation to transitory factors. That said, Fed Chair Yellen in her post-meeting press conference noted that the policy rate was "approaching neutral" and suggested that future hikes would be increasingly predicated on a rise in observed inflation. The median of meeting participants' forecasts for the Fed Funds rate released in June suggests Fed officials expect to hike once more in 2017 (*see Figure 3*).

FIGURE 3 FOMC MEDIAN YEAR-END FED FUNDS RATE PROTECTIONS (%)[4]



The Fed also provided additional details on its plan to begin reducing the size of its holdings of U.S. Treasury and Agency mortgage-backed securities (asset portfolio) and reinforced its intention to begin phase-in later this year. Under the plan, the Fed will gradually reduce the amount it reinvests into new securities from maturities and principal paydowns in order to slowly shrink its asset portfolio. The targeted reductions ($30bn per month for Treasuries, $20bn per month for Agency MBS) will be phased-in over 12 months. At the fully phased-in level, on an annual basis the reduction caps represent approximately 5% of the Fed's total holdings of Treasuries and Agency MBS, respectively. Given the modest size and gradual nature of the reduction plan, the market's reaction has thus far been quite muted.

LOOKING AHEAD

U.S. GDP growth looks to be on pace to grow around 2.0% in 2017. If business investment remains robust (too early to tell) there is some potential for growth to surprise to the upside. However, the lack of almost any progress on tax reform – and continued fumbling attempts at healthcare reform – means that any expectation for a policy-based growth boost in 2017 is all but gone.

With a relatively calm growth and inflation outlook, the Fed may well have room to slow the pace of rate hikes. As we move into the second half of 2017, we judge it likely that the Fed will raise rates once more and will begin the process of reducing its asset portfolio.

Overall, global economic conditions have improved and growth in Europe and developed Asia may outpace U.S. growth this year. Recently, several global central banks (notably the ECB, BOE and Bank of Canada) have communicated the possibility of starting to gradually reduce stimulus in the not-too-distant future. Improved global growth should provide a tailwind for corporate earnings and, as a result, credit spreads.

[1]Source: Bloomberg | [2]Goldman Sachs US Economics Analyst, The Rocky Road to Reflation. 26 May 2017 | [3]Source: U.S. Bureau of Economic Analysis | [4]Source: Federal Reserve, Bloomberg

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