

Firmer U.S. Forecast Ahead of an Interesting End of the Year

By the end of the year we know that we will have a new president-elect, and we think we will have higher interest rates courtesy of the Federal Reserve. We also think that we will see stronger real GDP growth for the second half of the year after lackluster growth through the first half of 2016. A key lever on GDP in 2016H2 will be inventories. The GDP component graph on page 2 shows that inventories have been a drag on GDP growth for the previous four quarters (the recently completed third quarter is still a forecast quarter until the Q3 GDP data is released at the end of this month). We expect the reduction in manufacturing inventories that we saw in the first half of 2016 to ease in H2, reducing or eliminating the drag from overall inventory accumulation. Also, international trade looks like it will be more of a positive in Q3, helping to support stronger GDP growth. After a surge in consumer spending in Q2 we look for less growth from consumer activity in Q3, stepping down a little more in Q4. But it will be growth nonetheless, and with a little help from inventories and trade, real GDP growth improves to about 3 percent for the next few quarters. One thing to keep in mind however, is the approach of the dreaded first quarter. Since 2010, real GDP growth for the first quarter of the year has been weaker than the previous quarter six out of seven times even after accounting for seasonality.

With GDP growth improving, we expect job creation to remain reasonably strong through year-end, eventually bringing the unemployment rate lower to around 4.7 percent by the end of 2017, putting more upward pressure on wages. U.S. nonfarm payrolls increased by a net 156,000 jobs in September, a little below expectations. The unemployment rate ticked up from 4.9 percent to 5.0 percent in September. A surge in the labor force in September of 444,000 workers allowed the unemployment rate to tick back up to 5.0 percent, the highest it has been since last April. The strong expansion of the labor force over the summer is a positive for the U.S. economy and should counter concern about the small increase in the headline unemployment rate. In September, average hourly earnings gained a moderate 0.2 percent, and are up by 2.6 percent over the previous 12 months. We expect to see gradually stronger wage growth through next year. This will get the Fed's attention and keep them on the path of gradually firmer interest rates.

We still expect to see one fed funds rate hike this year, most likely coming at the December 13/14 FOMC meeting. Loretta Mester, President of the Federal Reserve Bank of Cleveland, has voiced her support for a rate hike at the upcoming November 1/2 FOMC meeting. However, a rate hike coming a week before the general election could put the Fed in the middle of a political minefield. We expect the Fed to step gingerly in November and keep the fed funds rate range unchanged until December. The fed funds futures market shows implied odds of only 8 percent for a November rate hike. That increases to 65 percent for December. We have two fed funds rate hikes in the forecast for 2017, one in June and one in December. More pressure on wages and stronger-than-expected overall inflation could accelerate that schedule. However, given the very cautious nature of the Yellen Fed, and their ongoing mantra of data-dependency, weaker-than-expected economic data next year, from either inside or outside of the U.S., could result in an even shallower trajectory for fed funds lift-off.

U.S. Economic Outlook, Summary

	2Q'16a	3Q'16a	4Q'16f	1Q'17f	2Q'17f	3Q'17f	4Q'17f	1Q'18f	2015a	2016f	2017f
Real GDP (<i>Percent Change Annualized</i>)	1.4	3.1	2.7	3.1	2.3	2.3	2.2	2.1	2.6	1.6	2.6
CPI (<i>Percent Change Year-over-Year</i>)	1.1	1.1	1.4	2.0	2.0	2.1	2.1	2.0	0.1	1.2	2.1
Payroll Jobs (<i>Average Monthly Diff., Ths.</i>)	150.7	201.3	178.7	179.2	171.0	168.9	159.9	155.8	228.7	201.8	169.7
Unemployment Rate (<i>Percent</i>)	4.9	4.9	4.9	4.8	4.8	4.8	4.7	4.7	5.3	4.9	4.8
Federal Funds Rate (<i>Effective</i>)	0.37	0.40	0.42	0.63	0.67	0.88	0.92	1.13	0.13	0.39	0.78
10-Yr. Treasury Rate	1.75	1.56	1.73	1.86	1.89	2.05	2.08	2.26	2.14	1.74	1.97

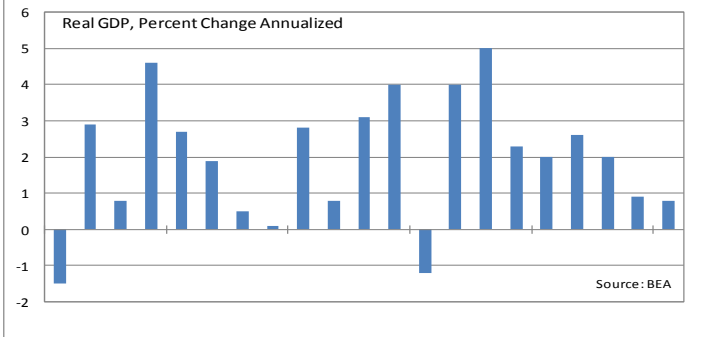
a = actual f = forecast

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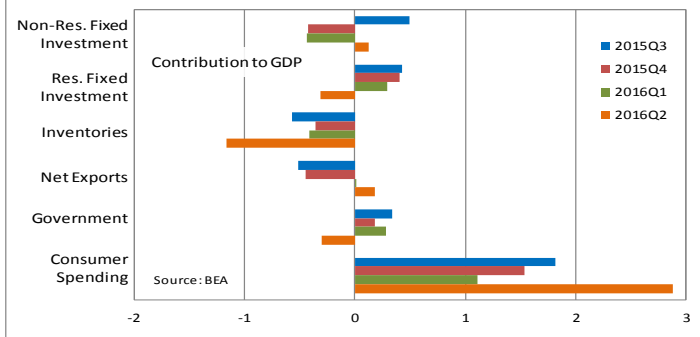
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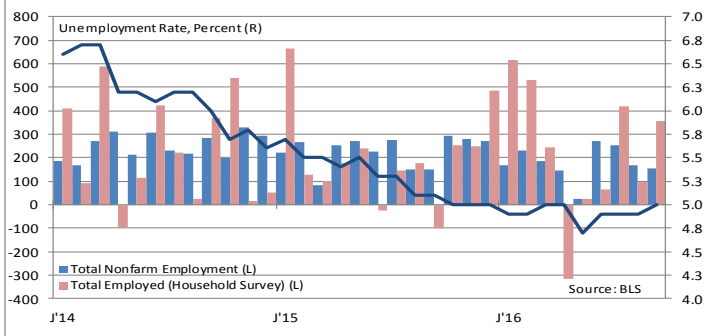
GDP Growth Q2 Revised Up to 1.4%



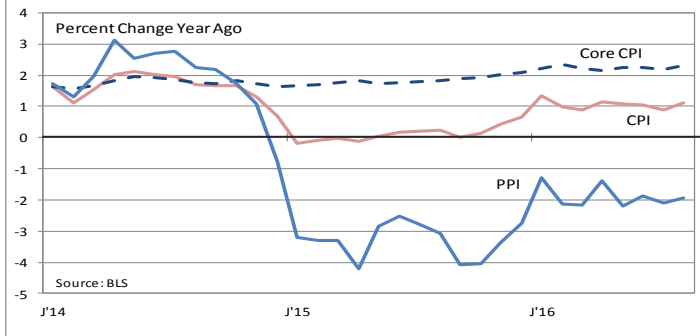
Consumer Spending Surged in Q2



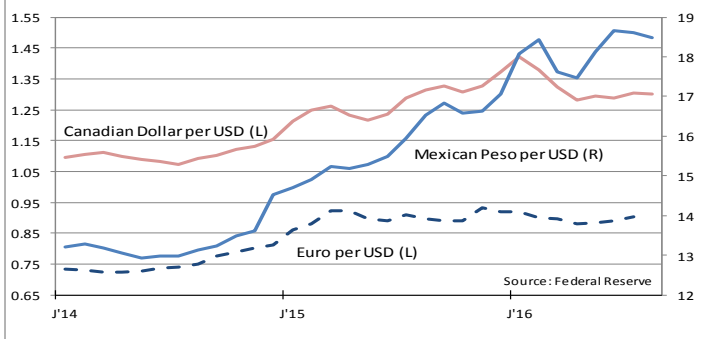
September Payrolls Up 156k



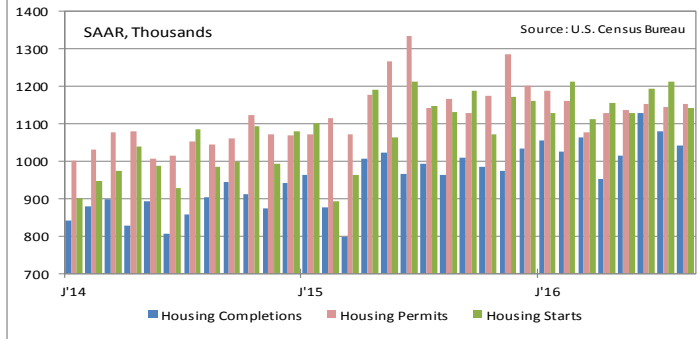
Core Inflation Moderate



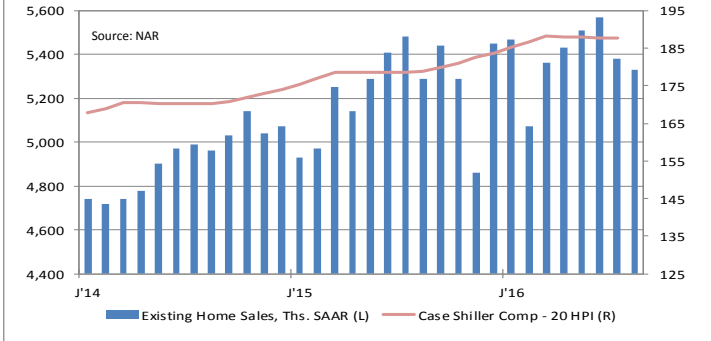
Falling Peso Raises Mexico Inflation Concerns



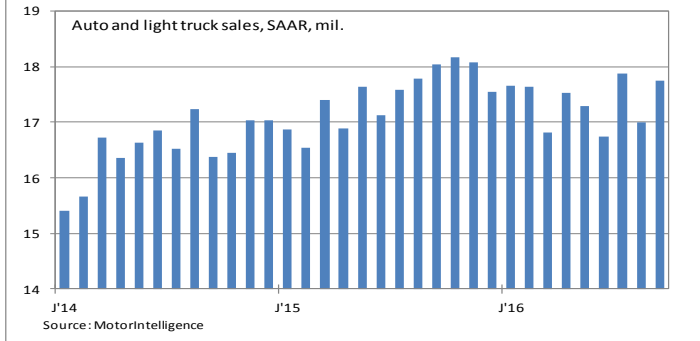
Housing Starts Ease in August



Existing Homes Sales Retreat in Q3



September Auto Sales Rebound to 17.8 mln



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	2Q'16a	3Q'16a	4Q'16f	1Q'17f	2Q'17f	3Q'17f	4Q'17f	1Q'18f	2015a	2016f	2017f
Output											
Nominal GDP (Billions \$)	18450	18662	18872	19101	19305	19508	19710	19907	18037	18566	19406
Percent Change Annualized	3.7	4.7	4.6	5.0	4.3	4.3	4.2	4.1	3.7	2.9	4.5
Real GDP (Chained 2009 Billions \$)	16583	16709	16822	16949	17046	17144	17238	17326	16397	16660	17094
Percent Change Annualized	1.4	3.1	2.7	3.1	2.3	2.3	2.2	2.1	2.6	1.6	2.6
Pers. Consumption Expenditures	11485	11546	11594	11660	11705	11757	11810	11860	11215	11498	11733
Percent Change Annualized	4.3	2.2	1.7	2.3	1.6	1.8	1.8	1.7	3.2	2.5	2.0
Nonresidential Fixed Investment	2185	2197	2226	2263	2293	2321	2347	2373	2200	2197	2306
Percent Change Annualized	1.0	2.2	5.5	6.7	5.6	4.9	4.5	4.4	2.1	-0.1	5.0
Residential Investment	589	598	609	619	628	637	645	652	565	599	632
Percent Change Annualized	-7.8	6.5	7.5	6.7	6.2	5.5	5.1	4.7	11.7	6.1	5.5
Change in Private Inventories	-10	14	31	41	49	55	58	58	84	19	51
Net Exports	-559	-554	-560	-567	-577	-588	-599	-609	-540	-560	-583
Government Expenditures	2901	2916	2930	2942	2956	2970	2985	3000	2884	2915	2963
Percent Change Annualized	-1.7	2.1	1.9	1.7	1.9	2.0	2.0	2.0	1.8	1.1	1.6
Industrial Prod. Index (2007=100)	104.0	104.6	105.3	105.9	106.3	106.6	106.9	107.2	105.2	104.5	106.4
Percent Change Annualized	-0.6	2.3	2.9	2.2	1.6	1.2	1.1	1.0	0.3	-0.7	1.9
Capacity Utilization (Percent)	75.3	75.8	76.2	76.5	76.6	76.7	76.8	76.8	76.7	75.7	76.7
Prices											
CPI (1982-84=100)	239.4	240.3	241.4	242.7	244.3	245.3	246.4	247.7	237.0	239.8	244.7
Percent Change Annualized	2.5	1.5	1.9	2.1	2.6	1.7	1.8	2.0	0.1	1.2	2.1
PCE Price Index (2009=100)	110.5	110.9	111.4	112.0	112.7	113.2	113.7	114.3	109.5	110.7	112.9
Percent Change Annualized	2.0	1.5	1.8	2.1	2.6	1.7	1.8	2.0	0.3	1.1	2.0
GDP Price Index (2009=100)	111.3	111.7	112.2	112.7	113.3	113.9	114.4	115.0	110.0	111.5	113.6
Percent Change Annualized	2.3	1.6	1.8	1.9	2.0	2.0	2.0	2.0	1.1	1.3	1.9
Producer Price Index, Finished Goods	191.3	191.7	192.8	193.7	195.0	195.8	196.8	197.7	193.8	191.4	195.3
Percent Change Annualized	3.4	0.8	2.2	1.9	2.7	1.7	2.0	2.0	-3.3	-1.2	2.0
Crude Oil, WTI (\$/barrel)	44.9	45.1	48.0	50.0	55.0	55.0	55.0	60.0	48.9	42.8	53.8
Labor Markets											
Payroll Jobs (Average Monthly Diff., Ths.)	150.7	201.3	178.7	179.2	171.0	168.9	159.9	155.8	231.3	187.6	169.7
Unemployment Rate (Percent)	4.9	4.9	4.9	4.8	4.8	4.8	4.7	4.7	5.3	4.9	4.8
Average Weekly Hours, Prod. Works.	33.6	33.6	33.6	33.6	33.6	33.6	33.6	33.6	33.7	33.6	33.6
Population (Millions)	324.0	324.7	325.4	326.0	326.7	327.3	328.0	328.6	321.7	324.4	327.0
Percent Change Annualized	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8
Personal Income											
Average Hourly Earnings (\$)	21.49	21.63	21.77	21.91	22.05	22.18	22.33	22.48	21.04	21.56	22.12
Percent Change Annualized	2.4	2.8	2.6	2.6	2.5	2.5	2.6	2.8	2.1	2.5	2.6
Real Disp. Income (2009 Billions \$)	12620	12707	12823	12924	13005	13114	13219	13315	12343	12677	13065
Percent Change Annualized	2.1	2.8	3.7	3.2	2.5	3.4	3.2	2.9	3.5	2.7	3.1
Personal Saving Rate (Percent)	5.7	5.7	5.7	5.7	5.7	5.7	5.7	5.7	5.8	5.8	5.7
Housing											
Housing Starts (Ths., Ann. Rate)	1159	1176	1190	1207	1223	1237	1250	1262	1108	1169	1229
Ext. SF Home Sales (Ths., Ann Rate)	4870	4778	4823	4869	4905	4939	4966	4986	4627	4797	4919
New SF Home Sales (Ths., Ann Rate)	572	623	620	631	639	646	652	657	502	586	642
Case/Shiller HPI (Jan. 2000=100)	179.5	180.8	182.2	184.1	186.1	188.0	189.9	191.9	172.3	180.3	187.0
Year/Year Percent Change	5.1	4.7	3.5	3.1	3.7	4.0	4.3	4.2	4.6	4.6	3.7
Consumer											
Household Economic Stress Index	0.9	1.3	2.8	3.8	3.2	2.8	2.5	2.5	0.8	1.4	3.1
Auto Sales (Millions)	17.2	17.5	17.3	17.4	17.2	17.1	16.9	16.6	17.5	17.3	17.1
Interest Rates (percent per year)											
Federal Funds Rate (Effective)	0.37	0.40	0.42	0.63	0.67	0.88	0.92	1.13	0.13	0.39	0.78
Prime Rate	3.50	3.50	3.50	3.63	3.67	3.88	3.92	4.13	3.26	3.50	3.78
1-Month LIBOR	0.44	0.51	0.58	0.80	0.84	1.05	1.09	1.30	0.20	0.49	0.95
3-Month LIBOR	0.64	0.79	0.90	1.05	1.08	1.25	1.29	1.49	0.32	0.74	1.17
1-Yr. Treasury Rate	0.57	0.56	0.67	0.84	0.88	1.06	1.11	1.30	0.32	0.59	0.97
5-Yr. Treasury Rate	1.24	1.13	1.28	1.42	1.45	1.62	1.65	1.84	1.53	1.25	1.53
10-Yr. Treasury Rate	1.75	1.56	1.73	1.86	1.89	2.05	2.08	2.26	2.14	1.74	1.97
30-Year Fixed Rate Mortgage	3.59	3.45	3.43	3.56	3.60	3.77	3.81	3.98	3.85	3.55	3.68

a = actual f = forecast

October 11, 2016

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