

## Warming Inflation May Push the Fed to a Fourth Rate Hike in 2018

In the first quarter of 2018, many U.S. economic metrics were strong, but real GDP growth was soft at just 2.3 percent. In the second quarter, we may see the mirror image of that picture. Economic metrics that are at or near their cyclical peaks can either go sideways or down in Q2. At the same time, some of the factors that kept Q1 GDP growth in check, including net exports and residential investment, look like they will strengthen in Q2.

Job growth in April was moderate, with payrolls up by 164,000 net new jobs for the month. Revisions to payrolls for the previous two months were +30,000, bringing the three-month average for payroll gains to 208,000 per month, a strong number at this stage of the business cycle. Average hourly earnings were up by 0.1 percent for the month and 2.6 percent over the previous 12 months, so wage pressure was light even though we are seeing more evidence of wage pressure in other reports. The unemployment rate fell to 3.9 percent, the lowest it has been since December 2000. The average workweek was unchanged at 34.5 hours, about where it has been since early 2012.

Inflation remains a hot topic. Headline inflation metrics warmed up this spring. In March, the 12-month change in the Consumer Price Index hit 2.36 percent. The Producer Price Index for Final Demand was up by 3.04 percent over the previous 12 months. The Federal Reserve's preferred measure of inflation, the Trimmed-Mean PCE Inflation rate, is also warming up. It is a more stable measure, eliminating volatile components, but the 12-month Trimmed-Mean PCE Inflation Rate was up to 1.77 percent in March, and is expected to trend higher in the months ahead, closing in on the Fed's near-2-percent inflation target. Commodity costs are under pressure. Transportation and distribution costs are too, with trucking capacity very tight. Labor costs are going up. The Employment Cost Index, which measures both wages and benefits, was up 2.7 percent in Q1, compared to a year earlier.

We are revising our forecast for year-end oil prices. Last month we had a \$63 per barrel average for West Texas Intermediate crude oil in 2018Q4. This month we are showing \$75 per barrel. Supply/demand fundamentals are shifting in the global oil market. On the supply side, there are key developments. Venezuela, a key global oil producer, is imploding politically and this has resulted in a significant deterioration of its oil production capacity. Venezuelan oil production will be down nearly a million barrels per day in the second half of this year compared with just a few years ago. OPEC is maintaining production discipline. This is reducing the global oil inventory overhang. U.S. production is strong and expected to continue to increase, but there are infrastructure bottlenecks making it difficult to expand export volumes quickly. Finally, on the supply side, President Trump appears to be positioning himself to withdraw from the Iran Nuclear Deal. This could result in new sanctions on Iranian oil exports. On the demand side, the global economy is growing, requiring more oil. Also, the Trump Administration appears likely to freeze fuel economy standards from 2020 through 2026, coming after U.S. auto demand has shifted toward less fuel efficient SUVs and light trucks. Higher oil prices will keep inflation metrics warm this year, adding to the probability of a fourth fed funds rate hike at the end of this year.

The Federal Open Market Committee did as expected last week, voting to keep the fed funds rate range unchanged at 1.50-1.75 percent. Solid U.S. economic indicators and warmer inflation metrics justify the strong expectations for a second 25-basis-point fed funds rate hike this year at the next FOMC meeting over June 12-13. A third rate hike, at the conclusion of the September 25-26 FOMC meeting, is also looking likely. As we move toward mid-year, financial market attention will increasingly focus on the possibility of a fourth rate hike this year, coming at the end of the December 18-19 FOMC meeting. We place the odds of a fourth rate hike in 2018 at about 50/50.

### U.S. Economic Outlook, Summary

	4Q'17a	1Q'18a	2Q'18f	3Q'18f	4Q'18f	1Q'19f	2Q'19f	3Q'19f	2017a	2018f	2019f
Real GDP (Percent Change Annualized)	2.9	2.3	3.5	2.8	3.0	2.6	2.5	2.4	2.3	2.9	2.7
CPI (Percent Change Year-over-Year)	2.1	2.3	3.0	3.2	3.0	2.7	2.4	2.3	2.1	2.9	2.4
Payroll Jobs (Average Monthly Diff., Ths.)	185.4	208.6	180.1	182.4	164.2	155.5	149.3	141.7	181.4	183.8	146.6
Unemployment Rate (Percent)	4.1	4.1	3.9	3.9	3.8	3.7	3.7	3.7	4.3	3.9	3.7
Federal Funds Rate (Effective)	1.20	1.45	1.69	1.91	2.13	2.17	2.42	2.66	1.00	1.80	2.53
10-Yr. Treasury Rate	2.37	2.76	2.98	3.15	3.22	3.16	3.34	3.54	2.33	3.03	3.44

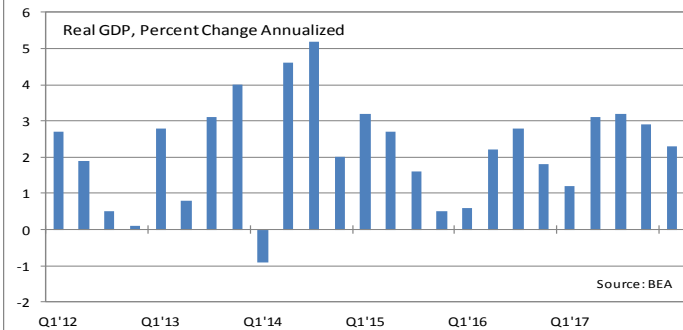
**a = actual f = forecast**

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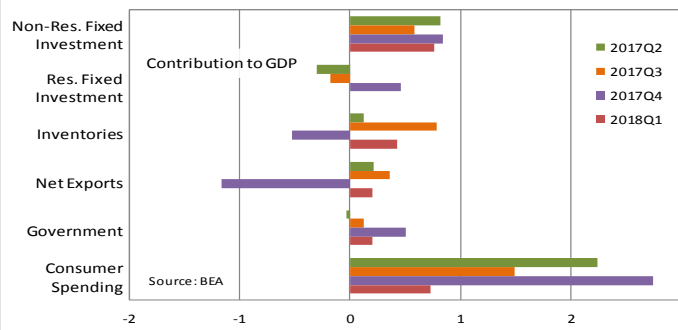
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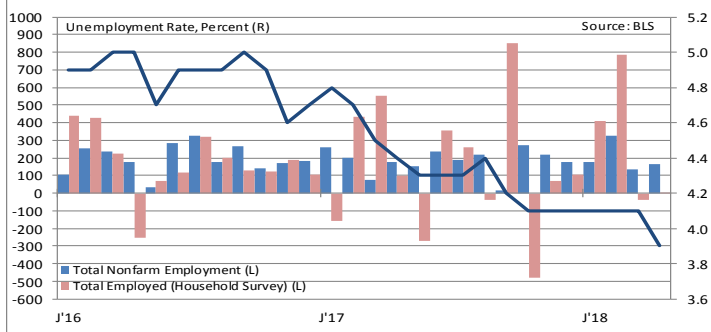
**Q1 GDP 1st Estimate at 2.3%**



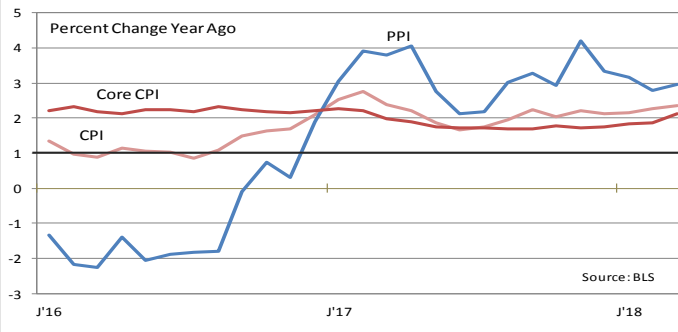
**Auto Sales Dragged Q1 Consumer Spending**



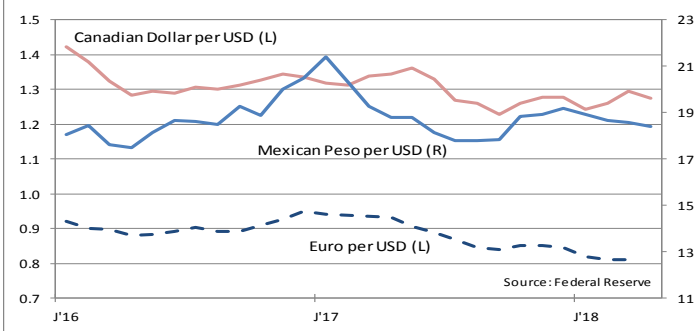
**April U. Rate Down to 3.9%**



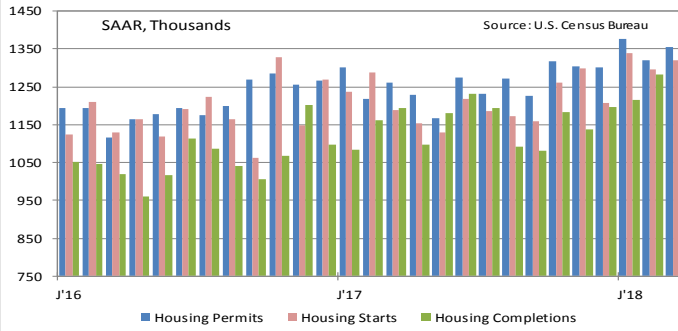
**Inflation Warming Up**



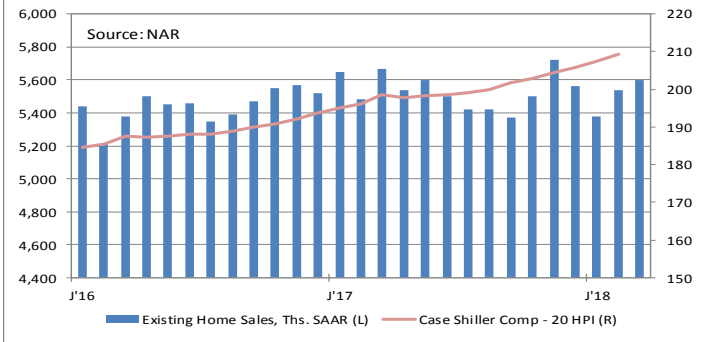
**Mexican Peso Strengthened in Early 2018**



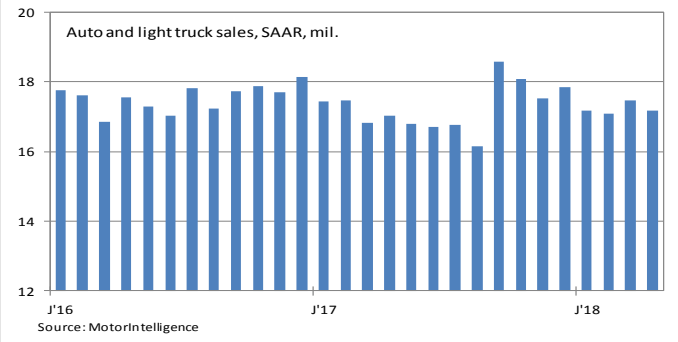
**Residential Construction Rebounded in March**



**Home Prices Advance With Tight Supply**



**Auto Sales Stepping Down from September**



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	4Q'17a	1Q'18a	2Q'18f	3Q'18f	4Q'18f	1Q'19f	2Q'19f	3Q'19f	2017a	2018f	2019f
<b>Output</b>											
Nominal GDP (Billions \$)	19754	19965	20237	20478	20728	20963	21192	21420	19391	20352	21304
<b>Percent Change Annualized</b>	<b>5.3</b>	<b>4.3</b>	<b>5.6</b>	<b>4.8</b>	<b>5.0</b>	<b>4.6</b>	<b>4.4</b>	<b>4.4</b>	<b>4.1</b>	<b>5.0</b>	<b>4.7</b>
Real GDP (Chained 2009 Billions \$)	17286	17386	17538	17661	17790	17906	18016	18124	17096	17594	18068
<b>Percent Change Annualized</b>	<b>2.9</b>	<b>2.3</b>	<b>3.5</b>	<b>2.8</b>	<b>3.0</b>	<b>2.6</b>	<b>2.5</b>	<b>2.4</b>	<b>2.3</b>	<b>2.9</b>	<b>2.7</b>
Pers. Consumption Expenditures	12035	12067	12131	12192	12262	12325	12387	12450	11891	12163	12418
<b>Percent Change Annualized</b>	<b>4.0</b>	<b>1.1</b>	<b>2.2</b>	<b>2.0</b>	<b>2.3</b>	<b>2.1</b>	<b>2.0</b>	<b>2.0</b>	<b>2.8</b>	<b>2.3</b>	<b>2.1</b>
Nonresidential Fixed Investment	2366	2401	2452	2497	2541	2579	2616	2651	2314	2473	2633
<b>Percent Change Annualized</b>	<b>6.8</b>	<b>6.1</b>	<b>8.8</b>	<b>7.5</b>	<b>7.2</b>	<b>6.2</b>	<b>5.8</b>	<b>5.5</b>	<b>4.7</b>	<b>6.8</b>	<b>6.5</b>
Residential Investment	605	605	612	619	625	631	637	642	598	615	640
<b>Percent Change Annualized</b>	<b>12.8</b>	<b>0.0</b>	<b>5.0</b>	<b>4.6</b>	<b>4.1</b>	<b>3.9</b>	<b>3.8</b>	<b>3.2</b>	<b>1.8</b>	<b>2.9</b>	<b>3.9</b>
Change in Private Inventories	16	33	46	54	60	60	60	60	15	48	60
Net Exports	-654	-646	-642	-650	-655	-656	-659	-662	-622	-648	-661
Government Expenditures	2922	2930	2942	2952	2960	2969	2978	2985	2903	2946	2981
<b>Percent Change Annualized</b>	<b>3.0</b>	<b>1.2</b>	<b>1.7</b>	<b>1.3</b>	<b>1.2</b>	<b>1.2</b>	<b>1.2</b>	<b>0.9</b>	<b>0.1</b>	<b>1.5</b>	<b>1.2</b>
Industrial Prod. Index (2007=100)	105.3	106.4	106.6	106.9	107.3	107.7	108.0	108.2	103.7	106.8	108.1
<b>Percent Change Annualized</b>	<b>7.8</b>	<b>4.5</b>	<b>0.4</b>	<b>1.1</b>	<b>1.7</b>	<b>1.4</b>	<b>1.1</b>	<b>1.0</b>	<b>1.6</b>	<b>3.0</b>	<b>1.2</b>
Capacity Utilization (Percent)	77.1	77.6	77.8	77.9	78.1	78.3	78.4	78.5	76.1	77.9	78.5
<b>Prices</b>											
CPI (1982-84=100)	247.3	249.4	251.4	253.0	254.7	256.1	257.5	258.7	245.1	252.1	258.1
<b>Percent Change Annualized</b>	<b>3.3</b>	<b>3.5</b>	<b>3.2</b>	<b>2.6</b>	<b>2.6</b>	<b>2.3</b>	<b>2.1</b>	<b>2.0</b>	<b>2.1</b>	<b>2.9</b>	<b>2.4</b>
PCE Price Index (2009=100)	113.5	114.2	115.1	115.8	116.5	117.1	117.7	118.3	112.7	115.4	118.0
<b>Percent Change Annualized</b>	<b>2.7</b>	<b>2.7</b>	<b>3.0</b>	<b>2.4</b>	<b>2.4</b>	<b>2.1</b>	<b>2.0</b>	<b>2.0</b>	<b>1.7</b>	<b>2.4</b>	<b>2.2</b>
GDP Price Index (2009=100)	114.3	114.8	115.4	116.0	116.6	117.1	117.7	118.3	113.4	115.7	118.0
<b>Percent Change Annualized</b>	<b>2.3</b>	<b>2.0</b>	<b>2.0</b>	<b>2.0</b>	<b>2.0</b>	<b>2.0</b>	<b>2.0</b>	<b>2.0</b>	<b>1.8</b>	<b>2.0</b>	<b>2.0</b>
Producer Price Index, Finished Goods	200.7	202.4	204.1	205.5	206.8	207.9	208.9	210.0	198.0	204.7	209.5
<b>Percent Change Annualized</b>	<b>5.9</b>	<b>3.6</b>	<b>3.3</b>	<b>2.9</b>	<b>2.5</b>	<b>2.2</b>	<b>2.0</b>	<b>2.0</b>	<b>3.2</b>	<b>3.4</b>	<b>2.3</b>
Crude Oil, WTI (\$/barrel)	55.4	62.9	68.0	72.0	75.0	75.0	75.0	75.0	50.8	69.5	75.0
<b>Labor Markets</b>											
Payroll Jobs (Average Monthly Diff., Ths.)	185.4	208.6	180.1	182.4	164.2	155.5	149.3	141.7	181.4	183.8	146.6
Unemployment Rate (Percent)	4.1	4.1	3.9	3.9	3.8	3.7	3.7	3.7	4.3	3.9	3.7
Average Weekly Hours, Prod. Works.	33.7	33.7	33.7	33.7	33.6	33.6	33.6	33.6	33.7	33.7	33.6
Population (Millions)	327.0	327.7	328.3	329.0	329.7	330.3	331.0	331.6	326.0	328.7	331.3
<b>Percent Change Annualized</b>	<b>0.8</b>	<b>0.8</b>	<b>0.8</b>	<b>0.8</b>	<b>0.8</b>	<b>0.8</b>	<b>0.8</b>	<b>0.8</b>	<b>0.7</b>	<b>0.8</b>	<b>0.8</b>
<b>Personal Income</b>											
Average Hourly Earnings (\$)	22.24	22.40	22.55	22.72	22.89	23.06	23.24	23.41	22.05	22.64	23.33
<b>Percent Change Annualized</b>	<b>2.1</b>	<b>2.8</b>	<b>2.8</b>	<b>3.0</b>	<b>3.0</b>	<b>3.1</b>	<b>3.0</b>	<b>3.1</b>	<b>2.3</b>	<b>2.7</b>	<b>3.0</b>
Real Disp. Income (2009 Billions \$)	12821	12930	12967	13028	13090	13164	13237	13314	12763	13004	13276
<b>Percent Change Annualized</b>	<b>1.1</b>	<b>3.4</b>	<b>1.2</b>	<b>1.9</b>	<b>1.9</b>	<b>2.3</b>	<b>2.3</b>	<b>2.3</b>	<b>1.2</b>	<b>1.9</b>	<b>2.1</b>
Personal Saving Rate (Percent)	2.6	3.1	3.0	3.0	3.0	3.0	3.0	3.0	3.4	3.0	3.0
<b>Housing</b>											
Housing Starts (Ths., Ann. Rate)	1256	1318	1327	1336	1344	1351	1357	1364	1208	1331	1361
Ext. SF Home Sales (Ths., Ann Rate)	4960	4903	4956	4979	5007	5033	5056	5081	4910	4961	5068
New SF Home Sales (Ths., Ann Rate)	657	668	694	699	704	708	713	716	617	691	714
Case/Shiller HPI (Jan. 2000=100)	196.3	200.0	203.8	207.6	211.3	214.9	218.5	222.1	191.7	205.7	220.3
<b>Year/Year Percent Change</b>	<b>6.1</b>	<b>6.4</b>	<b>7.3</b>	<b>7.8</b>	<b>7.6</b>	<b>7.5</b>	<b>7.2</b>	<b>7.0</b>	<b>5.9</b>	<b>7.3</b>	<b>7.1</b>
<b>Consumer</b>											
Household Economic Stress Index	0.1	-0.1	-0.4	-0.8	-0.8	-1.1	-1.1	-1.0	0.6	-0.5	-1.1
Auto Sales (Millions)	17.8	17.2	17.0	16.8	16.6	16.4	16.1	15.8	17.3	16.9	16.0
<b>Interest Rates (percent per year)</b>											
Federal Funds Rate (Effective)	1.20	1.45	1.69	1.91	2.13	2.17	2.42	2.66	1.00	1.80	2.53
Prime Rate	4.30	4.53	4.78	5.01	5.23	5.27	5.52	5.76	4.10	4.89	5.63
1-Month LIBOR	1.34	1.65	1.96	2.14	2.31	2.34	2.59	2.83	1.11	2.02	2.70
3-Month LIBOR	1.47	1.93	2.40	2.58	2.67	2.63	2.84	3.06	1.26	2.39	2.95
1-Yr. Treasury Rate	1.55	1.94	2.26	2.42	2.50	2.46	2.65	2.86	1.20	2.28	2.75
5-Yr. Treasury Rate	2.07	2.54	2.81	2.98	3.05	2.99	3.17	3.37	1.91	2.84	3.27
10-Yr. Treasury Rate	2.37	2.76	2.98	3.15	3.22	3.16	3.34	3.54	2.33	3.03	3.44
30-Year Fixed Rate Mortgage	3.92	4.27	4.58	4.79	4.87	4.81	4.98	5.16	3.99	4.63	5.07

a = actual f = forecast

May 7, 2018

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