

Flatlining the Fed

We have removed the one fed funds rate hike for 2019 that we had previously shown in our interest rate forecast. In our February interest rate forecast, we had one fed funds rate hike coming at the June FOMC meeting. Now, in our March interest rate forecast we show the fed funds rate range remaining at the current 2.25-2.50 percent through 2021. This reflects our uncertainty about both the timing and the direction of the Fed’s next move.

In his 60-Minutes interview from March 5, Fed Chairman Jay Powell again emphasized the Fed’s “patient” stance. Powell said, “Patient means that we don’t feel any hurry to change our interest rate policy.” Powell’s chief justification was a cooler global economy and he highlighted downside risks emanating from weaker demand in China and Europe and from the Brexit process in the U.K.

The flattening of the Treasury bond yield curve early this year is consistent with the view that the Fed is at the top of its rate tightening cycle. Also, the fed funds futures market shows a strong implied probability, 77.6 percent, that the fed funds rate range will remain at the current 2.25-2.50 percent through January 2020.

Flatlining the fed funds rate is also consistent with our view of cooler U.S. economic growth through the remainder of this year. We now expect U.S. real GDP growth to ease from 2.9 percent in 2018, to 2.5 percent in 2019, and ease further to 2.2 percent in 2020. While we are forecasting continued U.S. economic growth through the near term, we also recognize that the odds of recession for the U.S. over the next two years have materially increased.

Finally, we can say that a flat fed funds rate forecast is consistent with expectations for overall lower interest rates in this expansion cycle. R-star (or R*) is the terminology that the Fed uses to denote the “natural” rate of interest. It is more tightly defined as the real (inflation-adjusted) short-term interest rate expected to prevail when the U.S. economy is at full strength and inflation is stable. R-star is not directly measurable. It is only a theoretical construct. But the concept shows how the Fed’s thinking about interest rates has gradually changed over recent decades. The Fed’s estimates for R-star have dropped significantly from about 3.5 percent in the late 1980’s, to about 0.8 percent at the end of 2018. This estimate of R-star at 0.8 percent, plus inflation in the neighborhood of 2.0 percent, gives us an estimate of about 2.8 percent for a “neutral” fed funds rate. This is why the Fed thinks it is already close to neutral and is concerned about overshooting neutral if the global economy cools down and inflation falls.

Inflation is now the key variable in the Fed’s policy calculation. The Fed’s preferred measure of inflation, the 12-month trimmed mean PCE price index has been hovering near 2 percent since last June. Even though oil prices have firmed early this year, they will likely exert little upward pressure on the trimmed mean PCE because big pushes and pulls in inflation are dropped out of the index so that it represents a “core” reading on prices.

We expect overall inflation to remain calm, near 2 percent, for the remainder of this year, effectively removing the rationale for further rate increases. Wages are still going up due to the tight labor market, and there is still some upside risk to inflation from the Phillips Curve effect, that higher wages will eventually result in hotter inflation. However, to date, that remains a risk and not a fact. Further, the potential resolution of the U.S./China trade war this year represents a key downside risk for inflation.

On March 20, the Fed will release a new dot plot showing the FOMC’s expectations for the fed funds rate over the next few years. We expect to see the March dot plot flatten compared to the dot plot from last December.

U.S. Economic Outlook, Summary

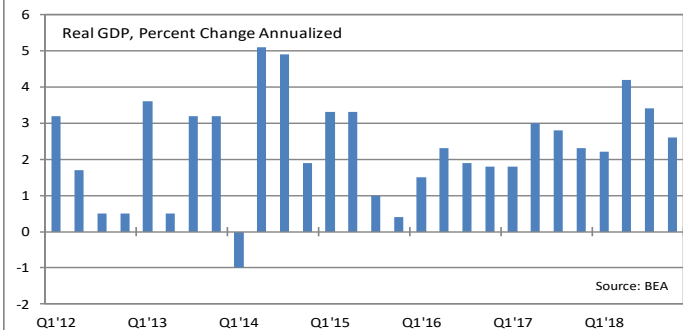
<i>a = actual f = forecast</i>	3Q'18a	4Q'18a	1Q'19f	2Q'19f	3Q'19f	4Q'19f	1Q'20f	2Q'20f	2018a	2019f	2020f
Real GDP (Percent Change Annualized)	3.4	2.6	1.7	2.5	2.3	2.4	2.2	2.0	2.9	2.5	2.2
CPI (Percent Change Year-over-Year)	2.7	2.6	2.2	2.0	2.0	2.0	2.2	2.1	2.1	2.4	2.0
Payroll Jobs (Average Monthly Diff., Ths.)	222.2	216.4	165.2	169.7	161.1	148.9	142.9	127.0	221.0	161.2	117.1
Unemployment Rate (Percent)	3.8	3.8	3.8	3.8	3.7	3.6	3.6	3.6	3.9	3.7	3.6
Federal Funds Rate (Effective)	1.92	2.22	2.39	2.38	2.38	2.38	2.38	2.38	1.83	2.38	2.38
10-Yr. Treasury Rate	2.93	3.03	2.67	2.64	2.71	2.79	2.85	2.89	2.91	2.70	2.90

Risk of Recession Outlook

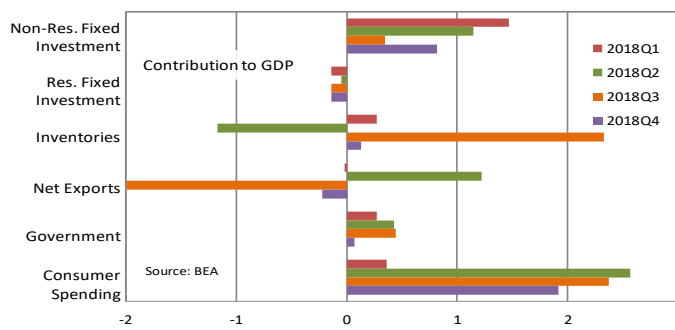
Probability of Recession (in the next)	6 months	12 months	24 months	36 months
February 2019	25%	38%	55%	63%

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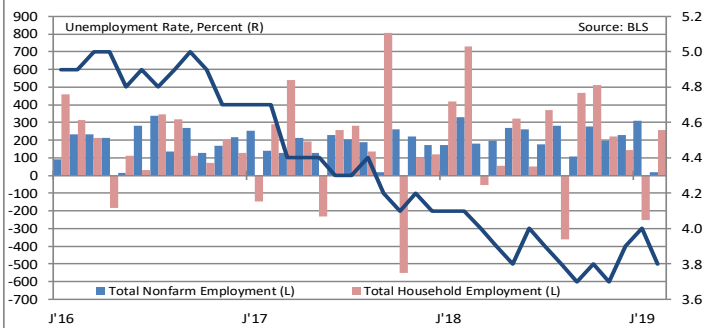
Q4 GDP Estimate at 2.6%



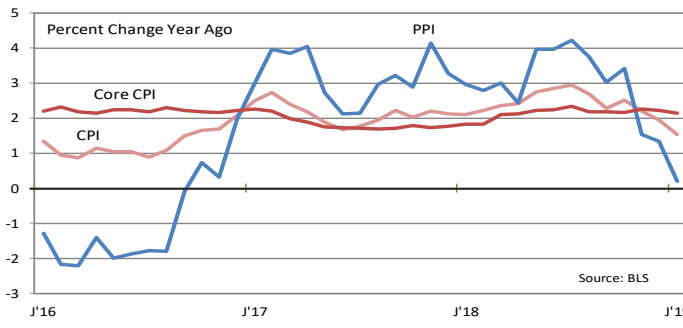
Non-Res. Fixed Investment Back Up in Q4



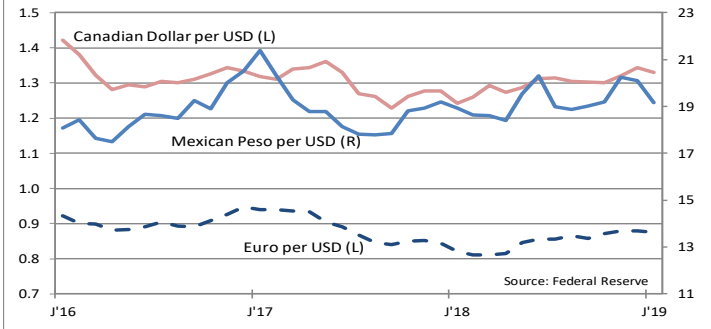
U.S. Added a Net 20,000 Jobs in February



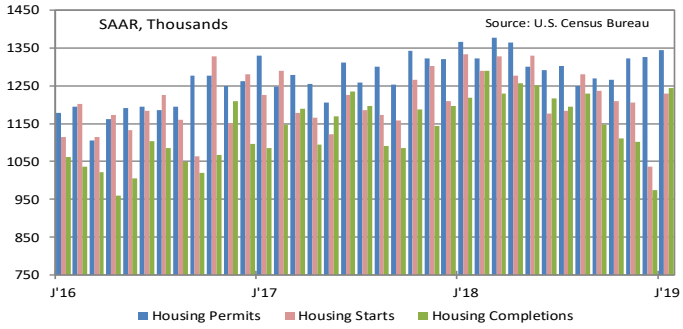
Inflation Remains Cool through January



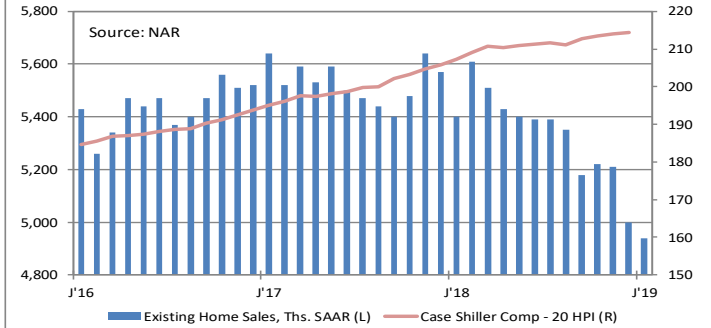
US Dollar Remains Strong through Jan.



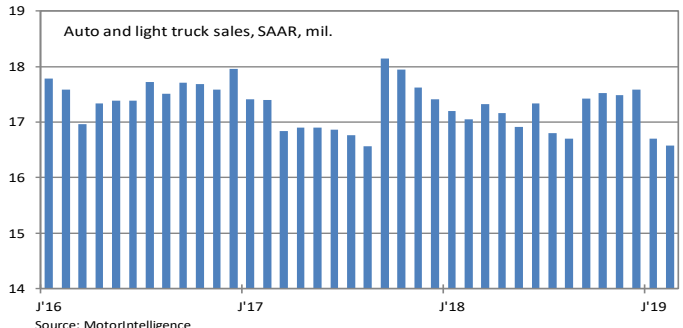
Housing Starts Picked Back Up in January



Existing Home Sales Continue to Ease in Jan.



Auto Sales Little Changed in February



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	3Q'18a	4Q'18a	1Q'19f	2Q'19f	3Q'19f	4Q'19f	1Q'20f	2Q'20f	2018a	2019f	2020f
Output											
Nominal GDP (Billions \$)	20658	20891	21080	21314	21541	21777	22003	22222	20501	21428	22324
Percent Change Annualized	4.9	4.6	3.7	4.5	4.3	4.4	4.2	4.0	5.2	4.5	4.2
Real GDP (Chained 2012 Billions \$)	18665	18785	18864	18983	19092	19207	19311	19408	18571	19036	19449
Percent Change Annualized	3.4	2.6	1.7	2.5	2.3	2.4	2.2	2.0	2.9	2.5	2.2
Pers. Consumption Expenditures	12953	13044	13119	13192	13260	13337	13404	13466	12891	13227	13492
Percent Change Annualized	3.5	2.8	2.3	2.2	2.1	2.3	2.0	1.9	2.6	2.6	2.0
Nonresidential Fixed Investment	2727	2768	2795	2832	2868	2904	2937	2969	2715	2850	2983
Percent Change Annualized	2.5	6.2	3.9	5.5	5.2	5.0	4.7	4.4	7.0	5.0	4.7
Residential Investment	608	602	606	606	605	604	602	601	610	605	600
Percent Change Annualized	-3.6	-3.5	2.2	0.5	-0.6	-1.0	-1.0	-0.9	-0.2	-0.7	-0.9
Change in Private Inventories	90	97	63	62	62	62	62	62	45	62	62
Net Exports	-950	-963	-968	-974	-980	-986	-989	-994	-914	-977	-997
Government Expenditures	3192	3195	3209	3222	3235	3244	3253	3261	3178	3228	3266
Percent Change Annualized	2.6	0.4	1.7	1.7	1.6	1.1	1.1	1.1	1.5	1.6	1.2
Industrial Prod. Index (2007=100)	108.6	109.8	110.7	111.1	111.3	111.4	111.4	111.2	107.9	111.1	111.1
Percent Change Annualized	4.9	4.6	3.3	1.6	0.7	0.3	-0.1	-0.5	4.0	3.0	-0.1
Capacity Utilization (Percent)	78.3	78.8	79.2	79.5	79.5	79.6	79.5	79.4	78.0	79.4	79.3
Prices											
CPI (1982-84=100)	251.8	252.8	254.2	255.6	256.9	258.2	259.5	260.8	251.1	256.2	261.4
Percent Change Annualized	2.0	1.5	2.3	2.2	2.0	2.0	2.0	2.0	2.4	2.0	2.0
PCE Price Index (2012=100)	108.5	108.9	109.5	110.1	110.6	111.2	111.7	112.3	108.2	110.4	112.6
Percent Change Annualized	1.6	1.5	2.3	2.2	2.0	2.0	2.0	2.0	2.0	2.0	2.0
GDP Price Index (2012=100)	110.7	111.2	111.7	112.2	112.8	113.4	113.9	114.5	110.3	112.5	114.8
Percent Change Annualized	1.8	1.8	2.0	2.0	2.0	2.0	2.0	2.0	2.2	2.0	2.0
PPI, Final Demand (Nov. 2009=100)	116.5	117.2	117.8	118.5	119.1	119.7	120.3	120.9	116.2	118.8	121.2
Percent Change Annualized	2.0	2.4	2.1	2.2	2.0	2.0	2.0	2.0	2.2	2.1	2.0
Crude Oil, WTI (\$/barrel)	69.7	59.4	53.0	55.0	60.0	60.0	60.0	60.0	65.0	57.0	60.0
Labor Markets											
Payroll Jobs (Average Monthly Diff., Ths.)	222.2	216.4	165.2	169.7	161.1	148.9	142.9	127.0	221.0	161.2	117.1
Unemployment Rate (Percent)	3.8	3.8	3.8	3.8	3.7	3.6	3.6	3.6	3.9	3.7	3.6
Average Weekly Hours	34.5	34.5	34.5	34.5	34.5	34.4	34.4	34.4	34.5	34.5	34.4
Population (Millions)	327.7	328.3	328.9	329.5	330.1	330.7	331.3	331.9	327.5	329.8	332.2
Percent Change Annualized	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.6	0.7	0.7
Personal Income											
Average Hourly Earnings (\$)	27.21	27.44	27.65	27.88	28.13	28.39	28.64	28.90	27.10	28.01	29.02
Percent Change Annualized	3.5	3.3	3.1	3.4	3.6	3.7	3.6	3.6	3.0	3.4	3.6
Real Disp. Income (2012 Billions \$)	14375	14524	14596	14682	14788	14889	14983	15071	14350	14739	15110
Percent Change Annualized	2.6	4.2	2.0	2.4	2.9	2.7	2.6	2.4	2.9	2.7	2.5
Personal Saving Rate (Percent)	6.4	6.7	6.4	6.0	6.0	6.0	6.0	6.0	6.7	6.1	6.0
Housing											
Housing Starts (Ths., Ann. Rate)	1234	1151	1210	1202	1198	1195	1193	1191	1241	1201	1189
Exst. SF Home Sales (Ths., Ann Rate)	4717	4567	4465	4433	4414	4401	4397	4389	4742	4428	4386
New SF Home Sales (Ths., Ann Rate)	605	590	608	603	601	599	597	595	621	602	594
Case/Shiller HPI (Jan. 2000=100)	203.6	206.0	208.4	210.5	212.8	215.1	217.6	220.2	202.8	211.7	221.5
Year/Year Percent Change	5.7	5.0	4.3	4.3	4.5	4.5	4.4	4.6	5.9	4.4	4.6
Consumer											
Household Economic Stress Index	0.7	1.0	1.5	1.5	1.2	1.3	1.2	1.0	0.5	1.4	1.0
Auto Sales (Millions)	17.0	17.5	16.8	16.7	16.5	16.4	16.4	16.3	17.2	16.6	16.2
Interest Rates (Percent)											
Federal Funds Rate (Effective)	1.92	2.22	2.39	2.38	2.38	2.38	2.38	2.38	1.83	2.38	2.38
Prime Rate	5.01	5.28	5.49	5.48	5.48	5.48	5.48	5.48	4.90	5.48	5.48
1-Month LIBOR	2.11	2.35	2.50	2.51	2.52	2.52	2.52	2.52	2.02	2.51	2.52
3-Month LIBOR	2.34	2.63	2.68	2.61	2.63	2.64	2.64	2.64	2.31	2.64	2.64
1-Yr. Treasury Rate	2.47	2.67	2.56	2.55	2.59	2.62	2.64	2.66	2.33	2.58	2.66
5-Yr. Treasury Rate	2.81	2.88	2.48	2.48	2.60	2.68	2.74	2.79	2.75	2.56	2.80
10-Yr. Treasury Rate	2.93	3.03	2.67	2.64	2.71	2.79	2.85	2.89	2.91	2.70	2.90
30-Yr. Fixed Rate Mortgage	4.57	4.78	4.41	4.45	4.53	4.58	4.58	4.59	4.54	4.49	4.60

a = actual f = forecast

March 13, 2019

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