Focus on Fundamentals

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For several years, the U.S. economy has produced a "Goldilocks" combination (neither too hot nor too cold) of solid growth with limited inflation. The absence of price pressures, even at very low levels of unemployment, has surprised many observers.

It may be too soon to conclude that Goldilocks has left the building, but recent economic and market readings suggest that she may at least be glancing toward the door. Inflation indicators have been rising, prompting a corresponding increase in long-term interest rates and a correction in equity prices. These developments have been seen globally, suggesting the U.S. experience is not an isolated incident.

For now, we've made only modest changes to our outlook. The most prominent of them is our updated expectation that the Federal Reserve will raise interest rates four times this year as inflation approaches its targeted level. But we think it is premature to make more substantive changes on the basis of a handful of trading days and data points.

Following is a discussion of recent developments.

Key Economic Indicators

	2017				2018				Q4 to Q4 change			Annual change		
	17:1a	17:2a	17:3a	17:4a	18:1f	18:2f	18:3f	18:4f	2016a	2017f	2018f	2016a	2017a	2018f
Real Gross Domestic Product (% change, SAAR)	1.2	3.1	3.2	2.6	3.3	2.5	2.2	2.1	1.8	2.5	2.5	1.5	2.3	2.8
Consumer Price Index (% change, annualized)	1.5	0.1	4.2	2.6	2.1	2.2	2.3	2.3	1.8	2.1	2.3	1.3	2.1	2.3
Civilian Unemployment Rate (%, average)	4.7	4.3	4.3	4.1	4.1	4.0	3.9	3.8				4.8*	4.4*	4.0*
Federal Funds rate	0.70	0.95	1.13	1.18	1.43	1.68	1.93	2.18				0.40*	0.99*	1.80*
2-yr. Treasury Note	1.24	1.29	1.36	1.68	2.04	2.24	2.47	2.70				0.84*	1.39*	2.36*
10-yr. Treasury Note	2.44	2.26	2.24	2.40	2.70	2.90	3.10	3.30				1.84*	2.34*	3.00*

a=actual
f=forecast
*=annual average

Influences on the Forecast

- Fourth-quarter real economic growth came in at an annual pace of 2.6%. This was somewhat below expectations, but was held back by a surge in imports and a trough in inventory building. Both of these developments are expected to normalize in the months ahead.
- Consumer spending was very strong at the end of the year, buoyed by strong job creation and wealth effects generated by rising asset prices. Consumption will get a further boost from tax reform: payroll withholding will be reduced this month, and companies will use some of their tax savings to boost wages and dividends. While much of America needs to save more, chances are that these adjustments will be seen as windfalls and spent accordingly.
- It's still too soon to gauge how much of an effect tax reform will have on capital spending by businesses this year. But in one indication, the Institute of Supply Management (ISM) purchasing managers index stands at 59.1, and the new orders component of the index stands at 65.4. On a scale where 50 is neutral, both of these readings are exceptionally strong. Capital goods orders have been increasing steadily for about a year now.

- In the wake of strong domestic and global activity, inflation readings have become less benign. The Fed's favorite inflation indicator (the deflator on personal consumption expenditures, excluding food and energy) has risen at a 1.9% annual rate over the last quarter. Goods prices continue to move up slowly, but service prices (shelter, medical care, education) are rising more briskly.
- The January employment report provided additional fodder for those concerned about inflation. Another strong month of job creation was accompanied by the fastest pace of wage growth since 2009. Hourly earnings are now 2.9% higher than they were a year ago, bringing the data into harmony with legions of anecdotes and surveys suggesting firms were having difficulty attracting and retaining talent. Higher wage growth does not always translate into higher inflation, but it does tend in that direction.
- Market-based measures of inflation expectations have increased in the past month. Ten-year Treasury breakeven rates (the yield difference between fixed rate and inflation-protected Treasury securities) are 25 basis points higher than they were in December and 45 basis points higher than they were last June. Some of this reflects rising oil prices (which are highly influential on inflation expectations), but recent moves suggest a broader set of motivations. Inflation expectations are an important leading indicator of actual inflation.
- U.S. interest rates are higher than they were at the start of the year. Heightened inflation risk explains some of the movement, but concerns over a rising budget deficit, reductions in the Fed's holdings of Treasury securities, and a falling dollar may also be contributing. Offsetting this somewhat is the recent equity correction, which has made bond markets more popular and caused a retreat in yields.