U.S. Economy: The Tortoise Wins the Race

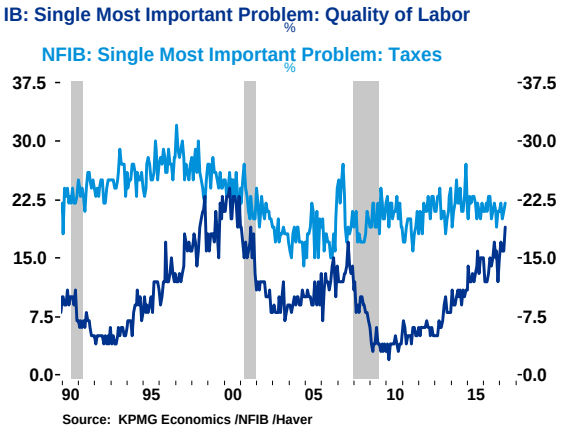
Office of the Chief Economist

June 20, 2017

GDP	Core CPI	Unemployment	Total Home Sales	o/n rate	10-year bond
1.2%	1.7%	4.3%	1.5% (Y/Y)	1.0 – 1.25%	2.15%

- The **Federal Reserve hiked rates in June** with the expectation that low unemployment will lead to wage growth and **inflation in the coming quarters**
- Continued **steady jobs growth** is likely to support consumption, which we expect to be 2.3% for 2017
- Globally, the **manufacturing cycle is turning positive** and this should help the U.S. rebound as well
- The **yield curve is flattening** which means the **Fed will be limited in the number of rate hikes** it can do before the 10-year yield starts to rise
- While slow and steady growth has been the mantra, **the US recovery may hit a wall** in the coming quarters

We still anticipate that growth will pick up slightly in the second half of 2017. With **80 months of consecutive jobs growth,** many households are in a stable position to continue spending at 2.0% pace. However, **the recovery is in the 8th inning of the expansion,** and expectations of a pickup to growth in the second half are being challenged by a number of data points. Inflation appears to be slowing despite tight labor markets (see expanded note below). Housing starts over the past six months have seen greater volatility and a slower pace of expansion. However, corporate Investment is a bright spot, rebounding from 2016 (-0.6%) to grow at 11.4% in the first quarter and adding 134 basis points to growth. This could well trigger a virtuous circle of slightly stronger growth down the road.



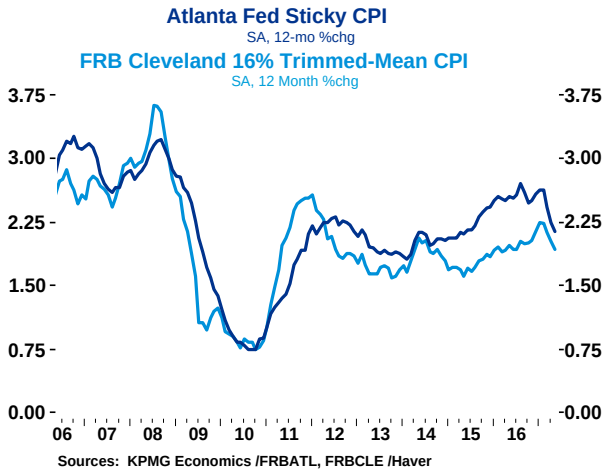
With the focus in D.C. remaining on tax reform we take a look at the history of taxes through the lens of small business. The graph at the left illustrates two important features of the business landscape. Taxes have always been cited most frequently as the top problem perceived by businesses. However, **at times of labor market tightness, quality of labor often rivals taxes as the top problem** as seen in the chart to the left**.** Currently **51% of small businesses report few or no qualified applicants for job openings**[1] – often a sign that a recession is only several quarters away**. Stimulative tax measures taken at this point** in the business cycle would likely lead to more labor market tightness and **not necessarily to more growth**. Add to this a likely continued tightening bias by the Fed, and it's difficult to see a near-term stimulative effect of the tax reforms currently being discussed in D.C.

[1] NFIB Small Business Survey, May 2017

Ask the Economist

In our previous U.S. update, I addressed a question on whether or not I believe in the unemployment statistics (in case you missed it, the short answer is yes). In this update I discuss the issue of prices and flation – inflation, disinflation, and deflation. To do this we need to focus on some technical terminology (see glossary to the right).

The graph below depicts two types of inflation indices that correct for the substitution effect. The Sticky CPI[2] does so by including only those goods for which prices are less flexible, aka sticky. The Trimmed-Mean CPI[3] does so by eliminating the top and bottom greatest price changes.



The key takeaway from this graph is that both the sticky and trimmed-mean CPI are trending downwards – to such an extent that **both are below their 10-year average levels**. This suggests that, despite the low unemployment rate, we are actually experiencing disinflation. This is especially noticeable in the sticky CPI which has been moving lower on a year-over-year basis for three months. Without a reversal of these trends the **Fed will be challenged to keep hiking rates**, even at the slow pace seen thus far.

Inflation: when the period-over-period price level rises.
Disinflation: when the period-over-period price level rises at a slower pace each period.
Deflation: when the period-over-period price level shows absolute declines below zero.
Core Price: price changes excluding food and energy (which are volatile and can distort underlying cyclical inflation trends).
Hedonic Pricing: when prices are adjusted for improvements in quality (e.g., Apple iPhone 7 versus Western Electric Model 1500D phone).
Substitution: customers' ability to purchase a similar but different product if prices change (e.g., grapes go on sale and are purchased versus oranges; air fares go on sale and a choice is made to fly versus driving or taking a train).
Sticky Price: the price level takes a longer time to change, unlike grapes or airfares and more like rent or a haircut. It's reasonable to assume that when these prices are set, they incorporate expectations about future inflation to a greater degree than prices that change on a frequent basis.
Flexible Price: the price level is more volatile and adjusts fairly quickly (e.g., gas prices).
Trimmed Mean: the measure of prices that eliminates the most extreme monthly price change at the top and the least monthly price change at the bottom

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[2] The Atlanta Fed Sticky CPI details can be found here.

[3] The Cleveland Fed Trimmed-Mean CPI details can be found here.