

U.S. 2016 Real GDP Growth May Disappoint Fed & Markets



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There are some significant headwinds that may slow U.S. economic activity in 2016 to a disappointing 1.60% annual average real GDP growth rate. And, with the current round of oil price declines, both headline and core inflation may finish 2016 more or less converging in the 1.35% to 1.75% range, staying below the Federal Reserve's (Fed) 2% long-term target. Given that economic activity and inflation expectations, and not Fed short-term rates policy, are the primary drivers of long-term U.S. Treasury bond yields, this subdued outlook suggests a potential trading range during 2016 of between 1.75% and 2.50% for 10-year Treasury yields as prices bounce with the ebbs and flows of anemic economic and inflation data. This base case also suggests the Fed may delay the next rate hike until the summer of 2016 and the effective federal funds rate may not climb above 1.0% until 2017.

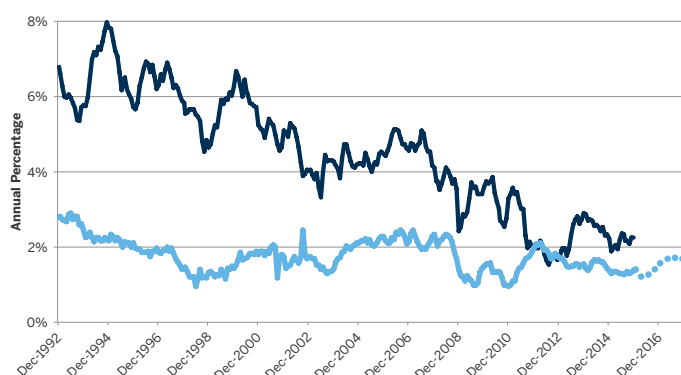
Retiring Boomers

Baby boomers, born between 1945 and 1965, are retiring in ever larger numbers. Those entering the work force after the turn of the century, known as millennials are now a larger segment of the labor force than boomers. Even if some boomers keep working past retirement age, the per capita consumption of the over-65 crowd tends to be significantly lower than when they were in their peak earnings years. As the percentage of the population over 65 heads for 20% in the 2020s, there will be a steady drag on economic growth.

Moreover, the U.S. labor force is hardly growing. Some of this is due to labor participation rates falling, but mostly it is due to an overall lack of population growth and the aging demographic pattern. Neither monetary nor fiscal policies are going to make a difference in reversing the implications of this powerful demographic trend.

When the labor force is not growing, real GDP growth has to come from increases in labor productivity. This means U.S. potential real GDP has probably declined to below 2% per year. Labor productivity can rise with more capital investment or technological improvements. But without something very special and unusual happening, a highly modernized, well-capitalized economy is unlikely to see its long-term (think decades) annual average labor productivity rate rise more than about 1.5% per year.

US Core Inflation & Treasury 10-Year Yield



Source: St. Louis Federal Reserve Bank FRED Database (GS10, PCEPILFE)

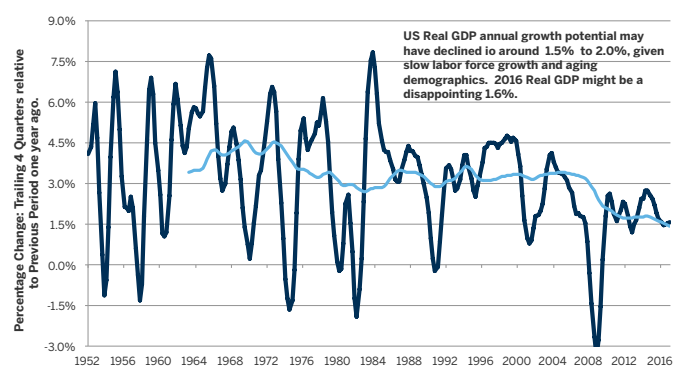
Flooding in Mississippi River Valley and Sluggish Global Growth

Then, there are the shorter-term headwinds. Flooding throughout the Mississippi River Valley may shave 0.3% to 0.6% or more off Q1/2016 real GDP. Barge traffic is disrupted, and upstream shippers may need to shift to rail. Downstream, the flow of good to ports is diminished. The effects are temporary and the economy bounces back, but it is still a drag on the first half of 2016. The dock strikes on the West Coast in Q1/2015 did similar damage.

Global growth is another material headwind. China is continuing to decelerate, possibly growing only 5.5% to 6.0% in 2016, despite a 6.5% growth target. Russia is in an oil-induced recession. Brazil is in a political-disarray induced recession. Europe is absorbing millions of immigrants, but not easily. Euro zone growth may be 1% to 2% in 2016; better than stagnation yet not exciting. Commodity-producing emerging market countries are suffering, as are mature commodity countries such as Australia and Canada. Exchange rates in the weakening countries are depreciating. It is not a “currency war”; it is just the natural market rebalancing of the value of countries whose fortunes have turned for the worse.

The combination of short-term disruptions, slow global growth, and the long-term consequences of a big generation of baby boomers retiring and spending less all adds up to a disappointing outlook. In Q1/2016, U.S. real GDP might grow only 0% to 1% (annual rate), and for the year the estimate is for 1.60% U.S. real GDP average annual growth.

US Annual Average Real GDP Growth



Source: St. Louis Federal Reserve Bank Fred Database (GDPCL).
Estimates for Q3/2015 - Q4/2017 by CME Economics.