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# U.S. economic outlook

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## Economic outlook

- A number of crosscurrents are buffeting the U.S. economy right now, clouding the outlook and complicating decision-making at the Federal Reserve (Fed). Although we still expect the economy to remain on a path of moderate, slightly-above-potential growth, sufficient to continue moving the labor market toward full employment and eventually helping lift inflation back up to target, downside risks to this central scenario have increased.
- One reason is that worries about growth in other countries (especially emerging economies) have intensified, fueling fears that their weakness could lap onto U.S. shores. In addition, financial conditions have tightened (partly as a result of those global concerns), posing added risks to the U.S. outlook. We're already seeing the adverse effects of the stronger dollar and sluggish growth abroad on U.S. exporters and manufacturers, and these drags are likely to persist. What's more, the decline in global energy prices continues to take a toll on activity in the domestic energy sector.
- To top it off, a sharp inventory correction is weighing on activity, cutting materially into gross domestic product (GDP) growth in the third quarter. More worrisome, the pace of job growth has slowed in recent months, heightening concerns that the deceleration in activity may become self-reinforcing and persistent.
- These are not idle concerns. But there are reasons to be more sanguine. For starters, some of the angst about growth in emerging economies seems overdone; there are signs, for example, that activity in China may be stabilizing. And

## Economic and financial market projections

	Real GDP	Core PCE Prices	10-year U.S. Treasury Yield	S&P 500 Index
<b>2014</b>				
1Q	-0.9%	1.2%	2.72%	1864
2Q	4.6%	1.5%	2.60%	1947
3Q	4.3%	1.5%	2.53%	1993
4Q	2.1%	1.4%	2.21%	2054
<b>2015</b>				
1Q	0.6%	1.3%	2.04%	2080
2Q	3.7%	1.3%	2.36%	2099
3Q	1.8% <sup>F</sup>	1.3% <sup>F</sup>	2.17%	1944
4Q(F)	2.7%	1.4%	2.10%	2025
<b>2016</b>				
1Q(F)	2.5%	1.4%	2.15%	2050
2Q(F)	2.4%	1.5%	2.20%	2085
3Q(F)	2.4%	1.5%	2.25%	2130

Source: DeAWM as of September 2015. **Performance is historical and does not guarantee future results.** Quarterly GDP change is annualized. The core Personal Consumption Expenditures (PCE) Price Index change is the four-quarter percentage change. The 10-year U.S. Treasury yield and S&P 500 Index level are from the last month of the quarter. F refers to forecast. FR is forecasted revision. The S&P 500 Index tracks the performance of 500 leading U.S. stocks and is widely considered representative of the U.S. equity market. The Personal Consumption Expenditures (PCE) Price Index tracks the average increase in prices for all domestic personal consumption items. The core PCE Price Index is a less volatile report than the PCE Price Index in that it does not include more volatile food and energy prices. It is not possible to invest directly in an index.

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the U.S. doesn't have much direct exposure to emerging economies anyway (exports to China comprise less than 1% of U.S. GDP).

- The tightening of financial conditions is where the U.S. is potentially more vulnerable, but some of that tightening has begun to reverse in recent weeks, likely limiting the damage.
- As for the inventory correction, that should be self-limiting, as final demands seem to be holding up quite well. In fact, domestic demand continues to expand at a healthy clip, supported by sound underlying fundamentals.
- Households are in strong financial shape, better than at any time since well before the financial crisis, having trimmed debt and especially debt service while also enjoying solid gains in real income driven by improving labor markets and lower energy prices. Household wealth has been well supported by recovering home prices and, a few recent wobbles notwithstanding, higher equity prices too.
- Housing is also well positioned for continued recovery. Recent housing data have been encouraging, the excess supply has been worked off, the rate of household formation seems to be picking up, and further gains seem likely as labor markets and income prospects improve.
- The worst cutbacks in energy-related capital expenditures seem behind us, especially if energy prices stabilize, and firms generally remain well positioned financially, if a bit less so since the recent tightening of financial conditions.
- Though there is some risk of a renewed fiscal showdown later this year, even if it were to occur it would likely be temporary, hardly a harbinger of the kind of persistent fiscal restraint that held back the recovery earlier on.
- All told, the fundamentals seem sufficiently positive to support growth that continues to run modestly above potential, at least over the next year or two. The economy just does not seem to be harboring the kinds of excesses—like private-sector overindulgence, or resource strains and inflation pressures—that have presaged sustained slowdowns in the past. This expansion appears still to have ample room to run.
- But the economy's potential output isn't what it used to be. The financial crisis and Great Recession likely impaired both productivity and labor supply, and some of these scars may linger. Other restraints seem even more deeply rooted; productivity growth was slowing even in the previous cycle, and the retirement of the baby

boomers has long been in train. So potential output—certainly its level, and likely its growth rate too—is apt to remain shy of pre-recession norms.

- Despite this diminished potential, the economy appears still to be operating with slack. Yes, much progress has been made in whittling it down over the past few years; the unemployment rate, for example, has fallen substantially, and even the reduced pace of job growth seen over the past two months would be sufficient to continue pushing it down. Other metrics of labor-market activity have improved too, and even broader measures of unemployment that include discouraged workers and those working part-time who want full-time work have come down sharply. Still, they remain above pre-recession readings. And while much of the decline in labor-force participation that has contributed to the drop in unemployment is structural and not likely to reverse, some still seems cyclical and potentially reversible if job opportunities continue to improve.
- The behavior of labor costs also suggests that slack has not been exhausted. These costs are showing only faint hints of accelerating, continue to run below the pace consistent with the Fed's 2% inflation target, and seem hardly indicative of firms bidding feverishly for scarce talent. We still expect labor costs to pick up, but only gradually, restrained by residual slack, sluggish productivity, and low inflation expectations.
- Inflation continues to run below target, and is likely to remain there for some time, held in check for a while longer by the dollar's appreciation and declining energy prices. Over time, though, as these transitory effects fade, and the domestic slack continues to be reduced, inflation should begin to edge back up to target, though it's likely to take time, and downside risks persist.

## Monetary-policy outlook

- We continue to see Fed policymakers as getting closer to raising interest rates. The main reasons are: They feel that the economy has made good progress in moving closer to full employment; there are sound reasons to expect such progress to continue; tighter labor markets should eventually help lift inflation back toward target (especially as some of the temporary restraints recede); the current funds rate is well below neutral levels; starting liftoff soon affords the luxury of moving slowly rather than risking more abrupt and potentially destabilizing moves later.

- But a rate hike before year-end remains a close call. Economic and financial conditions will have to co-operate. We'll need to see signs that the economy's underlying growth momentum is solid, better than suggested by the most recent data; that the labor market continues to heal (at a better pace than in the past two months, though not necessarily as fast as earlier in the year); that financial conditions continue to improve or at least stabilize; that global fears continue to ease; that a U.S. fiscal crisis is averted; and that labor costs, core inflation, and inflation expectations do not slip (a bit of a pickup would help).
- We put about a 55% to 60% probability that enough of this picture will come into focus by December to convince the Fed to hike (and to better prepare the markets for such a move).
- If Fed policymakers do begin to hike, they'll likely stress that they expect to move very slowly. Indeed, "low and slow" has long been our mantra when it comes to Fed policy in this cycle. With inflation below target and the funds rate at the zero bound, the potential adverse consequences of moving too quickly seem to outweigh those of moving too slowly.
- Of course, it will all depend on incoming information and how it shapes the Federal Open Market Committee's (FOMC's) outlook. But our take remains that conditions will not spur policymakers to move quickly and aggressively. After all, we hardly expect the economy to be overheating or inflation to be ramping up quickly. Moreover, we suspect that policymakers' inclinations—reinforced by lingering slack, only a gradual return of inflation to target, and growing conviction that the neutral rate may have declined—will likely be to move slowly, gauging how resilient the economy is to higher rates and probing to see where the economy's full-employment limits may lie, perhaps even erring on the side of letting the labor market overheat a little to ensure that inflation gets back up to target and stays there. They'll also likely tread carefully in slowing the pace of reinvestments of maturing securities.

## Financial-market outlook

- After a period of heightened anxiety—seemingly driven by concerns about global growth prospects—caused market volatility to spike and risk assets to suffer, fears have subsided more recently, helping reverse part of the previous market moves. Although calm seems to have been restored, a lingering sense of unease lurks beneath the surface, not least because it's still not clear just what caused such angst in the first place, and how some of the putative causes—like weakness in China, and a potential rate hike by the Fed—will play out.
- Our base-case macroeconomic outlook remains mildly supportive of U.S. risk assets and a slight weight on U.S. Treasuries. It is usually only well into a rate-tightening cycle, when investors can sense that the business-cycle peak might be approaching, that risk assets become truly vulnerable, and that still seems a distant prospect. However, a turn in the monetary policy cycle and a possible peak in profit margins (as slack is reduced) suggest a somewhat less supportive environment for equities and risk assets generally than in recent years. Similarly, U.S. Treasury yields are likely to back up if something close to our central economic scenario plays out and the Fed begins to hike, but we see that rise being modest even in the shorter and intermediate areas of the term structure, and especially for longer-dated securities, restrained by low global yields, still-tame domestic inflation, a less-than-robust recovery, and a Fed that is unlikely to be aggressive.

The **Federal Open Market Committee (FOMC)** is a committee within the Federal Reserve system that determines the direction of monetary policy. **Gross domestic product (GDP)** is the value of all goods and services produced by a country's economy. **Quantitative easing** is the introduction of new money into the money supply by a central bank.

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