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Monthly Note

November 2016

Understanding Where the US Economy Sits

The final quarter of the year began with minimal fanfare. Early in October, the employment report showed a mildly disappointing 156,000 jobs created in September. While the figure was lower than anticipated, workers continued to return to the labor force in droves with 440,000 coming back in the month alone. Wages tracked higher as well, especially for those workers consistently employed. Average hourly earnings gained 2.6% from a year earlier, but for those constantly employed wages were 3.4% higher.

Released late in the month, third quarter US GDP growth accelerated to 2.9% and was well above estimates. However, most of these gains came from sources that do not accurately reflect the underlying health of the US economy. Gains from inventory accumulation and a one-time export jump accounted for about half of the GDP number. A more accurate reflection of the domestic US economy is "final sales" which strips out both of those contributions. Final sales' 1.4% gain is positive but mediocre.

More jobs and higher wages typically result in elevated inflation pressures, something the Federal Reserve System (the Fed) has been attempting to spark for some time. But this recovery is acting differently in terms of inflation as well. Inflation, whether it is the consumer price index or the personal consumption expenditures index, is beginning to percolate. Despite the uptick in the underlying inflation currently underway, markets do not have much faith it will last. Metrics are pointing towards a belief that inflation will remain below 2% for at least the next 5 years.

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Taking everything into account, the Fed remains on-track to raise rates at their next meeting. For the Fed to step away from this position, the US economy needs to slow substantially between now and the end of December. While the US economy is by no means robust, a dramatic slowing by year end is an unlikely scenario.

With the Fed set to raise short-term rates at the end of the year, attention should be paid to how Fed policy is likely to unfold in 2017. If inflation remains near current levels and there are no major growth shocks, the Fed is likely to continue on a path of slowly tightening monetary policy. Due to the composition of the FOMC, the Fed's monetary policy setting body, interest rates are likely to remain low and hikes slow in the upcoming year. Every year certain voters rotate off and new voters ascend. In 2017, the FOMC will become more dovish than the overall Fed as the hawks rotate off. This means the so-called "dot plot" of policy expectations is deceiving. After all, everyone gets a dot, but not everyone gets a vote.

With an election and a rate hike, the end of 2016 will not be without excitement. However, the long-term outlook for the US economy and rates will be little changed regardless of both outcomes. Slow growth and a patient Fed will keep rates low and the US economic outlook stable.

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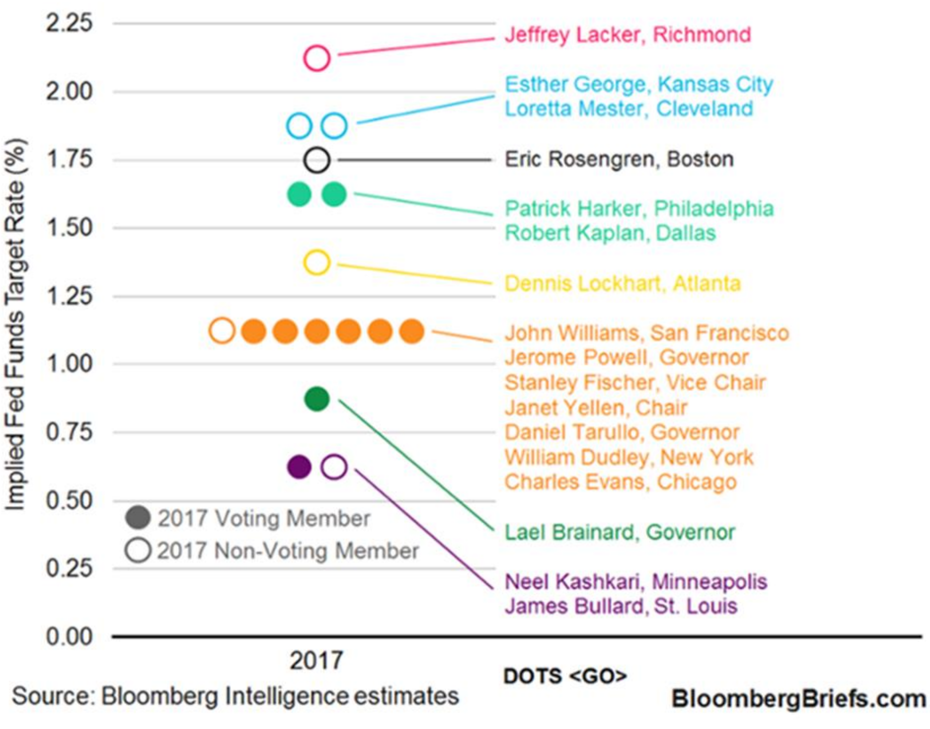

Source: Bloomberg

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