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Weekly Economic Monitor

The View From D.C.

Heading into the second half of the year, there are a number of key policy uncertainties in Washington. For the Fed, a clear near-term picture is a contrast to the longer-term outlook where views of the market and the Fed have diverged. On Capitol Hill, the repeal and replacement of the Affordable Care Act is still seen as a key hurdle to tackling tax reform and there's haste to get the ACA repeal done before the July 4 recess. In the months ahead, Congress will have to address the debt ceiling and complete a budget. Lawmakers view Trump tweets and potential charges of obstruction of justice as possible impediments to advancing the agenda.

At the June policy meeting, the Fed laid out its plan to begin unwinding the balance sheet. No start date was specified, but there's a strong consensus among economists that it will begin in October (to be announced at mid-September policy meeting). The Fed announced starting caps ($6 billion for Treasuries, $4 billion for mortgage-backed securities) for how much will be allowed to run off each month. The Fed will then increase those caps every three months until it reaches $50 billion per month ($30 billion in Treasuries, $20 billion in MBS). Starting slow, the markets shouldn't have much difficulty, but once the drawdown hits its stride ($600 billion per year), there may be some trouble in absorbing that. The bond market hasn't reacted much to the Fed's balance sheet plans. Some of it was likely already baked in, but the markets also seems to doubt that the balance sheet drawdown will proceed as planned.

Economists generally expect the Fed to refrain from raising rates at the September policy meeting to give the balance sheet drawdown an unobstructed runway. However, most expect a resumption of rate increases at the mid-December policy meeting. Beyond that, the outlook is more clouded, partly because we will see a number of personnel changes at the Fed.

Judging from the federal funds futures market, the odds of another 25-basis-point rate increase by yearend are somewhat below 50%. There has been some criticism of the Fed's June rate hike, which came amid a string of softer economic growth figures and low inflation readings. Here's the Fed's thinking. At 4.3%, the unemployment rate is below the long-term equilibrium rate (which the Fed pegs at 4.6%, down from 4.8% seen a just a couple of quarters ago). The Fed firmly believes in the Phillips curve, which describes a relationship between the unemployment rate and accelerating inflation. However, while the principles behind that relationship are basic (it's supply and demand), the slope of the curve may be flat with some nonlinearity further away from the equilibrium unemployment rate (meaning that at some point, a declining unemployment rate will lead to a much faster pickup in inflation). Inflation is still below the Fed's 2% goal, but suppose it stays low. The Fed could refrain from raising rates, pushing the unemployment rate lower to boost inflation, but then would have to raise rates later to get back to the equilibrium unemployment rate – a path that would be hazardous (risking a recession). There may be some uncertainty about the equilibrium unemployment rate, but given the balance of policy risks, a gradual path of rate increases is appropriate. If wrong, then the Fed hasn't raised rates much.

Meanwhile, the Senate healthcare bill is a lot like the House version. Taking the budget reconciliation route, the Republicans in the Senate (who hold a 52-48 majority) need only 50 votes to pass healthcare reform (Vice President Pence would break a tie). Publically, the Republican plan may be a tough sell. It's a clear trade-off between tax cuts for upper-income households and reduced benefits for millions of the poor and some fear a possible backlash in the 2018 midterms. However, voters have a short memory and Democratic voters tend not to show up for midterm elections. Four Republican senators currently oppose the bill because it doesn't go far enough in repealing the ACA. There is a lot of pressure to get a completed bill on the president's desk before the July 4 recess.

There are a number of tax issues in the ACA and a failure to repeal makes broad tax reform virtually impossible. Still, even if Congress passes a bill and the president signs it, broad tax reform was always going to be difficult. There is not enough discretionary spending to cut to balance the budget and no one wants to give up their current tax deductions. Congress has dropped the border tax adjustment as a means of generating revenues to offset the impact of lower tax rates. We may still see a reduction of tax rates into 2018, but on a much smaller scale than was hoped for previously. A drop in the tax rate on retained foreign earnings is seen as a one-off holiday generating some increase in revenue, but only for the short term (that is, not a sustained higher revenue source for the government).

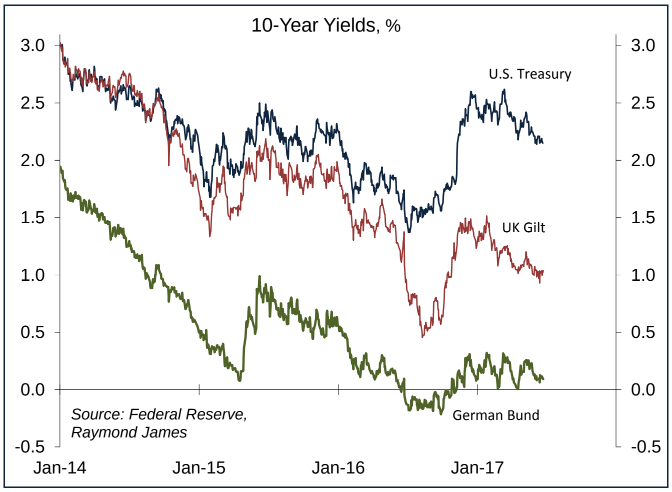
By the autumn, the debt ceiling will have to be raised. It would be better if it were eliminated. In early May, the president signed an omnibus appropriations bill, funding the government through September. In the months ahead, Congress will work on appropriation bills for FY18. We're likely to see a Continuing Resolution to fund the government into October, but there's some potential for fireworks related to both the debt ceiling and the budget.

Financial regulation legislation is also on the table, with notable differences between the two chambers of Congress. Federal Reserve "reform" has been an issue for a number of Republicans in recent years, but it's unclear what we'll see. Note that, with the president's approval, Congress has the power to abolish the Fed at any time. Sleep well.

	Treasury Yields								Dollar				Equities		
	13-wk	26-wk	52-wk	2-yr	3-yr	5-yr	10-yr	30-yr	$/Euro	$/BP	JY/$	CD/$	NASD	SPX	DJIA
5/26/17	0.94	1.08	1.17	1.30	1.46	1.79	2.25	2.92	1.117	1.280	111.30	1.345	6210.19	2415.82	21080.28
6/16/17	1.03	1.13	1.21	1.32	1.48	1.75	2.16	2.78	1.119	1.278	110.84	1.324	6151.76	2433.15	21384.28
6/23/17	0.95	1.10	1.21	1.34	1.48	1.76	2.15	2.72	1.119	1.272	111.25	1.326	6264.70	2438.31	21396.33

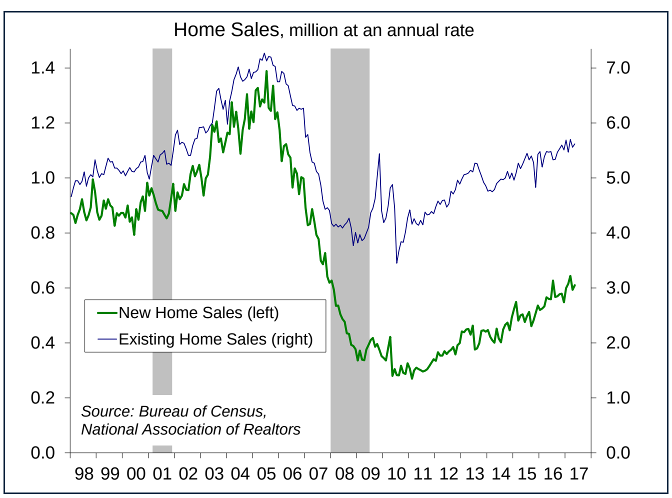
Recent Economic Data and Outlook

The economic data calendar was thin and inconsequential. Crude oil prices fell further (often interpreted by the stock market as a sign of economic weakness, but that didn't seem to be the case this time). The repeal and replacement of the Affordable Care Act is still seen as a hurdle for broader tax reform. The Senate bill was not much different from the House's version and faces some difficulty as lawmakers try to get things done ahead of the July 4 recess. Even with an ACA repeal, broad tax reform is difficult, but we may still see some reduction of tax rates into 2018.



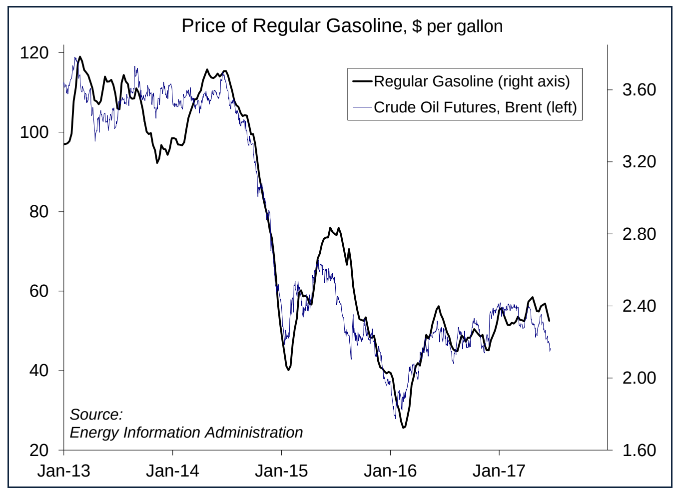
The **Current Account Deficit** widened less than anticipated in 1Q17, to $116.8 billion (2.5% of GDP), vs. $114.0 billion in 4Q16. A wider trade deficit in goods and smaller surplus in services was partly offset by a drop in secondary income (net transfers).

New Home Sales rose 2.9% in May (±13.0%), to a 610,000 seasonally adjusted annual rate (+8.9% y/y, ±21.9%). Results were mixed across regions (-10.8% in the Northeast, -25.7% in the Midwest, +6.2% in the South, and +13.3% in the West).



Existing Home Sales rose 1.1% in May, to a 5.62 seasonally adjusted annual rate (+2.7% y/y). Results were mixed across regions (+6.8% in the Northeast, -5.9% in the Midwest, +2.2% in the South, and +1.0% in the West).

The Index of **Leading Economic Indicators** rose 0.3% in May, a 2.3% gain over the last six months. The drop in building permits was the only negative contribution. The Index of Coincident Economic Indicators (with two of four components estimated) edged up 0.1%. The Conference Board noted that "taken together, the current behavior of the composite indexes and their components suggest that the expansion in economic activity will continue through the end of 2017, with some upside potential in the near term."



Economic Outlook (2Q17): around 2.5-3.0% GDP growth, a smaller rebound (from 1Q17) than was anticipated earlier.

Employment: The trend in job growth remains moderately strong, slowing due to tighter labor market conditions.

Consumers: Job gains and wage growth are supportive. Purchasing power should improve as gasoline prices ebb. Debt levels are manageable, with few signs of strain in the aggregate.

Manufacturing: Factory output has been uneven in recent months, but the trend appears to be moderate.

Housing/Construction: Job growth has been supportive, but higher home prices and rising building costs are restraints.

Prices: Ex-food & energy, the PCE Price Index has continued to trend below the Fed's 2% target. There is little inflation in consumer goods. Inflation in services has been boosted by higher rents. Wage growth has been moderate.

Interest Rates: The Fed remains in tightening mode, and is expected to continue raising short-term rates gradually. Balance sheet reduction is expected to be gradual.

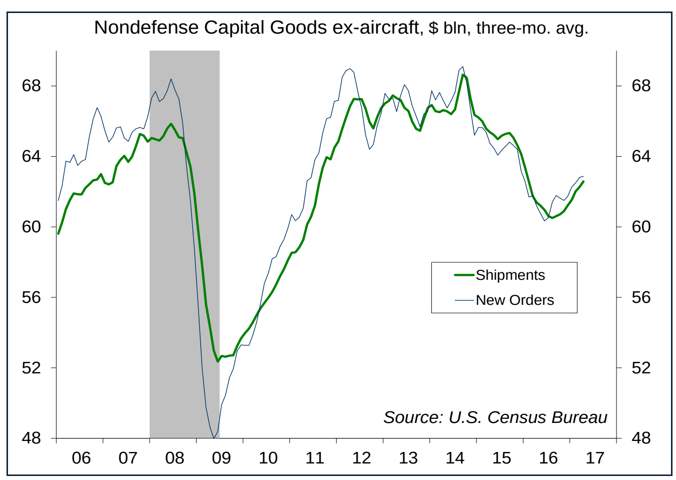
This Week:					*forecast*	last	last –1	comments
Monday	6/26	8:30	**Durable Goods Orders**	May	***-0.6%***	-0.8%	+2.4%	aircraft orders still soft
			ex-transportation		***+0.3%***	-0.5%	+0.9%	choppy, but a moderate trend
			nondef cap gds ex-aircraft		***+0.3%***	+0.1%	+0.0%	likely to pick up some
		1:00	Treasury Note Auction					$26 billion in 2-year notes
Tuesday	6/27	10:00	**CB Consumer Confidence**	Jun	***115.4***	117.9	119.4	still high, but likely to move lower
		1:00	Treasury Note Auction					$34 billion in 5-year notes
Wednesday	6/28	8:30	Advance Econ Indicators:	May				filling in the 2Q17 picture
			Merch. Trade Balance, $bln		***NF***	-67.6	-65.1	seen wider in 2Q17
			Wholesale Inventories		***NF***	-0.5%	+0.1%	failing to pick up in 2Q17
			Retail Inventories		***NF***	-0.2%	+0.2%	watch auto inventories
		10:00	Pending Home Sales Index	May	***+0.2%***	-1.3%	-0.9%	room for improvement
		11:30	FRN Auction					$13 billion in re-opened 2-year FRNs
		1:00	Treasury Note Auction					$28 billion in 7-year notes
Thursday	6/29	8:30	Jobless Claims, th.	6/24	***240***	241	238	still a low trend
		8:30	Real GDP (3rd estimate)	1Q17	***+1.3%***	+2.1%	+3.5%	+1.2% in the 2nd estimate
			Priv. Dom. Final Purchases		***+2.8%***	+3.4%	+2.4%	+2.7% in the 2nd estimate
Friday	6/30	8:30	**Personal Income**	May	***+0.3%***	+0.4%	+0.2%	more modest growth in wages & salaries
			Personal Spending		***+0.2%***	+0.4%	+0.3%	soft
			PCE Price Index		***+0.1%***	+0.2%	-0.1%	the core CPI rose 0.063%
		9:45	Chicago PM Index	Jun	***57.6***	59.4	58.3	still strong, but seen a bit lower
		10:00	UM Consumer Sentiment	Jun	***90.6***	97.1	97.0	94.5 at mid-month
Next Week:								
Monday	7/03	10:00	Construction Spending	Jun	***-1.2%***	-1.4%	+1.1%	some seasonal shift (2Q to 1Q)
		10:00	**ISM Manf. Index**		***54.5***	54.9	54.8	moderate
		1:00	NYSE early close					should be a light session
		2:00	SIFMA: bond close					market should thin out early
Tuesday	7/04		Independence Day Holiday					markets closed
Wednesday	7/05	10:00	Factory Orders	May	***NF***	-0.2%	+1.0%	seen a bit lower
		2:00	**FOMC Minutes**	6/14				insights into internal debates
		tba	Motor Vehicle Sales, mln	Jun	***16.5***	16.6	16.8	a modest downtrend
			domestically built		***12.7***	12.8	13.1	pace is slowing
Thursday	7/06	8:15	**ADP Payroll Estimate, th.**	Jun	***+160***	253	174	recently at odds with BLS data
		8:30	Jobless Claims, th.	7/01	***245***	***240***	241	seasonal noise in autos
		8:30	Trade Balance, $bln	May	***NF***	-47.6	-45.3	seen wider
			goods only		***NF***	-68.4	-66.1	seen wider
		10:00	**ISM Non-Manf. Index**	Jun	***56.5***	56.9	57.5	moderately strong
Friday	7/07	8:30	**Nonfarm Payrolls, th.**	Jun	***+150***	+138	+174	susceptible to some seasonal noise
			three-month average			+121	+152	trend is slower in 2017
			Private-Sector Payrolls		***+150***	+147	+173	moderate
			three-month average			+126	+151	slowing as job market tightens
			Unemployment Rate		***4.3%***	4.3%	4.4%	seen steady (reported accurate to ±0.2%)
			Employment/Population		***62.8%***	62.7%	62.9%	should rebound
			Avg. Weekly Hours		***34.4***	34.4	34.4	steady
			Avg. Hourly Earnings		***+0.3%***	+0.2%	+0.2%	moderate trend in wage growth

This Week…

While revisions to the first quarter GDP growth estimate are due on Thursday, this week's data is largely about filling in the 2Q17 picture. Reports on durable goods orders and consumer confidence have potential to surprise, but next week's data (including the employment report) carry much more weight.

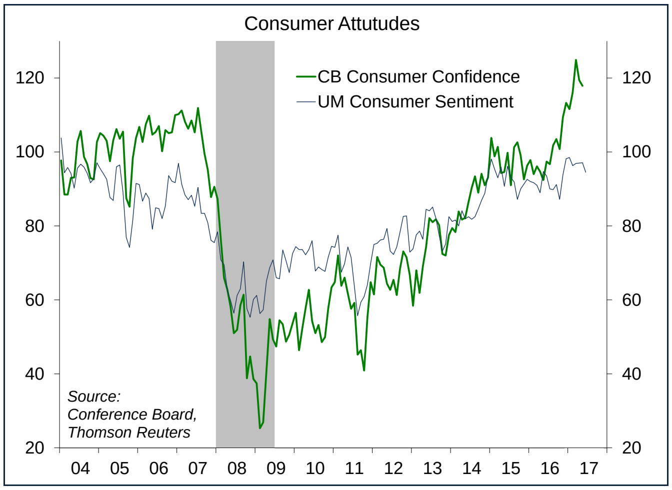
Monday

Durable Goods Orders (May) – Boeing reported weak orders again in May, which points to a further softening in transportation orders. Ex-transportation, orders are likely to be mixed, but generally up modestly. Note that the rebound in oil and gas well drilling has had an impact in recent months.



Tuesday

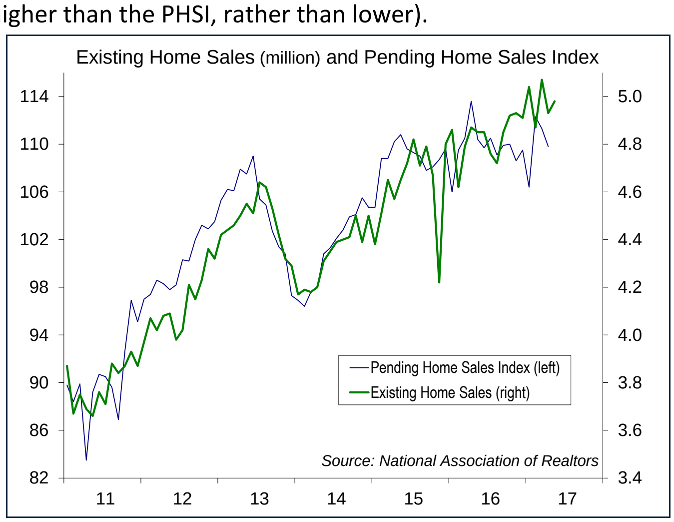
Conference Board Consumer Confidence Index (June) – In contrast to the UM measure, the Conference Board survey has a more direct emphasis on job market perceptions, which have been generally improving. Some moderation is likely in the June data.



Wednesday

Advance Economic Indicators (May) – Inventories and foreign trade are relatively small components of Gross Domestic Product, but they account for more than their fair share of volatility in the quarterly growth estimate. The financial markets will ignore this report, but the May data will help to fill in the picture for 2Q17 GDP growth.

Pending Home Sales Index (May) – Over long stretches, the PHSI tends to lead existing home sales, but monthly moves can be misleading. The relationship appears to have broken down over the last several months. Credit problems don't appear to be causing a failure to close (as existing home sales are trending higher than the PHSI, rather than lower).



Thursday

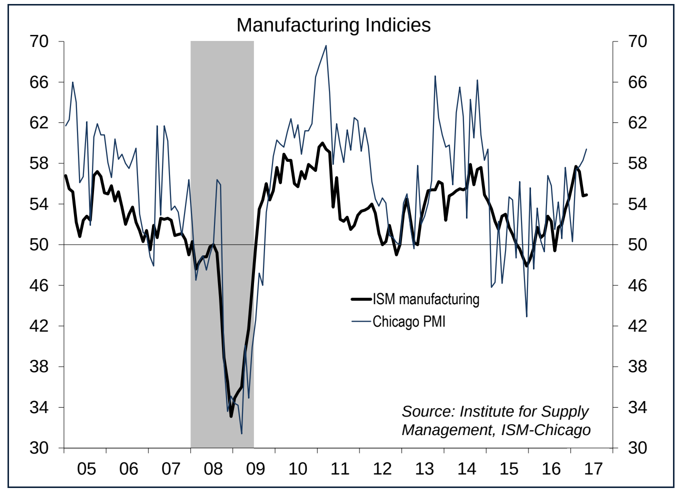
Jobless Claims (week ending June 24) – The weekly figures will be subject to some seasonal noise (the end of the school year), but the underlying trend is expected to remain low. Note that seasonal auto plant layoffs may distort the figures in early July.

Real GDP (1Q17, 3rd estimate) – Little change is expected from the previous estimate.

Friday

Personal Income and Spending (May) – The spending numbers are a direct input into the GDP calculation, but the financial markets rarely react to these figures (the employment report gives us a good idea of wage income, and the retail sales report is a reliable signal of consumer spending). May figures are expected to be relatively soft.

Chicago Business Barometer (June) – Investors often look to the Chicago Purchasing Managers data as an indicator of the more-important ISM numbers, but the headline Chicago figure tends to be a lot more volatile than the ISM.



UM Consumer Sentiment Index (June) – The headline figure fell at mid-month, but the report indicated that it was trending about flat until the 8th, when it fell sharply. The 8th corresponded to news that President Trump was under investigation for obstruction of justice. However, respondents to the survey did not specifically mention that.

Next Week …

An important week for economic data, with an expected focus on the June employment figures. However, the holiday should result in thinner market activity.

Coming Events and Data Releases

July 12	Fed Beige Book
July 14	Consumer Price Index (June) Retail Sales (June) Industrial Production (June)
July 26	FOMC Policy Decision (no press conf.)
July 28	Real GDP (2Q17, advance estimate)
September 20	FOMC Policy Decision, Yellen press conf.
November 1	FOMC Policy Decision (no press conf.)
December 13	FOMC Policy Decision, Yellen press conf.