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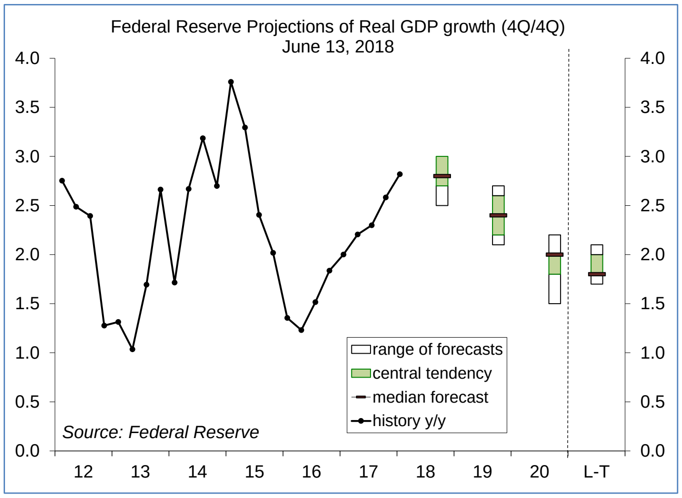
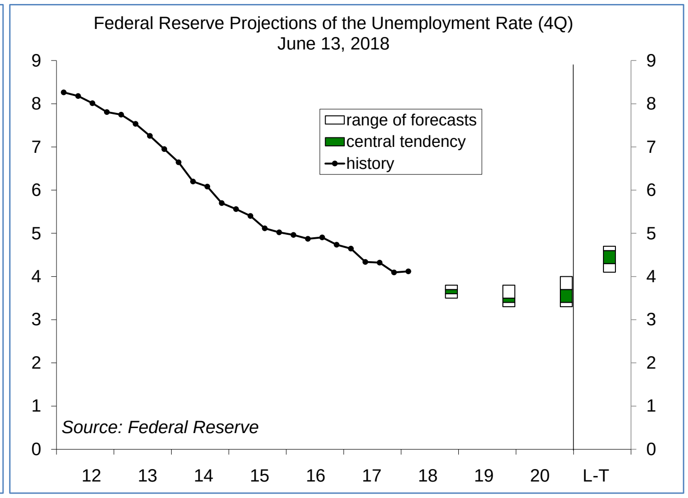
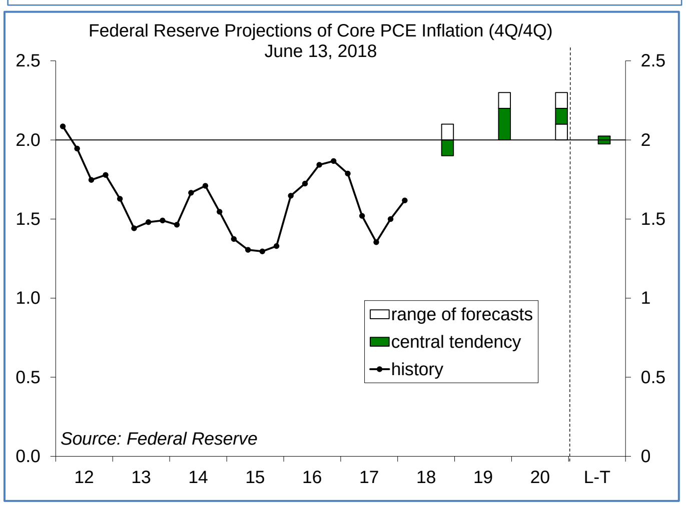
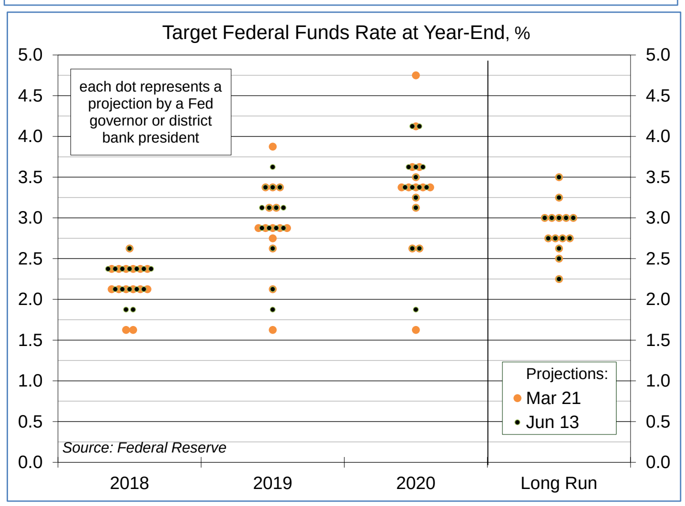
Weekly Economic Monitor

Tightrope Walking – As expected, the Fed raised short-term interest rates following the June 12-13 policy meeting. Investors were more concerned about the pace of future rate increases and the revised dot plot showed a median of four rate increases in 2018, although (as in the March plot), most fed officials were divided between three and four. More importantly, Fed officials generally believe that above-potential growth will push the unemployment rate lower and inflation a bit higher, and that would likely require that the Fed boost the overnight lending rate above a neutral level in 2019 and 2020.







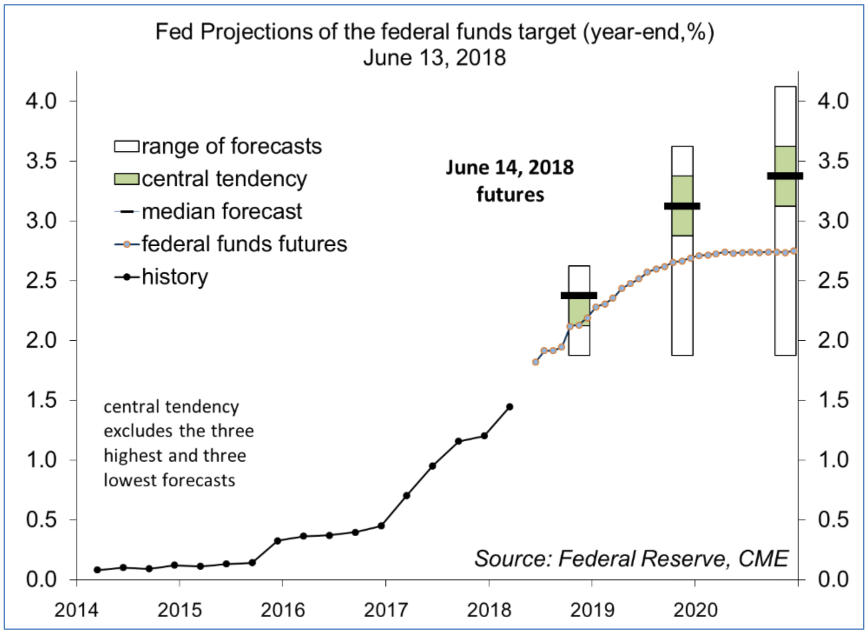


In his post-meeting press conference, Fed Chair Powell indicated that most Fed policymakers (and indeed, most economists) believe that individual and corporate tax cuts will provide support for demand this year and next. Faster business fixed investment would, in turn, facilitate faster growth in productivity. While there is a possibility that lower taxes will add to labor supply (by inducing workers back into the labor force), the timing and magnitude of that is uncertain (and some would argue, very much in doubt). Demographic changes (the aging of the population) and limitations on immigration, will severely constrain labor force growth relative to recent decades. If labor force growth is about 0.5% per year and productivity growth is 1.0-1.5%, then potential GDP growth would be 1.5-2.0%. The Fed's long-term GDP growth estimate is 1.8-2.0%.

The Fed expects that the unemployment rate (currently 3.8%) will fall a bit further (averaging 3.6-3.7% in 4Q18 and about 3.5% in 4Q19). That seems a little high given the Fed's expectations for GDP growth (unless there is a lot more slack in the job market than is currently believed). Nobody knows the natural rate of unemployment (the rate consistent with normal frictional and structural forces), but Fed officials peg it at around 4.5%. We're well below that now, which should imply upward pressure on inflation. However, there's been little evidence of a steady relationship between the unemployment rate and inflation over the last 18 years (suggesting that the [Phillips curve] is dead, or at least very flat – but it could be resting).

There's a good chance that the unemployment rate will fall further than the Fed expects. We've already seen the Fed's unemployment rate forecasts come down over time. If that's the case, then inflation ought to be higher than the Fed is forecasting. In his post-meeting press conference, Powell signaled a willingness to allow inflation to stay above the 2% goal for a while. This sentiment should help establish 2% as a goal rather than a ceiling. Inflation in prices of raw materials remains elevated, and higher oil prices have boosted transportation costs. Tariffs aren't going to help (in the Consumer Price Index, the component for laundry equipment rose 16.1% in the last two months, following tariffs on washing machines). However, while inflation is expected to move higher, this isn't the 1970s. We're unlikely to see a much sharper pickup in consumer price inflation.

Monetary policy isn't easy. Decisions are made based on data that may be unreliable (noisy and subject to revisions). As one looks through the Fed's economic forecasts, it's clear that there are major uncertainties and inconsistencies in the outlook. In a late-cycle economy, the Fed always has to walk a fine line - and it's nearly impossible to get that right. In the near term, as Powell noted, "the economy is doing very well." There are no storm clouds on the immediate horizon. Trade policy missteps remain a concern, obviously, but the bigger risks involve Fed policy in 2019.



Data Recap – While the focus was on the Fed and trade policy, the economic data were mixed.

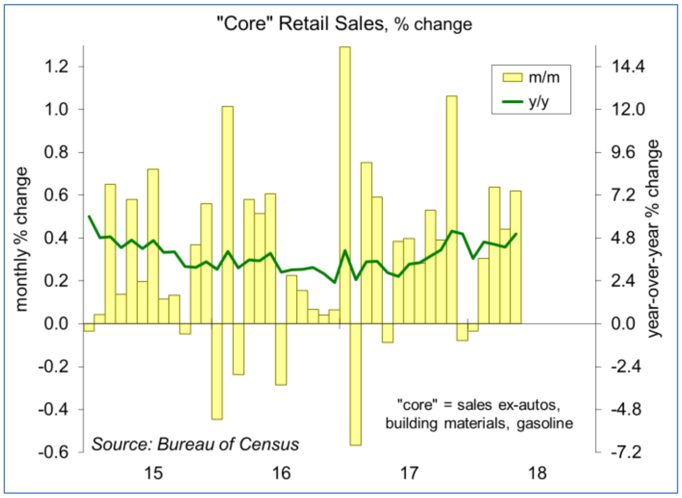
The **Federal Open Market Committee** raise the federal funds rate by another 25 basis points (to 1.75-2.00%). The Fed's Board of Governors approved a similar increase in the primary credit rate (the discount rate), to 2.5%, and raised the Interest on Excess Reserves rate (IOER) by 20 basis points, to 1.95% (5 basis points below the upper end of the federal funds target rate – a technical adjustment to help keep the federal funds rate more toward the middle of the range). In its policy statement, the FOMC eliminated its forward guidance (removing the phrase: *"the federal funds rate is likely to remain, for some time, below levels that are expected to prevail in the longer run"*).

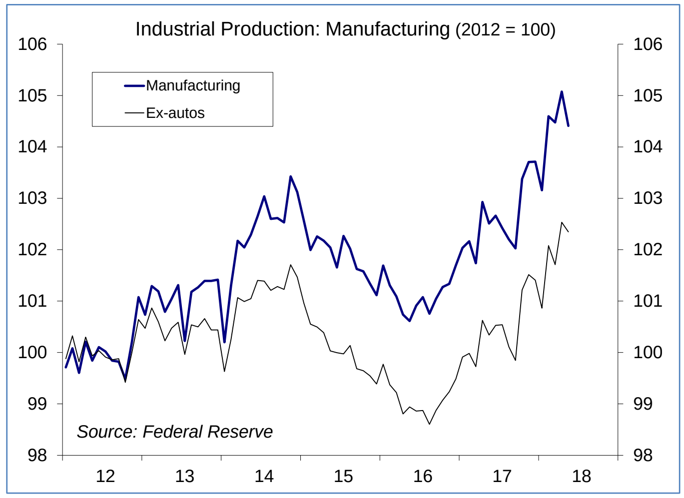
In the Fed's **Summary of Economic Projections**, the median forecast of 2018 GDP growth rose to 2.8%, while the unemployment rate was expected to end the year at 3.6% (vs. a 3.8% estimate made in March). Inflation was generally expected to edge above the 2% goal (2.1% for 2018, 2019, and 2020).

In his press conference, **Fed Chair Powell** began with *"a plain-English summary of how the economy is doing, what my colleagues and I at the Federal Reserve are trying to do, and why."* He added that *"the main takeaway is that the economy is doing very well."* Powell said that he will conduct press conferences after every policy meeting (eight times per year, vs. the current four) beginning in January. Fed officials *"continue to believe that a gradual approach for increasing the federal funds rate will best promote a sustained expansion of economic activity, strong labor market conditions, and inflation near our symmetric 2 percent goal."* Officials "*are aware that raising rates too slowly might raise the risk that monetary policy would need to tighten abruptly down the road in response to an unexpectedly sharp increase in inflation or financial excesses, jeopardizing the economic expansion."* Conversely, *"if we raise interest rates too rapidly, the economy could weaken and inflation could continue to run persistently below our objective."*

President Trump said he would proceed with a 25% tariff on $50 billion in Chinese goods and said that the U.S. would pursue further tariffs if China retaliated with tariffs on U.S. goods – which they did about an hour after the announcement.

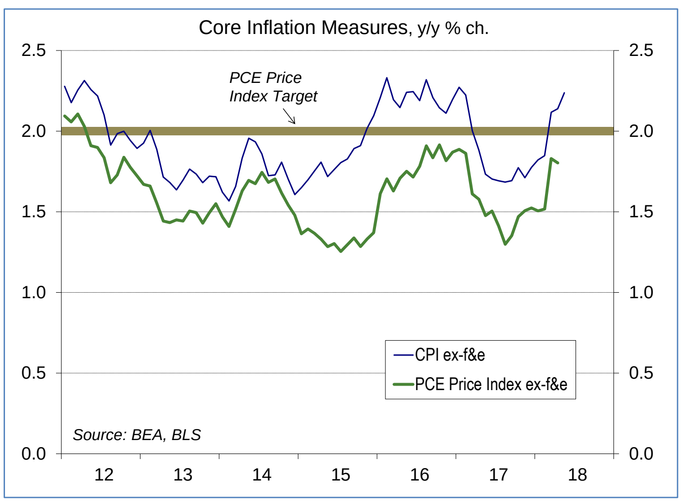
Retail Sales rose 0.8% in May (median forecast: +0.4%), up 5.9% y/y. Figures for March and April were revised higher. Ex-autos, sales rose 0.9% (+6.4% y/y). Core sales, which exclude vehicles, building materials, and gasoline, rose 0.6% (+5.0% y/y).

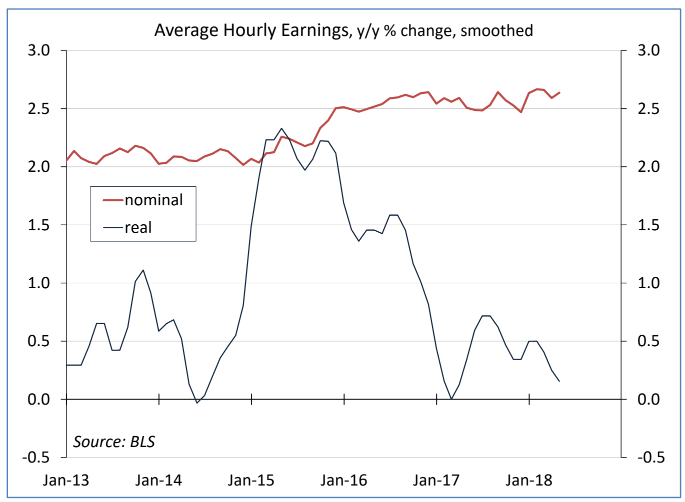




Industrial Production edged down 0.1% in May (+3.5%), reflecting the impact of a fire at a truck marts supplier. Manufacturing output fell 0.6% (+1.9%), with motor vehicle production down 6.5% (-2.3% y/y). Ex-vehicles, factory output slipped 0.2% (+2.0% y/y), mixed but generally soft across industries. The output of utilities rose 1.1% (+4.0%). Mining output rose 1.8% (+12.6% y/y), reflecting a 2.0% rise in oil and gas well drilling (+15.3% y/y) and a 3.9% increase in energy extraction (+13.8% y/y).

The **Consumer Price Index** rose 0.2% in May (+2.8% y/y), up 0.2% ex-food & energy (+2.2% y/y). Food prices were flat (+1.2% y/y – food-at-home up 0.1% y/y and food-away-from-home up 2.7% y/y). Gasoline (4.2% of the overall CPI) rose 1.7% (+5.9% before seasonal adjustment, and +21.8% y/y). Laundry equipment rose 7.4%, following a 9.6% jump in April, reflecting the impact of tariffs.





Real Hourly Earnings rose 0.1% in May (0.0% y/y), up 0.1% for production workers (-0.1% y/y).

The **Producer Price Index** rose 0.5% in May (+3.1% y/y), up 0.1% excluding food, energy and trade services (+2.6% y/y). Food rose 0.1% (+0.5% y/y). Energy rose 4.6% (+16.5%), with wholesale gasoline prices up 9.8% (+10.6% before seasonal adjustment, and +36.6% y/y). Rail transportation (freight) rose 0.2% (+5.2% y/y), while truck transportation rose 0.8% (+6.5% y/y) and air transportation of freight rose 1.0% (+6.8% y/y). Pipeline inflation indicators remained consistent with a build-up of inflationary pressure at the earlier stages of production. Ex-food & energy, unprocessed intermediate goods rose 8.8% y/y, with processed intermediate goods up 4.2% y/y. Intermediate services rose 3.3% y/y.

Import Prices rose 0.6% in May (+4.3% y/y), up 0.2% ex-food & fuels (+1.9% y/y). Ex-fuels, prices of imports supplies and materials rose 0.2% (+8.8% y/y). Prices of imported finished goods have risen modestly over the last 12 months (capital goods +0.9%, autos -0.1%, consumer goods +0.7%).

The **European Central Bank** left short-term interest rates unchanged, but signaled that asset purchases will be reduced after September and ended in late December. The ECB also said that it expected to keep rates low at least through the summer of 2019.

This Week – The economic calendar thins out, with nothing to significantly alter the overall economic outlook. Residential construction figures are choppy, but we should see a continued strong year-over-year trend in single-family activity. Fed Chair Powell will appear on a panel at an ECB forum – the topic is "Monetary Policy at a Time of Uncertainty and Tight Labor Markets."

This Week:					*forecast*	last	last –1	comments
Monday	6/18		Homebuilder Sentiment	Jun	***70***	70	68	roughly steady and relatively strong
Tuesday	6/19	8:30	**Building Permits, th.**	May	***1375***	1364	1377	seen somewhat higher
			% change		***+0.8***	-0.9	+4.1	but reported with a lot of uncertainty
			Single- Family Permits		***870***	863	851	trending higher
			% change		***+0.8***	+1.4	-4.0	restrained by builder constraints
			Housing Starts		***1345***	1287	1336	rebounding
			% change		***+4.5***	-3.7	+3.6	but watch for revisions
		9:30	**Powell Panel Discussion**					at and ECB forum on monetary policy
Wednesday	6/20	10:00	Existing Home Sales, mln	May	***5.55***	5.46	5.60	moderately strong
			% change		***+1.6***	-2.5	+1.1	supply constraints still a factor
Thursday	6/21	7:00	BOE Policy Decision					no change
		8:30	Jobless Claims, th.	6/16	***220***	218	222	a low trend
		10:00	Leading Econ Indicators	May	***+0.4***	+0.4	+0.4	mixed components, but mostly higher
		1:00	TIPS auction					$5 billion in re-opened 30-yearTIPS
Friday	6/22		no significant data					burn on big river (1969)
Next Week:								
Monday	6/25	10:00	New Home Sales, th.	May	***675***	662	672	these figures are erratic
			% change		***+2.0***	-1.5	+2.0	but trend should remain strong
Tuesday	6/26	10:00	**CB Consumer Confidence**	Jun	***127.0***	128.0	125.6	still elevated
		1:00	Treasury Note Auction					2-year notes
Wednesday	6/27	8:30	**Durable Goods Orders**	May	***-0.2***	-1.6	+2.7	lower aircraft orders
			ex-transportation		***+0.5***	+0.9	+0.5	moderate otherwise
			nondef cap gds ex-aircraft		***+0.5***	+1.0	-1.0	a moderate trend
		8:30	Advance Econ Indicators	May				filling in the 2Q picture
			merch. trade balance, $bln		***NF***	-67.3	-68.5	narrower in 2Q18
			wholesale inventories		***NF***	+0.1	+0.2	pace expected to pick up
			retail inventories		***NF***	+0.5	-0.7	likely to have picked up in 2Q18
		10:00	Pending Home Sales Index	May	***+1.5***	-1.3	+0.6	a bit choppy, but likely higher in May
		11:30	FRN Auction					2-year FRNs
		1:00	Treasury Note Auction					5-year notes
Thursday	6/28	8:30	Jobless Claims, th.	6/23	***220***	***220***	218	a low trend
		8:30	Real GDP (3rd estimate)	1Q18	***+2.2***	+2.9	+3.2	+2.2% in the advance estimate
			Priv. Dom. Final Purchases		***+2.1***	+4.8	+2.2	+2.1% in the advance estimate
		1:00	Treasury Note Auction					7-year notes
Friday	6/29	8:30	Personal Income	May	***+0.4%***	+0.3	+0.2	wage growth was better in May
			Personal Spending		***+0.5%***	+0.6	+0.5	a stronger trend in 2Q18
			PCE Price Index ex-f&e		***+0.2%***	+0.2	+0.2	the core CPI rose 0.171%
			year-over-year		***+2.0%***	+1.8	+1.8	on target
		9:45	Chicago Business Barometer	Jun	***60.5***	62.7	57.6	moderately strong
		10:00	UM Consumer Sentiment	Jun	***98.5***	98.0	98.8	99.3 at mid-month