THE UCLA ANDERSON FORECAST FOR THE NATION

DECEMBER 2017 REPORT

Sunny 2018, Cloudy 2019

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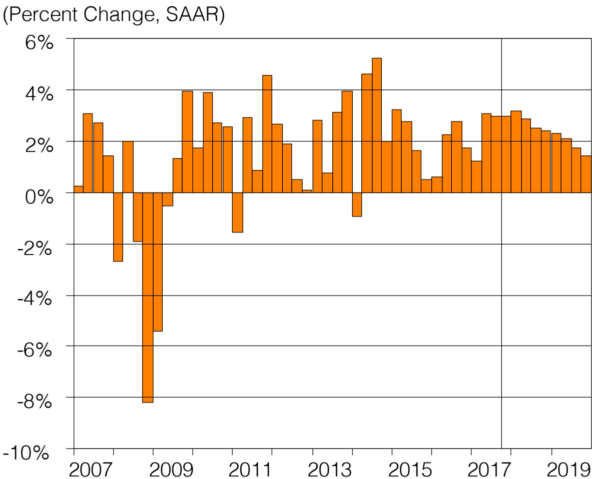
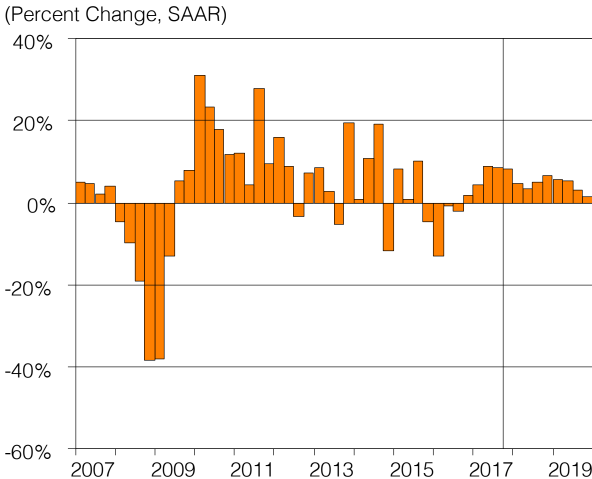
Of a sudden, propelled by strength (8% quarterly growth) in equipment spending, the economy is growing at a 3% clip and the near-term outlook has become decidedly sunny. (See Figures 1 and 2) Moreover, the 3% pace of growth is expected to continue through the second quarter of 2018. However, as the unemployment rate drops below 4% and employment growth stalls in the face of a labor shortage, economic growth will drop back to the 2% growth rate we have been used to since the end of the financial crisis eight long years ago. Indeed, by the end of the forecast horizon in 2019 real GDP growth could very well be running at a rate below 1.5% as the outlook becomes cloudy. (See Figures 3 and 4)

Figure 1 Real GDP Growth, 2007Q1 – 2019Q4F



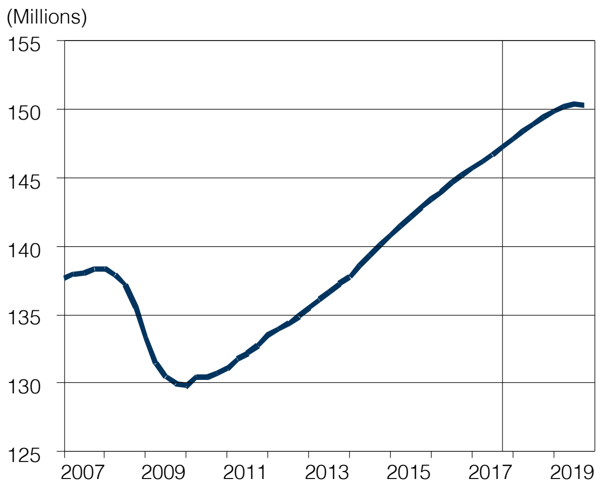
Sources: U.S. Department of Commerce and UCLA Anderson Forecast

Figure 2 Real Equipment Spending, 2007Q1 – 2019Q4F



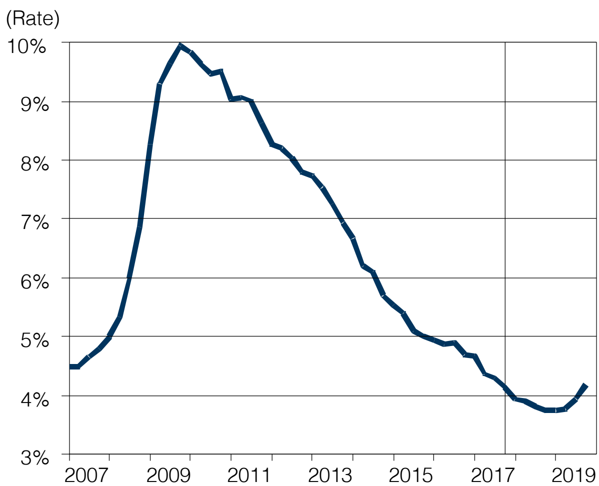
Sources: U.S. Department of Commerce and UCLA Anderson Forecast

Figure 3 Nonfarm Employment, 2007Q1 - 2019Q4



Sources: U.S. Bureau of Labor Statistics and UCLA Anderson Forecast

Figure 4 Unemployment Rate, 2007Q1 - 2019Q4

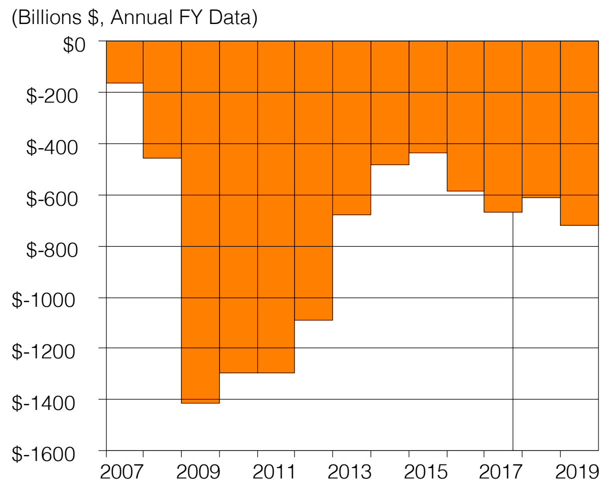


Sources: U.S. Bureau of Labor Statistics and UCLA Anderson Forecast

Questions about Fiscal Policy

As we are writing in late November, many questions remain about the major tax bills now working their way through Congress. There is uncertainty surrounding the corporate tax rate, state and local tax deductions, child credits and the permanence of the entire package. For modeling purposes we have assumed a ten-year $1.5 trillion tax cut, with a 25% corporate tax rate (a compromise from 20%), some allowance for state and local tax deductions and $100 billion in revenues coming from a tax on repatriated corporate profits in 2018. This last point is one of the reasons why the federal deficit declines in 2018. (See Figure 5)

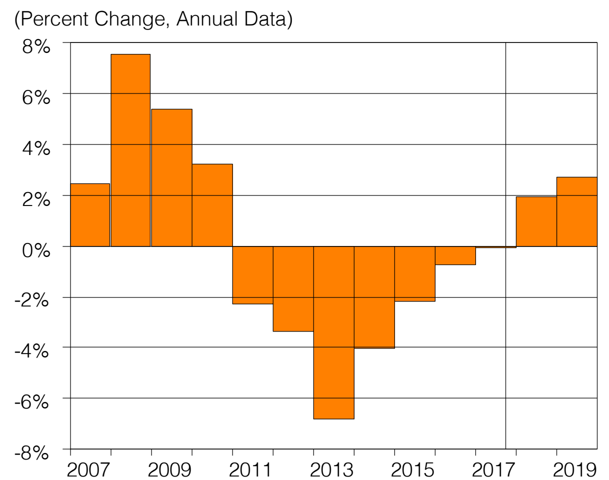
Figure 5 Federal Deficit, FY2007 - FY2019F



Sources: Office of Management and Budget and UCLA Anderson Forecast

We are more certain that the next few years will reverse the seven-year annual decline in defense spending. (See Figure 6) With the potential for missiles from North Korea reaching the West Coast, continued fighting in the Middle-East and growing worries about Russia and China, defense spending will likely be on the rise over the next several years. We are assuming real defense spending will increase by 2% and 2.7% in 2018 and 2019, respectively. If anything, our forecast is more likely to be low than high.

Figure 6 Real Defense Spending, FY 2007 – FY 2019F



Sources: U.S. Department of Commerce and UCLA Anderson Forecast

Monetary Policy in the Post-Yellen Era

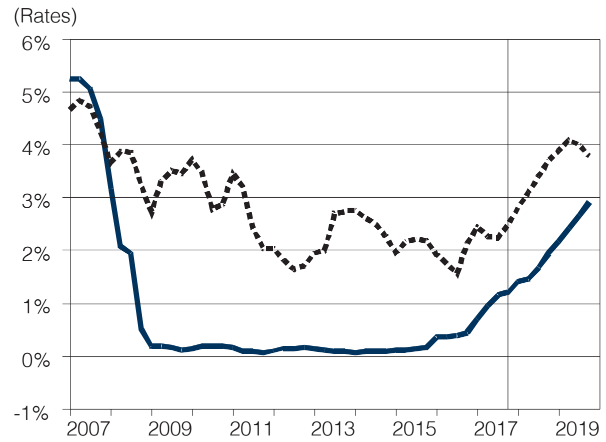
With the appointment of Jerome Powell as Fed chairman, the Janet Yellen era is coming to an end. Because Powell's views on monetary policy are very similar to Yellen's we do not anticipate any significant changes. However, with respect to regulatory policy, Powell is believed to be far more open than Yellen to reviewing the financial crisis regulations that were put into place from 2009 – 2012.

Thus, we expect that the gradual interest rate normalization policy that has been underway for a year will continue well into 2019 with a 25 basis point increase from the current 1.375% rate in December and three more increases in 2018. By the end of 2019, the fed funds rate will likely approximate 3%. (See Figure 7) We caution that the futures markets, in contrast to our forecast and the Fed's "dot plots", are forecasting only one rate hike next year.

Concomitantly, with the rise in short-term interest rates long rates will rise as well and we would not be surprised to see the yield on 10-year U.S. Treasury bonds to exceed 4%, up from the current 2.4%. Rising inflation will be the driver in the increase in long rates, more on that below.

The Powell Fed will also continue the policy of gradually shrinking the Fed's bloated balance sheet that began in October. (See Figure 8) Simply put, after three phases of quantitative easing that expanded the balance sheet from $800 billion to over four trillion dollars will be unwound over a period of several years with the ultimate target of $2.5 - $3.0 trillion, quantitative tightening if you will. (See Figure 8) **But make no mistake the balance sheet shrink the Fed is attempting to do is unprecedented.**

Figure 7 Federal Funds vs. 10-Year U.S. Treasury Bond Rates, 2007Q1 - 2019Q4F



Sources: Federal Reserve Board and UCLA Anderson Forecast

Figure 8 Federal Reserve Assets, 2003 –Nov. 15, 2017, In $ Millions, SA

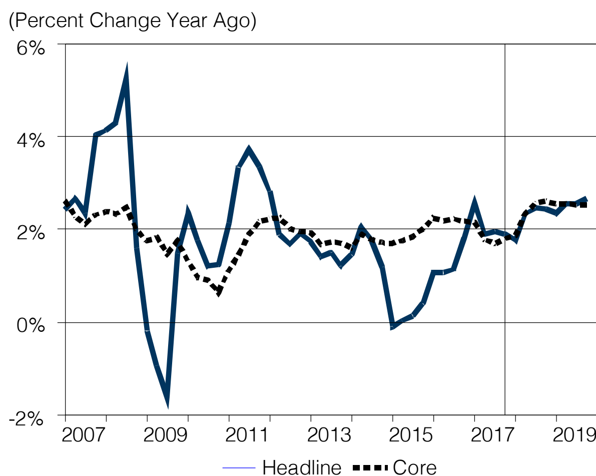
Sources: Federal Reserve Board via Fred

Inflation on the Rise

It now appears that the second quarter slowdown in inflation was transitory and the future quarterly track in inflation will be in excess of 2% throughout the forecast horizon. (See Figure 9) This will hold true for both "headline" and "core" consumer prices. Further, oil prices now appear to be tracking about $10/barrel higher than our forecast of just one quarter ago.

The primary source of the rising rate of inflation will be a significant rebound in wage growth. After creeping along in the 2% range, we forecast acceleration in total compensation growth to approximately 4% by late 2018 on a year-over-year basis. (See Figure 10) The recent rise in labor productivity buttresses our view that the long-anticipated increase in wages is at hand.

Figure 9 Headline vs. Core Inflation, 2007Q1 - 2019Q4F



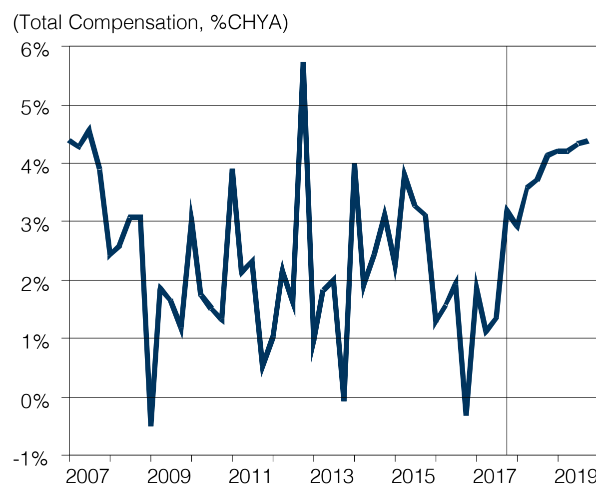
Sources: U.S. Bureau of Labor Statistics and UCLA Anderson Forecast

Consumer Spending Supported by Rising Wages and Asset Prices

Real consumption spending is maintaining its strength experienced in 2016 by increasing 2.7% and 2.8% in 2017 and 2018, respectively. (See Figure 11) However, as auto sales slow in 2019 consumption growth will slip back to 2.2%. (See Figure 12) Simply put it is getting very late in the auto cycle. However, as long as stock and house prices remain elevated the consumer, or at least the high-end consumer, will remain in good shape. (See Figures 13 and 14) In the case of the lower end consumer we are encouraged by Wal*Mart reporting a strong 2.7% increase in year-over-year same store sales in their latest quarter.

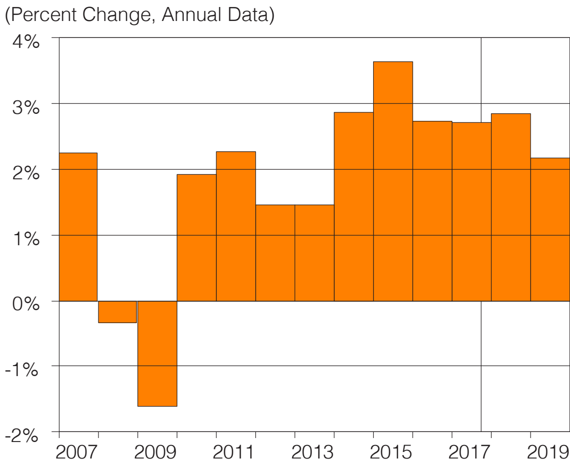
One of the big puzzles in recent years is the lack of robustness in new single-family housing construction. Given low interest rates and strong employment growth housing activity should be doing much better. **Two factors that are being discussed more and more are the unwillingness of the baby boom generation to move as they age in place and highly restrictive zoning in the booming coastal cities**. As a result, housing starts have remained below the underlying demographic demand of 1.4 – 1.5 million units a year for a decade. We are forecasting modest increases in housing starts from an estimated 1.19 million units this year to 1.27 million and 1.34 million in 2018 and 2019, respectively. (See Figure 15)

Figure 10 Total Compensation per Hour, 2007Q1 – 2019Q4



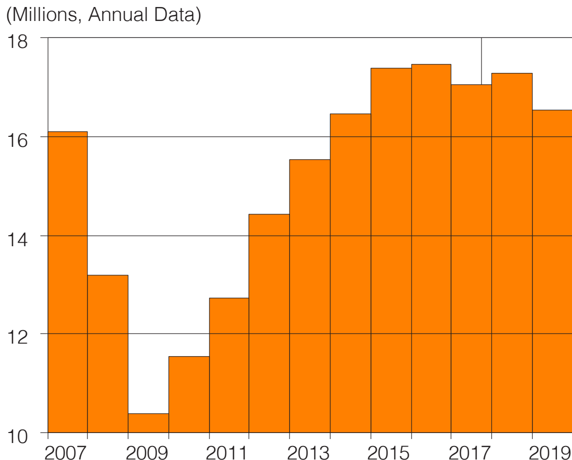
Sources: U.S. Bureau of Labor Statistics and UCLA Anderson Forecast

Figure 11 Real Consumption Expenditures, 2007 – 2019F



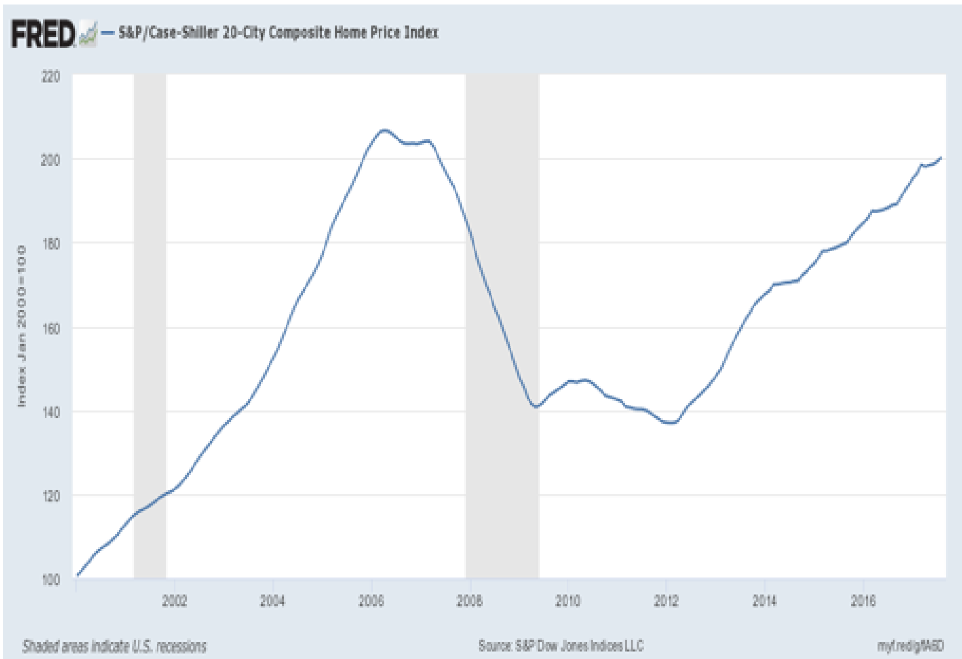
Sources: U.S. Department of Commerce and UCLA Anderson Forecast

Figure 12 Light Vehicle Unit Sales, 2007 – 2019F



Sources: Bureau of Economic Analysis and UCLA Anderson Forecast

Figure 13 S&P/Case-Shiller 20-City Composite Home Price Index, Dec 1999 – Aug 2017, December 1999 =100, SA

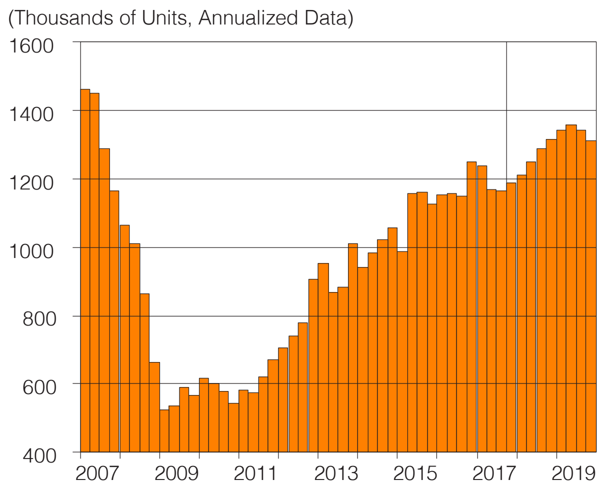


Sources: Standard & Poor's via FRED

Figure 14 S&P 500 Stock Index, 18 Nov 2007 – 17 Nov 17

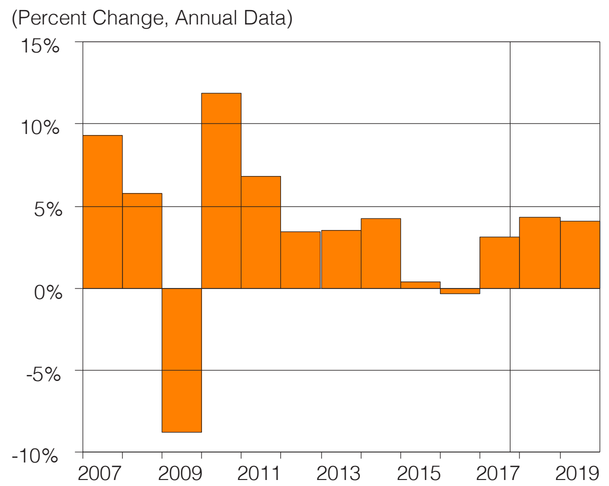
Sources: Standard & Poor's via BigCharts.com

Figure 15 Housing Starts 2007Q1 -2019Q4F



Sources: Bureau of the Census and UCLA Anderson Forecast

Figure 16 Real Export Growth, 2007 – 2019F



Sources: U.S. Department of Commerce and UCLA Anderson Forecast

Exports Rebounding, But NAFTA Risk Looms

In response to a recovering global economy, real exports are recovering from the near zero growth of 2015 and 2016. Real exports are estimated to increase by 3.2% this year and 4.5% and 4.1% in 2018 and 2019, respectively. (See Figure 16) According to a recent Goldman Sachs report, world economic growth is forecast to increase 3.7% this year and 4.1% in 2018.[1] Growth will come from, 2+% growth in the Euro Area, 6.5% in China, a very strong 8% in India and a rebound in Brazil from O.9% in 2017 to 2.7% in 2018. (See Figure 17)

Figure 17 Global Real GDP Growth, 2016 – 2019F, Annual Data

Country/Region	2016A	2017F	2018F	2019F
Japan	1.0	1.6	1.6	1.3
Euro Area	1.7	2.3	2.2	1.8
UK	1.8	1.5	1.3	1.6
China	6.7	6.8	6.5	6.1
India	7.1	6.4	8.0	8.3
Brazil	-3.6	0.9	2.7	3.1
World (incl. U.S.)	3.2	3.7	4.0	3.9

Source: Goldman Sachs

The real risk to our export forecast and for that matter the entire forecast is political. In less than a year, President Trump has blown up the Trans Pacific Partnership (TPP) trade treaty and the global climate accord. The North American Free Trade Treaty (NAFTA) could be next especially given the hawkish views espoused by Secretary of Commerce Wilbur Ross and Trade Representative Robert Lighthizer. Although news from the Mexico City negotiations is not on the front burner, it would be advisable to pay very close attention. Why? Leaving NAFTA is not so simple because it would undo countless supply chains among the three countries (U.S., Canada and Mexico) involved. **Just as a reminder, the gross trade volumes among the three NAFTA partners amounts to over one trillion dollars per year.**[2] Especially hard hit would be the U.S. automobile industry where parts cross borders several times in the manufacturing of a single automobile. In our view, should the U.S. leave NAFTA the growth outlook would deteriorate and the chance of a recession in late 2018 or 2019 would significantly increase.

Conclusion

With our weather forecast analogy for a title we are hoping to be as accurate as modern weather forecasting. Economics has a lot to learn from near-term weather forecasting. It looks like 2018 is shaping up to be a pretty good year. There is momentum coming from the recent strength in 2017, strong equipment spending, the likelihood of a tax cut and a consumer that is benefitting from higher asset prices and the prospect of higher wages. Unemployment will drop below 4% and remain there throughout most of the forecast horizon and inflation will experience an uptick. The Fed will respond by continuing to normalize short-term interest rates with the Fed Funds rate on a path to 3% by 2019. However, as we get into 2019, inflation could be approaching 3% and the economy will slow as it reaches capacity constraints.

The risks to the forecast include the unknowable consequences of the Fed reducing its balance sheet and the potential failure of the ongoing NAFTA negotiations. All told a sunny 2018 with clouds coming in 2019.

1. *See Hatzius, Jan et al., "As Good as it Gets," Goldman Sachs, November 15, 2017*
2. *See Shulman, David, "Extreme Makeover: Second Pass at Trumponomics," UCLA Anderson Forecast, March 2017*