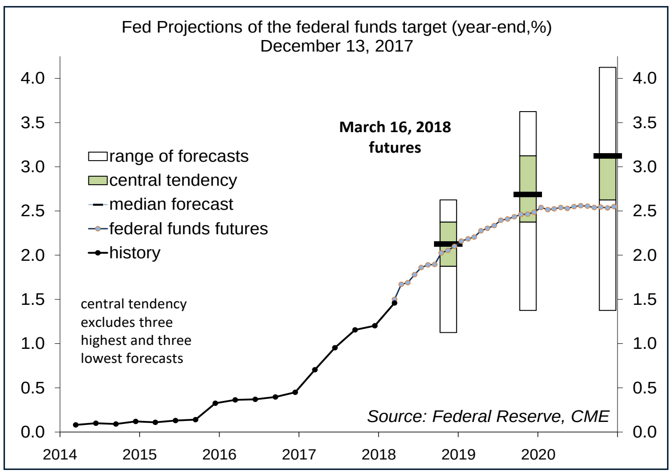
Scott J. Brown, Ph.D., (727) 567-2603, Scott.J.Brown@RaymondJames.com **March 19, 2018**

Weekly Economic Monitor

Fed Policy: Soft Landings Are Hard

The Federal Open Market Committee is widely expected to raise the federal funds target rate on Wednesday (to 1.50-1.75%). For investors, the key question is the pace of tightening that will follow. We should get some clues in the wording of the policy statement, in the revised Fed projections (including a refreshed dot plot), and in Chair Powell's post-meeting press conference. Monetary policy decision will certainly remain data-dependent. However, markets are likely to price in 25 basis points per quarter. Looking further ahead, pegging the rate of growth to a sustainable pace will be a difficult task.

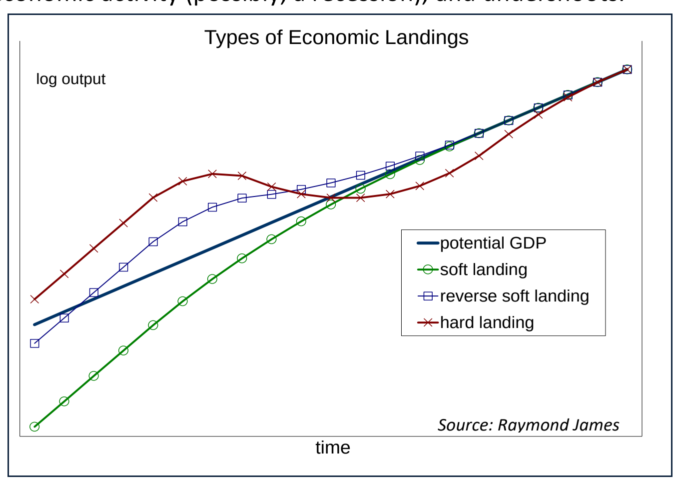


In late 2015, Fed officials generally expected to raise short-term interest rates a number of times in 2016, but moved only once. Then-Chair Yellen later indicated that low inflation readings and signs of a tentative slowing in job growth left the FOMC more cautious. While not on a preset path, the Fed raised rates once per quarter in 2017 and seemed set to continue, except for September. Hurricanes Harvey, Irma, and Maria had a significant impact on economic activity. The Fed anticipated a rebound from hurricane effects in 4Q17, but the lull allowed it a safer backdrop to begin its balance sheet unwinding (policymakers were unsure of whether the financial markets might over-react to the initial steps). The bottom line is that the central bank had a couple of excuses for taking a break from the 25-bp per quarter pace of tightening.

The economy was expected to show strong momentum at the start of 2018, with increased uncertainty building in the middle of the year (reflecting the convergence of fiscal stimulus, tighter monetary policy, and job market constraints). Surprise! Most of the major economic data reports for January and February (including retail sales) were on the soft side of expectations, leading to a general decline in economists' forecasts of 1Q18 GDP growth. Much of that may be weather-related. Expectations for the remainder of the year remain strong.

Every year seems to begin with an inflation scare for the financial markets. CPI inflation figures can be misleading in the early part of the year, partly due to difficulties in the seasonal adjustment. Moreover, the Fed isn't worried about past inflation. The policy focus is on *future* inflation. Pipeline pressures in supplies and raw materials remain somewhat elevated, and tariffs aren't going to help, but this isn't a major threat to the outlook for consumer prices (as raw materials represent only a modest contribution by the time you get to the consumer level). The bigger concern for the Fed is labor cost pressures. Tight job market conditions haven't led to a big increase in wage pressure, but the Fed believes that may simply be a matter of time if the job market continues to tighten (and there is plenty of evidence that that is the case). Hence, the Fed remains in tightening mode, but the low inflation readings allow the central bank to be gradual.

The late MIT economist Rudi Dornbusch once noted that economic expansions never die of old age "asleep in their beds." Rather, "they are murdered by the Fed." The Fed seeks to get the economy on a long-term sustainable path. If the economy operates above its potential, inflation will increase. In a soft landing, the Fed raises rates until growth slows to its potential. In a reverse soft landing, where the economy is operating beyond its potential, the Fed attempts to push the economy on a slower path to get back to its potential. In a hard landing, the Fed works harder to slow the economy, resulting in a decline in economic activity (possibly, a recession), and undershoots.

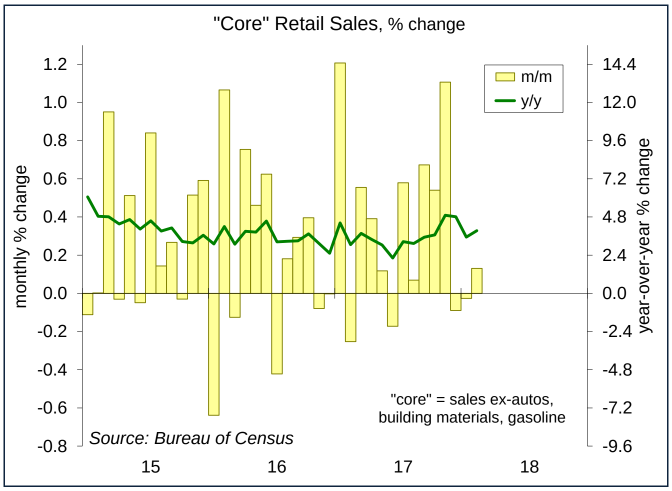


Needless to say, it's unclear where we may be relative to potential, but as long as job growth remains beyond a sustainable pace (that is, consistent with the growth in the labor force), the Fed is expected to tighten further. Additionally, the economy is likely to be hit by unforeseen developments, such as a potential trade war. Monetary policy uncertainty will remain a key concern for the financial markets in the months ahead.

	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
2/16/18	1.62	1.83	2.00	2.21	2.38	2.63	2.87	3.13	1.244	1.406	106.10	1.253	7239.47	2732.22	25219.38
3/09/18	1.67	1.89	2.03	2.27	2.45	2.65	2.90	3.16	1.233	1.386	106.74	1.282	7560.81	2786.57	25335.74
3/16/18	1.78	1.95	2.06	2.30	2.45	2.64	2.85	3.08	1.229	1.394	106.05	1.309	7482.25	2751.84	24946.23

Recent Economic Data and Outlook

The economic data reports were mixed, with disappointing retail sales and an upside surprise in industrial production (a moderate pace if you combine January and February). Investors remained nervous about pending tariffs on Chinese goods, but market sentiment remained generally positive.



The **Consumer Price Index** rose 0.2% in February (+2.2% y/y). Food prices were flat (+1.4% y/y, with food at home +0.5% y/y and food away from home +2.6% y/y). Gasoline fell 0.9% (+1.6% before seasonal adjustment, and +12.6% y/y). Ex-food & energy, the CPI rose 0.2% (+0.182% before rounding, +1.8% y/y).

Real Hourly Earnings were flat in February, essentially unchanged over the last four months (+0.4% y/y). For production workers, real hourly earnings rose 0.2% (vs. -0.5% in January, +0.1% y/y).

The **Producer Price Index** rose 0.2% in February (+2.8% y/y). Ex-food, energy, and trade services, the PPI rose 0.4% (after +0.4% in January, +2.7% y/y). Pipeline pressure remained moderately high, but not a major threat to the consumer price outlook.

Import Prices rose 0.4% in February (+3.5% y/y), up 0.5% excluding food and fuels (+1.9%). Inflation in imported supplies and raw materials remained elevated. Prices of finished goods (capital equipment, consumer goods), having trended flat in 2017, picked up noticeably in January and February.

Retail Sales fell 0.1% in February (+4.0% y/y), up 0.2% ex-autos (+4.4% y/y). Ex-autos, building materials, and gasoline, sales edged up 0.1%, essentially unchanged over the last three months.

Business Inventories rose 0.6% in February (+3.7% y/y), a faster pace than in 4Q17. Business sales slipped 0.2% (+5.7% y/y).

The UM **Consumer Sentiment Index** rose to 102.0 in the mid-March assessment (vs. 99.7 in February), with a surge in evaluations of current conditions (an all-time high). The report noted mixed results across the income scale (better at the low end, soft at the high end). Near-term inflation expectations rose.

Industrial Production jumped 1.1% in February (+4.4% y/y), following a weather-restrained -0.3% in January (revised from -0.1%). The output of utilities fell 4.7% (+10.5% y/y), reflecting more seasonable temperatures (following colder conditions in December and January). Mining rose 4.3%, reflecting an 11.6% rise in oil and gas well drilling (which had fallen 11.7% from July to January, +27.2% y/y) and a 2.9% increase in energy extraction (+11.8% y/y). Manufacturing output surged 1.3%, following three weak months (+2.7% y/y), up 1.0% ex-autos (+2.5% y/y).

Building Permits fell 5.7% in February to a 1.298 million seasonally adjusted annual rate (+6.5% y/y). Single-family permits, the key figure in the report, slipped 0.6% (±0.9%), up 4.6% y/y, with mixed results across regions (+10.0% in the Northeast, +2.4% in the Midwest, -1.5% in the South, and -2.6% in the West). **Housing Starts** fell 7.0% (±16.7%).

Homebuilder Sentiment edged down to 70 in March, from 71 in February and 72 in January. Demand has remained strong, despite higher mortgage rates, but builders continue to note supply constraints and rising costs.

The Index of **Small Business Optimism** rose to 107.6 in February (a 35-year high), vs. 106.9 in January. Capital spending was reported higher, but capital spending plans have remained little changed over the last several months.

Economic Outlook (1Q18): around 3.0% GDP growth, likely to be boosted by lower imports (which had surged in 4Q17).

Employment: Job growth has remained strong, but the pace should slow (eventually) as the job market continues to tighten.

Consumers: Real wage growth has been lackluster, but reduced tax withholding boosted take-home pay in February. Credit is easy, except at the low end.

Manufacturing: Sentiment remains strong. Figures are often choppy at the start of the year, but the underlying trends in orders and production appear to be moderate.

Housing/Construction: Job growth has been supportive. Monthly figures are often erratic and supply constraints remain, but the underlying year-over-year trends are relatively strong.

Prices: Core inflation has continued to trend below the Fed's 2% target, partly reflecting the Mar-17 "one-off" plunge in wireless telecom services. Wage pressures are moderate.

Interest Rates: The Fed remains in tightening mode, and is expected to continue gradually raising short-term rates, but personnel changes add uncertainty. Balance sheet reduction has begun and should not be disruptive for the markets.

This Week:					*forecast*	last	last –1	comments
Monday	3/19		no significant data					
Tuesday	3/20		no significant data					vernal equinox
Wednesday	3/21	10:00	Current Account, $ bln	4Q17	***-120.1***	-100.6	-124.4	rebounding from hurricane effects
			% of GDP		***-2.4***	-2.1	-2.6	moderate
Wednesday	3/21	10:00	Existing Home Sales, mln	Feb	***5.46***	5.38	5.56	rebound from weather
			% change		***+1.5***	-3.2	-2.8	but continued supply constraints
		2:00	**FOMC Policy Decisions**		***+25 bps***	0	+25 bps	quarter-point hike all but certain
		2:00	**Fed: Summary of Econ Proj**					includes a revised dot plot
		2:30	**Powell Press Conference**					still data-dependent
Thursday	3/22	7:00	BOE Policy Decision					a bit more hawkish at previous meeting
		8:30	Jobless Claims, th.	3/17	***225***	226	230	a low trend
		10:00	Leading Econ Indicators	Feb	***+0.6%***	+1.0%	+0.6%	most components positive
		1:00	TIPS Auction					$11 billion in re-opened 10-year TIPS
Friday	3/23	8:30	Durable Goods Orders	Feb	***+0.6%***	-3.6%	+2.7%	Boeing reported a small increase in orders
			ex-transportation		***+0.4%***	-0.3%	+0.8%	should rebound from bad weather
			nondef cap gds ex-aircraft		***+0.5%***	-0.3%	-0.5%	choppy, but a moderately strong trend
		10:00	New Home Sales, th.	Feb	***615***	593	643	seen rebounding
			% change		***+3.7***	-7.8	-7.6	reported with a huge degree of uncertainty
Next Week:								
Monday	3/26		Treasury Note Auction					2-year notes
Tuesday	3/27	10:00	CB Consumer Confidence	Mar	***129.5***	130.8	124.3	likely to remain strong (revisions?)
			Treasury Note Auction					5-year notes
Wednesday	3/28	8:30	Advance Econ Indicators	Feb				
			Wholesale Inventories		***NF***	+0.8%	+0.7%	seen trending higher in 1Q18
			Retail Inventories		***NF***	+0.7%	+0.3%	adding to GDP growth
			Merch. Trade Deficit, $bln		***NF***	-74.4	-72.3	Jan deficit was the highest since 2008
		8:30	Real GDP (3rd estimate)	4Q17	***+2.5%***	+3.2%	+3.1%	+2.5% in the 2nd estimate
			Priv. Dom. Final Purchases		***+4.4%***	+2.2%	+3.3%	+4.6% in the 2nd estimate
		10:00	Pending Home Sales	Feb	***+2.0%***	-4.7%	0.0%	rebounding from weather effects
		11:30	FRN Auction					2-year FRNs
		1:00	Treasury Note Auction					7-year notes
Thursday	3/29	8:30	Jobless Claims, th.	3/17	***225***	***225***	226	a low trend
		8:30	Personal Income	Feb	***+0.5%***	+0.4%	+0.4%	led by a rebound in wages and salaries
			Personal Spending		***+0.2%***	+0.2%	+0.4%	lackluster
			PCE Price Index ex-f&e		***+0.2%***	+0.3%	+0.2%	the core CPI rose 0.182%
			year-over-year		***+1.6%***	+1.5%	+1.5%	
		9:45	Chicago Bus Barometer	Mar	***60.0***	61.9	65.7	still strong
		10:00	UM Consumer Sentiment	Mar	***102.2***	99.7	95.7	102.0 in the mid-month assessment
Friday	3/30		Good Friday Holiday					markets closed

This Week…

The Federal Open Market Committee meeting is a big deal for the financial markets. It's widely expected that the FOMC will raise short-term interest rates another 25 basis points (bringing the target for the overnight lending rate to 1.50-1.75%). For investors, the bigger question is the pace of tightening beyond this meeting. We can expect Chair Powell to remind us that policy decisions will be data-dependent. However, the policy statement, revised dot plot, and Powell's testimony will help to set expectations of how fast the Fed will move in the quarters ahead. The data calendar is relatively thin (nobody is likely to care much about February home sales). Watch the nondefense capital goods ex-aircraft figure in the durable goods report.

Monday

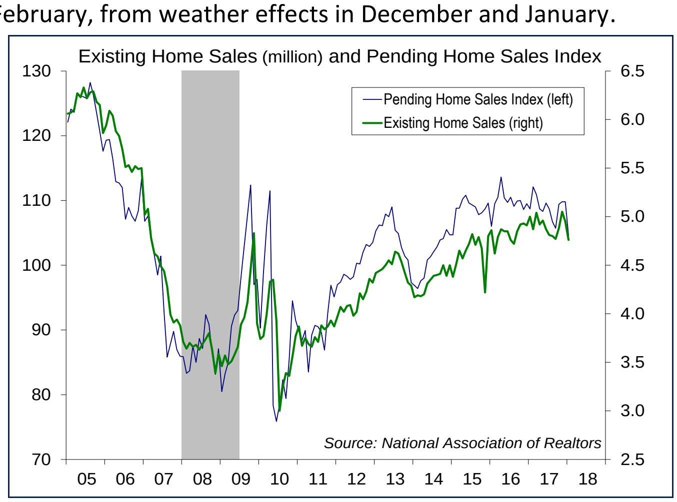
No significant data

Tuesday

No significant data

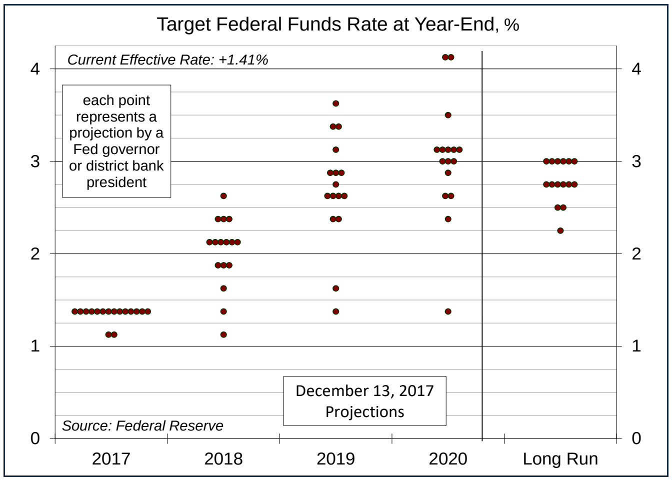
Wednesday

Existing Home Sales (February) – Sales track the Pending Home Sales Index well, but not precisely. Expect a rebound in February, from weather effects in December and January.



FOMC Policy Decision – Policymakers are widely expected to raise short-term interest rates again. The statement should acknowledge the mixed economic data for January and February, but remain optimistic about growth for the remainder of the year. Investors will watch for changes in the wording of the policy statement (and may over-react).

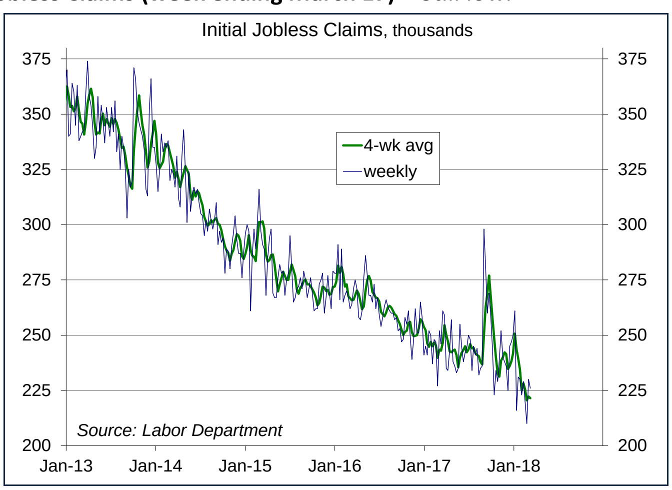
Fed Summary of Economic Projections – Fed officials will revise their forecasts of growth, unemployment, and inflation, but financial market participants will be more interested in the dot plot. There's a tendency for the markets (and the financial press) to forecast on the median of the dots, but that is just the midpoint in the range of individual expectations. There is likely to remain a wide dispersion in expectations for 2019 and 2020.



Powell Press Conference – The new Fed chair is expected to stress that future policy moves will remain data-dependent.

Thursday

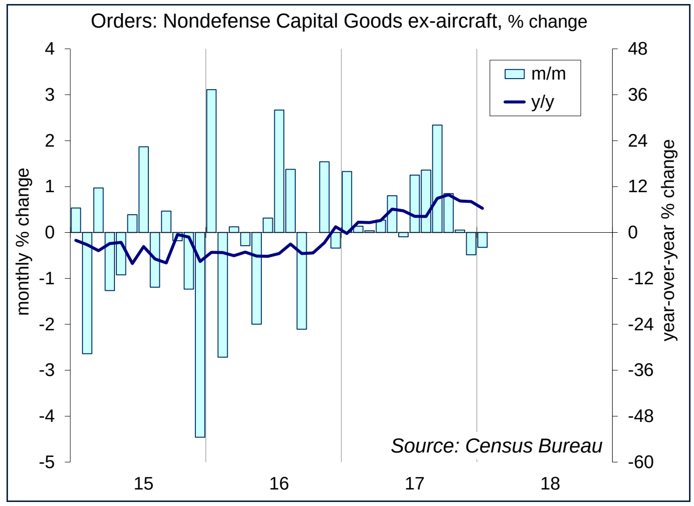
Jobless Claims (week ending March 17) – Still low.



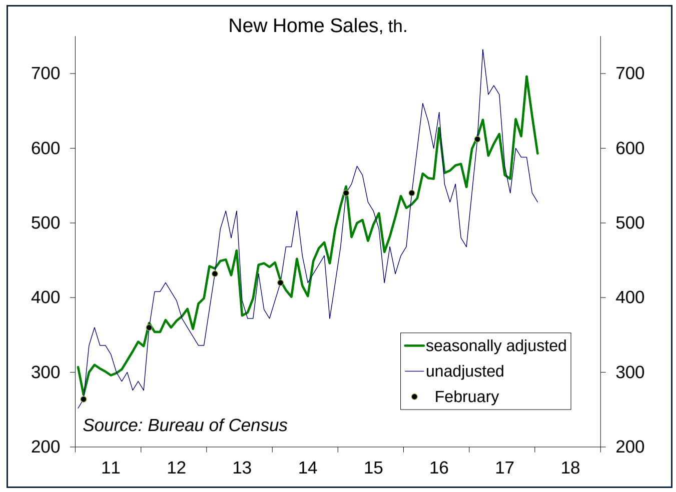
Leading Economic indicators (February) – Lower building permits and the stock market correction will subtract, but positive contributions from the other components will be greater.

Friday

Durable Goods Orders (February) – Orders are choppy, but the recent trend in nondefense capital goods orders ex-aircraft has been soft. We should see a pickup in February.



New Home Sales (February) – These data are erratic (choppy and reported with a huge degree of statistical uncertainty).



Next Week …

Personal income and spending data (Thursday) will help to fill in the GDP picture of 1Q18. Friday's a holiday. The economic data for the first week of April will be much more important.

Coming Events and Data Releases

April 2	ISM Manufacturing Index (March)
April 4	ADP Payroll Estimate (March) ISM Non-Manufacturing Index (March)
April 6	Employment Report (March)
April 9	CBO Budget Outlook
April 11	Consumer Price Index (March) FOMC Minutes (March 20-21)
April 16	Retail Sales (March)
April 27	Real GDP (1Q18, advance estimate)
May 2	FOMC Policy Decision (no press conf.)
June 13	FOMC Policy Decision, press conf.
November 6	Election Day