ECONOMIC OUTLOOK

REGIONS
January 2018

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2018 Economic Outlook: Meet The New Year, Same As The Old Year?

If the calendar says "January" then that means it's time for us to offer our economic outlook for the year ahead. Admittedly, with the current economic expansion, now in its ninth year, soon to become the second longest expansion on record but already the slowest on record, it becomes more difficult with each passing year to make the outlook seem all that interesting. And, as if to prove our point, the main questions facing us as we head into 2018 – will changes in fiscal and regulatory policy lead to materially faster economic growth, how many times will the FOMC raise the Fed funds rate, will wage growth finally pick up, how much upside is left for the U.S. dollar, what actually constitutes a catch in the NFL – are pretty much the same questions we faced heading into 2017.

It only adds to the sense of ennui which envelops our economic outlook that the economy is coming off another year in which top-line real GDP growth dashed the hopes of many by being, well, decidedly average. As in pretty much right in line with the 2.1 percent average growth rate that has prevailed over the life of this expansion. For us, it wasn't so much that our hopes were dashed as it was that our expectations were fulfilled, as our expectations were considerably less lofty than those of many other analysts. Even leaving aside the keenly insightful yet very humble chap who a year ago declared that any arguments that 2017 real GDP growth would not approach 4.0 percent were "a pile of rubbish," the reality is that many had unrealistically high hopes for 2017.

As we noted in this space last January, our 2017 outlook was tempered by our view that there was far less certainty surrounding both the details and the timing of changes to tax policy than many thought would be the case. We also saw trade policy as a looming downside risk to our 2017 outlook, and thought any upside moves in interest rates and the exchange value of the U.S. dollar would be blunted by narrowing differentials in GDP growth and monetary policy stances between the U.S. and major foreign economies. This was in contrast to many analysts who argued wider growth and monetary policy differentials would send the exchange value of the U.S. dollar and U.S. interest rates sharply higher.

So, while we didn't have all of the details right (making last year like any other year, as will be the case this year), our forecast for another year of middling real GDP growth was pretty much on the mark. With the tax bill, which while sweeping in nature falls far short of constituting "tax reform," finally signed into law in mid-December, sure enough there are many who argue 2018 will be the year they thought 2017 would be but didn't quite turn out to be. As for us, with the tax bill now in place, we think 2018 will be better than we thought it would be but not by all that much, though we confess to being somewhat unsure about just how various sectors of the economy will be impacted by the tax bill.

Honestly, can you blame us for being unsure of the effects of a tax bill that is either the greatest gift to or the greatest heist from middle-and-lower income households in history, depending on whose narrative you're following? The reality is that, at this point, no one knows, and if forecasts of the bill's impact are all over the map, that's because the output any model gives you is highly dependent on the assumptions you feed into it. So, as they say in the sports world, that's why they play the games. Though, to be sure, sometimes even playing the game doesn't give you a clear-cut answer, as any irate Pittsburgh Steelers fan can tell you after the catch that was a catch until some guy in a booth nowhere near the game said it wasn't a catch. Okay, moving on.

As in any year, there is no shortage of questions surrounding the outlook for the U.S. economy in 2018, some of which we'll touch on in what follows. As we do each year at this time, we'll look both back and ahead; back to see how we did with our 2017 forecast and ahead to discuss what we think 2018 holds in store. We do so in a series of questions touching on what we see as the main points of interest for the U.S. economy in 2018. Our answers will lay down markers for how we expect 2018 to turn out, and as we go we'll look back on our answers for 2017 and see how our calls turned out. Doing so, as we do each year, is a useful reminder that those practitioners who do not find economic forecasting to be a humbling exercise probably should.

QUESTION 1: Real GDP growth – over or under 3.0 percent? Under. We've raised the bar for the economy this year, or, if you prefer, we've reset the bar. In our 2014, 2015, and 2016 outlooks, we set the bar for real GDP growth at 3.0 percent, and our answer evolved (devolved?) from "over" to "over – what, are you crazy?" So, it only seemed sporting to lower the bar to 2.5 percent in our 2017 outlook. Our answer was "under" – our forecast was for real GDP growth of 2.2 percent in 2017. While the Q4 GDP data are not yet available, it looks like 2017 growth will come in no better than 2.3 percent even if Q4 growth comes with a three-handle.

In a sense, setting the bar on 2018 real GDP growth at 3.0 percent is a given, as that is the marker many have laid down in the wake of the tax bill. As we laid out in our December 2017 *Monthly Economic Outlook*, we think the biggest positive impact of the tax bill will be on business investment spending, building on the solid growth seen over the final three quarters of 2017. Where a good deal of our uncertainty comes from, however, is on the individual side, as the numerous changes to tax rates, deductions, and exemptions seem to us a hodge podge that could spur a host of conflicting effects. Hence our earlier point about the output of any model being sensitive to the assumptions you feed into it. We think the tax bill will be a modest net positive on the individual side.

As a point of reference, the passage of the tax bill has led us to up our forecast for 2018 real GDP growth by about 25 basis points and our 2019 forecast by about 15 basis points. But, even with what we think will be a significant boost to business investment

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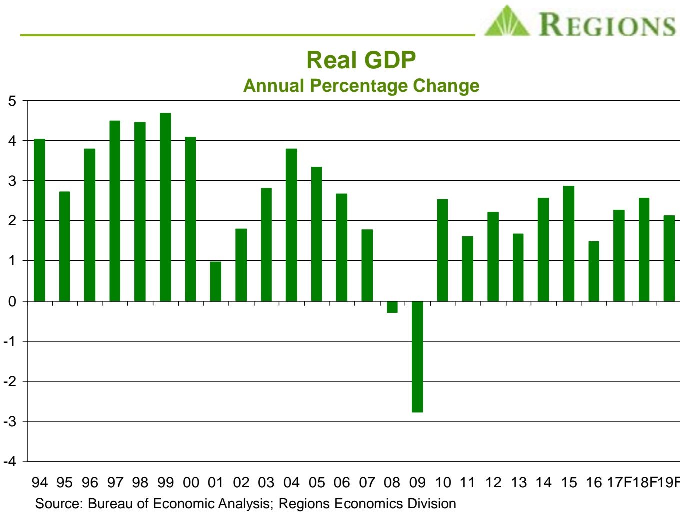
spending, at 2.8 percent our forecast for 2018 real GDP growth still falls short of the pace many argue the tax bill will spark.



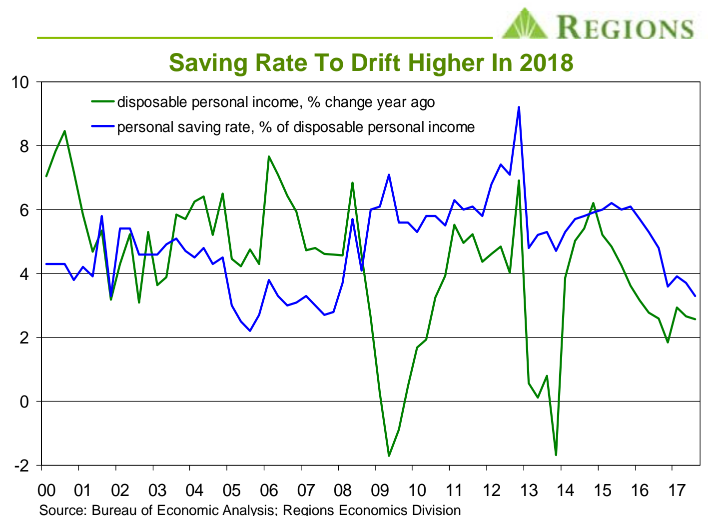
Our baseline 2018 forecast anticipates a different mix of real GDP growth than was the case in 2017, with a smaller contribution from consumer spending and, as noted above, a larger contribution from business investment spending. Growth in real consumer spending in 2017 looks set to come in right around our forecast, but we were caught off guard by how strong business investment spending on equipment and machinery turned out over the final three quarters of 2017. This basically offset weaker than anticipated residential investment and government spending, thus leaving top-line real GDP growth pretty much in line with our baseline 2017 forecast.

Note that even though we did not incorporate any fiscal stimulus – whether in the form of tax cuts or higher infrastructure outlays – into our 2017 forecast, we nonetheless expected modest growth in government spending. As it turns out, however, state and local government spending on goods and services turned out to be quite weak in 2017. As we have discussed in our quarterly reviews of state government finances, growth in tax revenue on the state level remains notably weak, particularly this deep into an economic expansion, while transfer payments continue to account for increasing shares of state government expenditures. In the GDP accounts, this means faster growth in personal income and slower growth, if not outright declines, in state government spending.

QUESTION 2: Personal saving rate – 4.0 percent or higher at year-end 2018? Yes. On a year-to-date basis through November, real consumer spending was up 2.7 percent in 2017, in line with our forecast for the year as a whole. Growth in real spending on goods was up 4.0 percent and growth in real spending on services up 2.2 percent year-to-date through November (services account for roughly two-thirds of consumer spending as measured in the GDP accounts). While growth in consumer spending was in line with our forecast, 2017 growth in disposable personal income came in below our expectations, one implication of which is that the personal saving rate fell over the course of 2017, sinking to 2.9 percent as of November (the last available data point).

With what figures to be better growth in disposable personal income and further tightening in the labor market, it would seem reasonable to expect growth in real consumer spending in 2018 to top that seen in 2017, but we're not so sure. Reasonable or not, our baseline forecast anticipates little change in the growth rate of inflation adjusted consumer spending in 2018. One reason for this is that we look for much slower growth in spending on consumer durable goods in 2018 than was the case in 2017, mainly due to what we expect will be a slower pace of motor vehicle sales.

One notable manner in which Hurricanes Harvey and Irma impacted the economic data in 2017 was that a run of post-hurricane replacement demand sent motor vehicle sales sharply higher in September. Unit sales came in at an annualized rate of 18.5 million in September, the highest since July 2005, and while this pace slowed over the final quarter of 2017, monthly unit sales nonetheless remained easily above what had been the run rate prior to the hurricanes. While considerable pent-up demand sustained growth in motor vehicle sales over the prior several years, that demand had been largely sated by 2017, as reflected in the decelerating pace of unit sales. We see the sustainable run rate somewhere between 16.0 and 16.5 million units at best, and as vehicle sales subside this will act as a drag on growth in spending on consumer durable goods. While the hurricanes disrupted this transition, they did not derail it and we expect this to be reflected in 2018 motor vehicle sales.



Keep in mind that swings in unit motor vehicle sales have an exaggerated effect in the data on consumer spending in the GDP accounts, as the entire purchase price of the vehicle is booked as spending in the month in which the sale is closed, as opposed to the monthly payment being booked each month. Another place this distinction comes into play is the personal saving rate which stood at 3.5 percent in August before making its way down to 2.9 percent in November 2017. Still, as seen in the above chart, the saving rate had been steadily declining since early 2016 in a somewhat delayed reaction to a sharp deceleration in growth in disposable (i.e., after-tax) personal income. The declining saving rate has been somewhat of a puzzle, though steadily rising household net worth and elevated consumer confidence can perhaps make consumers feel it is less important to save. To be sure, our own empirical work is consistent with a body of such work showing the secular decline in the saving rate since the mid-

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1980s can be explained by steadily rising household net worth. But, that does not, at least in our view, account for why the saving rate has fallen as much as it has over the past few quarters. Our sense is that the saving rate is at present unsustainably low.

Our forecast anticipates the saving rate rising, albeit slowly, over the course of 2018. To our earlier point, measurement issues alone will help push the saving rate higher if we are correct that motor vehicle sales will slow significantly from their late-2017 pace. To the extent the tax bill bolsters disposable personal income, households would be able to add to saving while sustaining the same rate of consumption spending, which would push the saving rate higher. But, to the extent consumers take on debt, in this case credit card debt, at a faster rate to support current consumption spending, that would put downward pressure on the saving rate. Still, after accounting for all of these effects, we look for the saving rate to end 2018 at or slightly above 4.0 percent. Whether or not our call here is on the mark will go a long way toward determining whether or not we are correct in our forecast of growth in real consumer spending and, in turn, top-line real GDP growth in 2018.

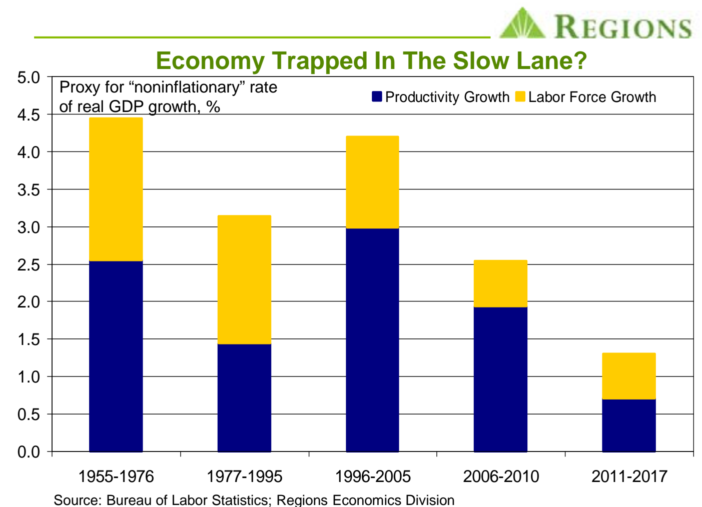
QUESTION 3: Average hourly earnings growth (year-on-year) – above or below 3.0 percent in Q4 2018? Above. We asked the same question in our 2017 outlook and our answer was also the same, i.e., average hourly earnings growth would top 3.0 percent in Q4 2017. This turned out to be the wrong call, as average hourly earnings were up by 2.4 percent on a Q4/Q4 basis, leaving them up 2.6 percent for 2017 as a whole. We have over the past few years consistently been below consensus in our forecasts of wage growth, meaning our forecasts have been closer to the mark. Our underlying premise has been that there is more slack remaining in the labor market than implied by the headline unemployment rate, which ended 2017 at 4.1 percent. While we thought the unemployment rate would end 2017 at 4.5 percent, we nonetheless thought the labor market would have tightened enough to generate more upward pressure on wages.

There are a number of reasons wage growth has remained fairly tame even with the unemployment rate on the verge of falling below 4.0 percent. For instance, data on labor force flows show that in 2017 on average 4.5 million people per month transitioned from not in the labor force in one month to being employed in the next month, and this figure has consistently risen as the current economic expansion has endured. This steady inflow has been a bit stronger than even we had expected, and has helped offset the gradual paring down of people transitioning from unemployed to employed – the average of just over 1.9 million per month since 2016 is the lowest since 2000. With the long-term unemployed continuing to account for a higher than normal share of total unemployment, firms are finding it harder and harder to hire from the pool of the unemployed (it is well documented that the odds of finding employment diminish as the duration of unemployment lengthens), but the inflow of new entrants/re-entrants into the labor force has been more than sufficient to facilitate hiring without sparking significantly faster wage growth.

At some point these inflows into the labor force will slow, but other factors also come into play. For instance, the length of the average workweek is still fairly low, certainly below where it would be were the labor market at or near full employment. We have referred to the still-short workweek as an underappreciated form of labor market slack, and firms still have ample capacity to add to total labor input by adding hours rather than by adding workers. Adding hours does not put material upward pressure on wages, so to the extent firms go this route it won't bolster hourly earnings growth.

Additionally, as we discussed in our September 2017 *Monthly Economic Outlook*, the combination of persistently low inflation and anemic labor productivity growth has acted as a material drag on wage growth over recent years. Unless and until these factors begin to reverse, wage growth will remain below the 3.5 percent or so rate that would be more consistent with a labor market at or near full employment, even as inflows into the labor force begin to diminish. While we don't think we'll see wage growth at this 3.5 percent rate by year-end 2018, we do think it will at least be above the 3.0 percent mark. And, as a side note, we look for the unemployment rate to end 2018 at 3.7 percent.

QUESTION 4: Nonfarm labor productivity growth – above or below 1.5 percent in 2018? Above. But not by much, as we look for productivity growth of 1.6 percent. Not quite a productivity miracle (see 1996-2005, when productivity growth averaged 3.0 percent per year) but we'll take it. Our marker for 2017 was productivity growth of 1.0 percent, and we took the under, which proved to be the wrong call. Year-to-date through Q3 productivity growth was running right at 1.3 percent for 2017 and even if the Q4 data show productivity flat or slightly lower as we expect, the annual number will still be right at 1.3 percent.



Our regular readers are by now familiar, if not too familiar, with the above chart showing the economy's "speed limit" – or, the rate at which it can grow on a sustainable basis without sparking inflation pressures. The speed limit is basically the sum of the rates of productivity growth and labor force growth, and over the past several years both have been sorely lacking. We have argued that the anemic trend rate of productivity growth over the past several years is primarily due to underinvestment on the part of firms over the course of the current expansion. Clearly this has begun to change, and though it is too soon for this to have had a material impact on productivity growth firms are at least on the right track, assuming the recent strength in capital spending is sustained.

We think that it will be (see below), and given that the rate of labor force growth is unlikely to pick up materially on a sustained

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basis over the next few years, faster productivity growth will be the key to upping the economy's speed limit. This has implications for wage growth and for monetary policy – we've heard more than one FOMC member speak to the importance of there being supply side effects from the tax bill, which would mean the FOMC could remain on a path of gradual increases in the Fed funds rate. But, while we look for faster productivity growth in 2018, the key questions are the extent to which productivity growth picks up and to what extent this faster growth can be sustained.

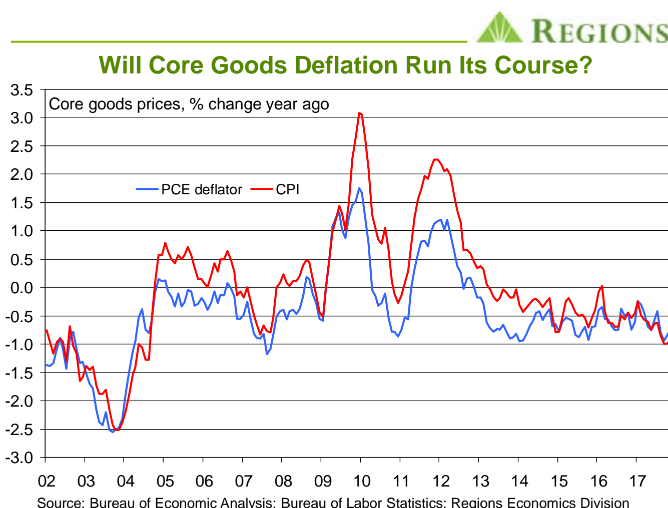
QUESTION 5: Growth in real business fixed investment in 2018 – above or below 5.0 percent? Above. Our marker for 2017 was 5.0 percent, and we took the under, which looks like it will be the right call. On a year-to-date basis through Q3 real business fixed investment was up 4.1 percent in 2017, and even if the Q4 data bring the double-digit growth (annualized) in business investment in equipment and machinery we expect, growth in total business fixed investment for 2017 would still fall shy of 5.0 percent.

Still, as we've noted above, this is clearly an improvement, and we look for even further improvement in 2018, thanks in part to the tax bill, particularly the provision allowing for immediate expensing of capital outlays. We think this will prompt significant growth in spending on equipment and machinery and, though to a lesser degree, spending on structures. Still, we can't adequately express our disdain, at least not in a family oriented publication such as this one, for the fact that the immediate expensing provision will start to be phased out five years down the road. While many brush this concern aside by simply assuming a future Congress will extend the provision, we wouldn't want to bet on this. The risk, as the law now stands, is that we see a barbell effect on capital spending, i.e., a spurt of growth in 2018, followed by much less activity for a few years than another spurt in the final year the immediate expensing provision is in full effect.

As we noted above, in order for there to be a material and sustained improvement in productivity growth, we will need a prolonged period of stronger business investment. As it is, for as strong as business investment was over the final three quarters of 2017, firms are still making up ground lost during the current expansion, when capital spending significantly underperformed historical norms. Our story has been consistent here – we've argued firms had little incentive to invest given an anemic trend rate of top-line growth, as they had access to a large pool of readily available and relatively cheap labor. In other words, firms had the incentive to substitute labor for capital, and they did so liberally. Now, with tighter labor market conditions and labor costs rising at a faster rate coupled with a more robust global growth outlook, the incentive structure facing firms has changed, and the tax bill only shifts that structure further in favor of capital over labor. Still, while we have high hopes for business investment in 2018, after that it's very much an open question.

QUESTION 6: PCE inflation – above or below 2.2 percent in 2018? Below. This was also our marker for 2017 and our answer was also below, which in hindsight seems a ridiculously easy call to have made. On a year-to-date basis through November the PCE deflator, the FOMC's preferred gauge of inflation, was up 1.7 percent. But, go back to last year at this time and expectations were that tighter labor market conditions would spark faster wage growth that would, in turn, spark inflation pressures in the broader economy. We have been quite consistent in disagreeing with this basic premise (that faster wage growth leads to faster inflation in the broader economy), but we did nonetheless expect inflation to pick up to 1.9 percent in 2017 from 1.2 percent in 2016.

That inflation has remained so tame has taken many private sector analysts, and more than a few central bankers, by surprise. To be sure, there are some transitory forces, such as plummeting prices for cell phone service, that acted as a drag on inflation in 2017. As these transitory factors wash from the data, that will push inflation higher over coming months. But, there are also structural forces, such as the changing nature of retail trade and how that is impacting goods prices, and a still-high degree of global economic slack, that will continue to weigh on inflation over coming quarters.



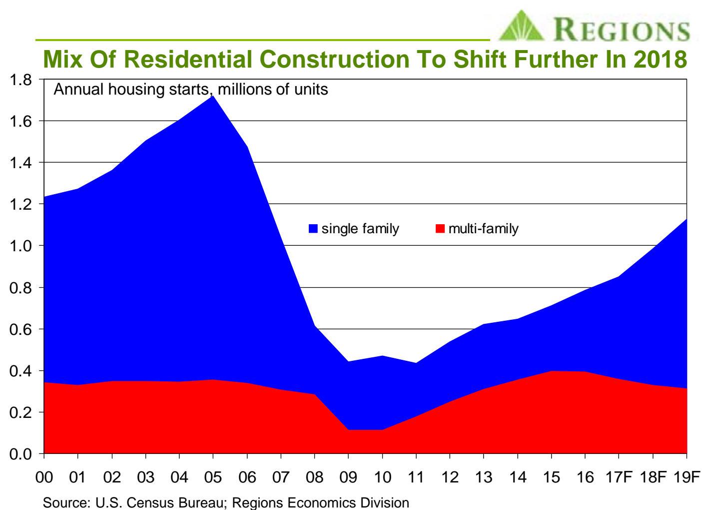
Contrary to the expectations of many analysts who, once the U.S. dollar began to weaken in 2017, thought core goods (i.e., goods excluding food and energy) prices would push higher, core goods deflation remains entrenched. As measured by the PCE deflator, core goods prices have declined year-on-year for 60 consecutive months and are down in 55 of the past 56 months as measured by the Consumer Price Index. Our 2017 forecast anticipated continued weakness in core goods prices (as well as a weaker U.S. dollar than most other forecasts), and while we do expect some firming in 2018, our expectations are somewhat tempered.

This will be one key determinant of the path of inflation in 2018. Some others are rent growth, which we expect to soften further, medical care costs, which have confounded expectations for some time now, and energy prices. Higher energy prices could easily push headline PCE inflation above our 2.0 percent forecast in 2018 while leaving core inflation behind (our forecast is 1.8 percent for 2018, up from 1.5 percent in 2017). Sure, tomorrow is always a day away, but it seems that inflation is always a year away, at least as far as the FOMC goes. Whether or not 2018 is the year that changes will have implications across the economy.

QUESTION 7: Housing starts – over or under 1.350 million units in 2018? Under. Over the past several years, our forecasts for housing permits and starts and for home sales have consistently been below consensus, and have been consistently closer to the mark. Our marker for total housing starts in 2017 was 1.250 million units, which was right at the consensus forecast going into the

year, and our call naturally was "under." Through November, the annualized rate of total housing starts was 1.207 million units, so our call was correct. As we have often noted, our below-consensus forecasts of housing market activity are not at all a reflection of how we see the demand side of the market – we've consistently argued demand is quite healthy. The same cannot be said for the supply side of the market, however.

Single family construction continues to be held back by shortages of buildable lots, labor shortages, higher costs for materials, and entitlement processes which, in many markets, are far more burdensome and costly than has been the case in the past. This has held down single family housing starts and sales of new single family homes. At the same time, extraordinarily low inventories have held down sales of existing homes. While we do look for some relief in 2018, we think inventory shortfalls will continue to be the main story in the single family segment of the housing market.



It is quite the opposite in the multi-family segment of the housing market, as the pipeline of multi-family units under construction is more full than at any time since the mid-1970s. The pace of multi-family completions remains somewhat shy of snail-like, but it was not until recently the pace of permits and starts began to slow. If we were surprised by anything in the housing market in 2017 it is that the deceleration in multi-family activity was as mild as it was, particularly as banks have sharply curtailed multi-family lending activity. That has not stopped private equity from filling the void, however, which has supported continued development activity even as the supply pipeline has gotten more and more full.

As we routinely note, we think demand for multi-family rental units remains strong, just but not strong enough to absorb the supply coming down the line. So, we look for further pullbacks in multi-family permits and starts in 2018 while single family permits and starts post healthy increases. The net result is our forecast for 1.321 million total housing starts in 2018. It is also worth noting that if we are correct in our call on the multi-family segment of the housing market, rent growth will slow further in 2018, thus acting as a drag on core inflation, though far more so on core CPI inflation than core PCE inflation. One thing that makes us a bit nervous here is that after years of being consistently below consensus, our 2018 forecast is slightly above consensus (which is around 1.300 million units). It just feels odd, but we'll see how it works for us.

QUESTION 8: The mid-point of the Fed funds rate target range at year-end 2017 – over or under 2.125 percent? Push. Our baseline forecast anticipates three 25-basis point hikes in the target range in 2018, which would leave the mid-point at 2.125 percent at year-end. As we've done the past few years, our marker for the year-end funds rate mid-point is the projected median from the FOMC's December "dot plot." What is different this year is that our baseline forecast lines up with the three hikes implied by the December 2017 dot plot – in the past we've always taken the under, as we did in our 2017 outlook. While that proved to be the correct call in prior years, it turned out to be the wrong call in 2017 as the FOMC raised the funds rate target range three times, with the mid-point standing at 1.375 percent at year-end 2017.

Unlike prior years, however, we don't have a lot of conviction behind our 2018 funds rate forecast. In prior years our basic premise was that even should the pace of growth pick up, there was a sufficient degree of slack in the economy, including the labor market, to blunt inflation pressures, hence affording the FOMC the option of raising the funds rate at a very gradual pace. As we start 2018, the degree of slack in the U.S. economy has diminished considerably, lending some upside risk to inflation. At the same time, however, the positive supply-side effect we anticipate from changes to the corporate tax system means a bigger buffer against inflation pressures even with a faster rate of top-line growth.

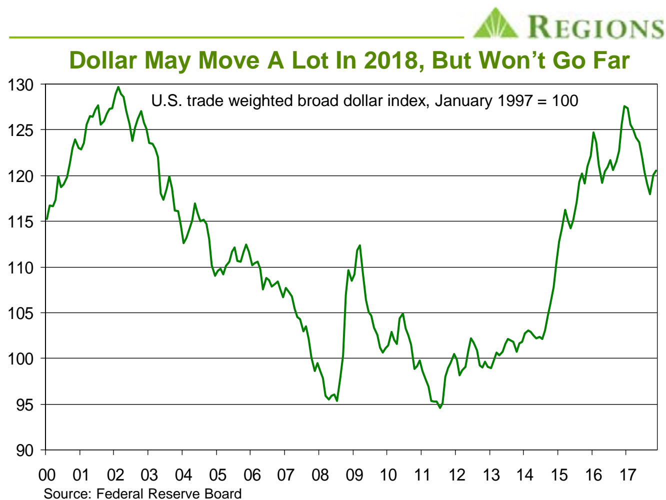
The most significant wild card, however, is that the composition of the FOMC will be different a few months from now than it has been over recent years. How different remains to be seen, at least in terms of how new members of the Board of Governors assess the FOMC's body of work over the past several years and what, if any, adjustments they deem appropriate going forward. With what is shaping up to be a more hawkish voting block of regional Fed presidents in 2018, new Board appointees with a more hawkish policy stance could tip the balance toward a more aggressive course of funds rate hikes, even with no upside inflation surprise.

In short, while our baseline forecast anticipates three hikes in the funds rate target range in 2018, we'd be no more surprised to see four hikes than we'd be to see two hikes, which is to say not a lot. What is more relevant, however, is how much conviction market participants have behind whatever rate call they've made for this year, which will go a long way in determining how much FOMC-related volatility we'll see in the markets in 2018.

QUESTION 9: U.S. dollar – year-end 2018 value within 3.5 percent (higher or lower) of the year-end 2017 value? Yes. Our measure of the dollar's value is the Fed's Broad Dollar Index, and we expect the index to end 2018 within 3.5 percent, higher or lower, of its year-end 2017 value. For some perspective, the Broad Dollar Index rose by 9.23 percent in 2014, by 10.31 percent in 2015, by 4.42 percent in 2016, then fell by 6.99 percent in 2017.

Our 2017 call on the dollar was a mixed bag. A post-election surge of optimism over prospects for U.S. growth and expectations of a more aggressive FOMC pushed the Broad Dollar Index to within 1.6 percent of its record high at year-end 2016. We thought that momentum would carry over into 2017, resulting in a new record higher for the index but that would be followed by the dollar falling as expectations gave way to reality. We were wrong on the former, the Broad Dollar Index did not reach a new record high in 2017, and actually peaked on January 3, and we were surprised by how

much the index fell over the remainder of the year. While there was a modest late-year rally when then it became clear the tax bill would pass, the index ended 2017 well off its year-end 2016 print.



One key premise of our 2017 call on the dollar was that there would be smaller differentials in rates of economic growth and in central bank policies between the U.S. and the major foreign economies than many expected. Going into 2018, global growth is clearly on the upswing and, even with the FOMC following a course of gradual Fed funds rate hikes and paring down the Fed's balance sheet, monetary policy divergences will not likely be a main source of upward pressure on the U.S. dollar in 2018. And, while U.S. firms will face far less severe tax consequences from repatriating foreign earnings, we do not think this will be a significant source of sustained upward pressure on the U.S. dollar in 2018.

That we expect the Broad Dollar Index to finish 2018 relatively close to where it finished 2017 does not preclude sharp moves during the year. For instance, monetary and trade policy are two areas where market participants may be caught off guard and forced to reassess their views of the dollar. It is also possible that, after years of significant flows of foreign capital into U.S. dollar denominated assets, global investors look to diversify in 2018, their confidence bolstered by a better global growth outlook. The same could be the case with foreign central banks, who may wish to diversify reserve holdings away from U.S. dollars. In short, even with a better U.S. growth outlook than in recent years, a significant and sustained appreciation of the U.S. dollar in 2018 is not a lock.

QUESTION 10: What are some of the main risks to our baseline 2018 forecast and which way does the balance of risks tilt? Our view is that no forecast can be considered worthwhile unless it comes with an assessment of the main risks to that forecast. And, sure, simply laying out such a list does not in and of itself make a forecast worthwhile. After all, you can never know every single thing that can go wrong, let alone know how, when, or why it will go wrong. But, even allowing for the things we don't know that we don't know, it is always a useful exercise to sort through the known unknowns, and below are some of the things that keep us up at night feeling either more worried or more hopeful.

It may seem trite at this point to cite geopolitical risk as a main downside risk, but at the same time one could make a compelling case that this is the main downside risk to not only the U.S. economy in 2018 but to the global economy. Elevated tensions between the U.S. and North Korea could easily spill over into open conflict involving a number of nations, with vast economic and financial fallout. The Middle East could be highly volatile in 2018 for a variety of reasons, territorial disputes between China and some of its neighbors could boil over, and Russia seems to always loom as a potential source of unrest. These potential risks come on top of the constant risk of terrorist attacks. One cannot plausibly dismiss out of hand the potential economic, financial, and psychological consequences of geopolitical shocks, even if it is not possible to assign probabilities or quantify outcomes.

Though by no means our baseline case, we think it would be unwise to dismiss out of hand the possibility of inflation surprising, perhaps significantly so, to the upside in 2018. With a considerable portion of slack having been pared down in the labor market and in the broader U.S. economy, the recent tax bill could have more powerful demand side than supply side effects, and with firming global growth putting upward pressure on commodity and materials prices, this could easily ignite inflation pressures. The downside risk in this scenario is that it would almost surely prompt the FOMC to become more aggressive than is expected to be the case, with short-term and long-term market interest rates reacting in kind, thus sowing the seeds of the end of the current expansion. In addition, a high volume of U.S. dollar denominated debt issued by foreign borrowers injects a global dimension to this risk.

Trade policy is a downside risk as U.S. steps to restrict imports would surely be met in kind. Though often overlooked, the flip side of a trade deficit is a capital surplus, meaning any sort of trade war would likely bring higher U.S. interest rates. Another potential source of larger than anticipated increases in U.S. interest rates is a widening federal government budget deficit, which would leave the U.S. Treasury in the market selling greater quantities of debt at a time when the Fed is actively paring down its balance sheet and foreign demand will likely be waning. Any scenario involving the FOMC and market interest rates moving at a much faster pace than anticipated could bring sharp reversals in asset prices, with significant adverse impacts on the economy.

Conversely, it could be that the tax bill has a larger positive impact on the household sector of the economy than anticipated in our baseline forecast. On top of the boost to the supply side built into our forecast, this would spark a faster rate of real GDP growth than our baseline forecast anticipates. It is also possible that stronger growth in business investment spending could lead to a more rapid and powerful boost to productivity growth than our baseline forecast anticipates, hence allowing for a faster rate of growth with no corresponding inflation pressures. The same would be true of any factor that leads to greater labor force participation than anticipated in our baseline forecast. Finally, though perhaps unlikely in an election year, a large-scale infrastructure program could also provide a lift to growth, though the details and the financing provisions would be critical to any such assessment.

Though by no means an exhaustive list, these are what we see as the most significant risks, downside and upside, to our 2018 forecast. At present, we'd say the risks are more or less balanced. As with each year's outlook, check back next year at this time to see how our 2018 forecast fares.

ECONOMIC OUTLOOK

REGIONS

January 2018

Q2 '17 (a)	Q3 '17 (a)	Q4 '17 (f)	Q1 '18 (f)	Q2 '18 (f)	Q3 '18 (f)	Q4 '18 (f)	Q1 '19 (f)		2016 (a)	2017 (f)	2018 (f)	2019 (f)
3.1	3.2	2.7	2.9	2.7	2.6	2.4	2.2	Real GDP[1]	1.5	2.3	2.8	2.2
3.3	2.2	3.5	2.1	2.1	2.4	2.3	2.1	Real Personal Consumption[1]	2.7	2.7	2.5	2.0
								Business Fixed Investment:				
6.7	8.5	9.2	7.0	6.1	4.7	3.8	3.3	Equipment, Software, & IP[1]	0.3	4.6	6.9	3.7
7.0	-7.0	2.0	3.1	3.7	3.5	3.2	3.4	Structures[1]	-4.1	5.3	2.0	3.1
-7.3	-4.7	8.0	8.3	7.8	7.5	9.0	8.3	Residential Fixed Investment[1]	5.5	1.5	5.4	7.7
-0.2	0.7	2.4	0.2	0.7	0.8	1.1	0.7	Government Expenditures[1]	0.8	0.1	0.9	0.8
-613.6	-597.5	-636.0	-632.7	-638.8	-646.8	-652.8	-659.9	Net Exports[2]	-586.3	-617.4	-642.8	-672.4
1.167	1.172	1.264	1.269	1.301	1.339	1.374	1.396	Housing Starts, millions of units[3]	1.177	1.210	1.321	1.434
16.8	17.1	17.7	17.3	16.9	16.7	16.6	16.6	Vehicle Sales, millions of units[3]	17.5	17.2	16.9	16.4
4.3	4.3	4.1	4.0	3.9	3.9	3.8	3.7	Unemployment Rate, %[4]	4.9	4.4	3.9	3.7
1.6	1.4	1.4	1.4	1.4	1.4	1.3	1.2	Non-Farm Employment[5]	1.8	1.5	1.4	1.1
1.6	1.8	1.9	1.9	2.1	2.1	1.9	2.0	GDP Price Index[5]	1.3	1.8	2.0	2.0
1.6	1.5	1.7	1.6	2.1	2.2	2.0	2.0	PCE Deflator[5]	1.2	1.7	2.0	2.0
1.9	2.0	2.1	1.9	2.6	2.7	2.4	2.3	Consumer Price Index[5]	1.3	2.1	2.4	2.2
1.5	1.4	1.5	1.5	1.8	2.0	2.0	2.1	Core PCE Deflator[5]	1.8	1.5	1.8	2.1
1.8	1.7	1.7	1.6	2.1	2.3	2.3	2.4	Core Consumer Price Index[5]	2.2	1.8	2.1	2.3
0.92	1.13	1.17	1.42	1.67	1.90	2.13	2.17	Fed Funds Target Rate, %[4]	0.39	0.97	1.78	2.40
2.26	2.24	2.37	2.50	2.60	2.70	2.80	2.90	10-Year Treasury Note Yield, %[4]	1.84	2.33	2.65	2.98
3.99	3.89	3.92	4.06	4.15	4.25	4.36	4.47	30-Year Fixed Mortgage, %[4]	3.65	4.00	4.20	4.56
-2.6	-2.1	-2.3	-2.4	-2.5	-2.6	-2.8	-2.7	Current Account, % of GDP	-2.4	-2.3	-2.6	-2.8

a = actual; f = forecast; p = preliminary

Notes:
1 - annualized percentage change
2 - chained 2009 $ billions
3 - annualized rate
4 - quarterly average
5 - year-over-year percentage change

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