RCF Economic & Financial Consulting, Inc.

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2018Q1 Forecasts for the Philadelphia Federal Reserve Society of Professional Forecasters

RCF Vice President Peter Bernstein is a member of the Philadelphia Fed's Society of Professional Forecasters. Below are his 2018Q1 forecasts and analysis.

Near Term Outlook is Solid; Longer-Term Things Get Dicey

The economy grew at a 2.3 percent rate in 2017, an improvement from 2016's 1.5 percent growth but not much more than the 2.0 percent average growth since the Great Recession. However, if one excludes the weak first quarter of the year, the economy grew close to 3.0 percent for the remainder of 2017, a pace that we expect to continue into 2018. In addition to cyclical momentum and solid growth around the world, the US economy will be boosted by tax cuts received by most individuals and businesses.

The tax cuts come at a cost, namely, higher budget deficits. And stronger consumer spending is likely to push up inflation. The hope is that both of these negatives can be mitigated by increases in economic output. For that to happen, one of two things must grow faster – employment or productivity. We are skeptical that employment will grow faster than it has and in fact project it to slow for the simple reason that low unemployment means there are fewer and fewer unemployed people to put to work. While there are many workers who have dropped out of the labor force and are not included in the official definition of employment, we have our doubts as to whether many of them will return to work after, in many cases, years removed from the labor market.

There is a greater chance of increases in productivity which has been notably weak in the last few years. Increases in business investment could boost productivity gains though it could also cause firms to substitute machinery for labor offsetting some of the contribution to economic growth. In sum, we are not convinced that the economy can really sustain long-term growth of 3.0 percent.

Instead, we see the fiscal stimulus from tax cuts providing mostly a short-term boost that will be "paid for" with slower growth in the future. Accordingly, we project the economy to grow 2.9 percent in 2018 and 2.6 percent in 2019 but see only 1.1 percent growth in 2020. Moreover, we wouldn't be surprised if the economy slipped into recession by then. The big concern for us is higher interest rates. The 10-year Treasury yield has already climbed to its highest level in four years and we see further increases in the future. Eventually, we think these higher rates will substantially dampen consumer and business spending.

Several factors are likely to drive up interest rates. The first is higher inflation. A second is increases in the fed funds rate. We don't think that the recent uptick in inflation will cause the Fed to accelerate its planned rate increases because somewhat higher inflation is exactly what the Fed expected and prefers. But even a continuation of gradual rate increases are rate increases nonetheless.

A third factor pushing up interest rates is changes in the supply and demand for bonds. Larger budget deficits mean more government bonds sales, perhaps as much as $1 trillion per year. True, we had trillion-dollar deficits before, but this time really is different. The deficit then was more easily financed by bond purchases from the Federal Reserve (quantitative easing) and from domestic and international investors' heightened demand for the safety of US government debt in the wake of the financial collapse. Neither of those factors is in play today. Moreover, the deficits following the Great Recession were primarily cyclical (short-term) deficits that declined as the economy slowly recovered. The deficits now and in the future are structural deficits that are likely to be with us for many years, barring substantial changes in future taxes and government spending.

It would be nice if the economy can sustain the stronger growth we see in 2018 for years to come. Nevertheless, hoping that higher fiscal deficits now and in the future can push up growth without also increasing inflation and interest rates is a roll of the dice. As a casino owner, President Trump should know how that usually ends.

Peter Bernstein's 2018Q1 Forecasts
Philadelphia Federal Reserve's Society of Professional Forecasters

	2017 Forecast	2017 Actual	2018 Forecast	2019 Forecast	2020 Forecast
Real GDP	2.6%	2.3%	2.9%	2.6%	1.1%
Real Consumer Spending	2.9%	2.7%	2.9%	2.4%	0.9%
Real Business Investment	5.0%	3.3%	5.8%	5.8%	2.9%
Real Government Purchases	0.8%	0.1%	1.2%	1.3%	1.2%
Real Exports	1.3%	3.6%	4.2%	2.7%	1.3%
Real Imports	3.6%	3.9%	5.3%	4.1%	2.6%
Consumer Price Inflation	2.5%	2.1%	2.6%	2.5%	2.4%
Core Inflation (ex food and energy)	2.3%	1.7%	2.4%	2.4%	2.4%
Unemployment Rate	4.6%	4.3%	4.0%	4.0%	4.5%
Employment (monthly average change)	191,625	189,479	171,500	165,729	156,271
Housing Starts (millions at annual rate)	1.28	1.21	1.34	1.42	1.44
10-Year Treasury Rate (annual average)	2.80%	2.33%	3.18%	3.57%	3.41%
3-Month Treasury Rate (annual average)	0.93%	0.93%	1.83%	2.64%	2.01%

** 2017 Forecast is Peter Bernstein's forecast submitted to Philadelphia Fed in February 2017*