U.S. ECONOMIC & INTEREST RATE OUTLOOK

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IN THIS ISSUE

- **Bull Steepening**

A persistent concern this year has been a flattening US Treasury yield curve, caused by long-term bond yields remaining low despite rising yields on shorter tenors. Flattening can lead to inversion, often a precursor of recessions.

We enter October with a steeper yield curve taking shape. As of this writing, the 10-year Treasury yield is solidly above 3%, a level not sustained since 2011. The bond market sell-off had no single explanation but appears to have been a confluence of robust US economic data, hawkish Fed commentary and inflation concerns among investors. Traders know this combination of circumstances as a “bull steepening.”

Though the volatility in bond yields is jarring after an extended low interval, the drivers of the movement are generally positive. We expect continued Fed rate hikes and strong economic growth in 2018, followed by slower growth and fewer rate movements in 2019.

Key Economic Indicators

	2018				2019				Q4 to Q4 change			Annual change		
	18:1a	18:2a	18:3f	18:4f	19:1f	19:2f	19:3f	19:4f	2017a	2018f	2019f	2017a	2018f	2019f
Real Gross Domestic Product (% change, SAAR)	2.2	4.2	3.3	2.7	2.1	2.1	2.1	1.8	2.6	3.1	2.0	2.2	2.9	2.5
Consumer Price Index (% change, annualized)	3.5	2.9	2.3	2.7	2.5	2.5	2.5	2.4	2.1	2.5	2.5	2.1	2.5	2.5
Civilian Unemployment Rate (%, average)	4.1	3.9	3.9	3.8	3.7	3.7	3.7	3.7				4.4*	4.0*	3.7*
Federal Funds rate	1.40	1.67	1.88	2.17	2.42	2.67	2.88	2.88				1.00*	1.65*	2.71*
2-yr. Treasury Note	2.16	2.47	2.70	2.83	2.93	3.05	3.17	3.17				1.40*	2.45*	3.08*
10-yr. Treasury Note	2.76	2.92	2.95	3.15	3.30	3.50	3.65	3.65				2.33*	2.88*	3.53*

a=actual
f=forecast
*=annual average

Influences on the Forecast

- To little surprise, the Federal Open Market Committee raised the Fed Funds target rate to 2.0%-2.25% at its meeting that concluded September 26. Fed watchers observed that the policy statement accompanying the decision no longer described U.S. monetary policy as “accommodative.” But Fed Chairman Jerome Powell took care to note in a subsequent speech that interest rates were still well below their neutral level.

  We continue to forecast rate increases following the Fed’s meetings in December, March, and June, at which time the rate will likely level off and allow the Fed time to observe the effects of higher rates.

- The September employment report showed the headline unemployment rate falling to 3.7%, a nearly 50-year low. However, the payroll gain was slower than most forecasters anticipated, with only 134,000 jobs created. At least some of this sluggishness can be attributed to slow hiring on the east coast in the aftermath of Hurricane Florence. Positive revisions to prior months' payrolls data helped to bolster the market's reaction to the report. As seasonal hiring gets underway for the holiday season, we expect continued increases to employment for the remainder of 2018.

- Wage growth continues but has yet to show the strength that a low unemployment rate would suggest. Average hourly earnings grew by 2.8% year-over-year in September, following a cycle-record high of 2.9% in August. Prominent employers have announced higher wage policies, suggesting another round of wage inflation has begun.
- Real gross domestic product (GDP) for the second quarter was affirmed at 4.2% annualized growth in its final estimate. We expect continued strength at a more tempered pace in the balance of the year as the export gains that boosted second quarter's GDP dissipate.
- The announcement of a revised free trade agreement between the U.S., Mexico and Canada, dubbed the United States–Mexico–Canada Agreement (USMCA), gives some comfort for the direction of trade negotiations. The existing North American Free Trade Agreement (NAFTA) framework was left fundamentally unchanged, with each party making some concessions. As of yet, tariffs have not noticeably lifted inflation nor led to a decrease in the U.S. trade deficit.
- Inflation remains moderate. The deflator on core personal consumption expenditures (PCE), the Fed's preferred measure of inflation, stands at the targeted level of 2.0% year-over-year. The Consumer Price Index (CPI) followed a path much like wage growth, dropping slightly to 2.7% growth in August after a high reading of 2.9% in July. These levels are high relative to the soft inflation observed in recent years.
- The U.S. federal budget deficit for fiscal year 2018 (which ended on September 30) was $782 billion, 17% higher than last year. The impact of tax reform is clearly visible; federal revenue growth was flat, despite very strong economic growth and strong markets.
- Oil prices continue to climb, closing September at a price of $73 per barrel for the West Texas Intermediate grade. Supply disruptions caused by the loss of Venezuelan output and sanctions against Iran are driving up global prices, with the Brent (European) price recently reaching $86. The cost of energy will continue to be a global driver of inflation.