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2016 ECONOMIC ENVIRONMENT IN REVIEW

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KEY TAKEAWAYS

While oil prices began to stabilize in 2016, we do believe the price per barrel has the potential to rise in 2017 and may accelerate inflation.

The Federal Reserve (Fed) stayed on the sidelines for much of 2016, requiring an updated forecast of only one rate hike for the year.

We maintain that in 2017 we see low odds of a recession in the U.S., as we expect growth to accelerate modestly.

"The man who makes no mistakes does not usually make anything."
– Edward John Phelps

This week we take a look back at some of our hits and misses of 2016. We certainly had some of both in a year that had some unusual macroeconomic drivers, including the impact of low oil prices at the beginning of the year on several sectors of the economy, slower-than-expected economic growth, and the Federal Reserve (Fed) and markets cautiously moving closer to consensus after starkly different expectations on the path of rates early in the year. Nevertheless, we also had a good read on some of the basic forces in play in the economy. Against this backdrop, we look at what we got right and where we missed in 2016 and the lessons learned going into 2017.

INFLATION/OIL PRICES

"Looking ahead to 2016, if oil prices move up as we expect, the goods portion of CPI may increase by 2–3%; and if the pace of service sector inflation remains between 2% and 2.5%, overall CPI will accelerate quickly and may be well over 2.0% by year-end."

"We believe that oil prices may begin to stabilize in 2016 with a bias to the upside as supply and demand continue to move into balance."

Outlook 2016: Embrace the Routine (November 2015)

Looking back, oil prices did move up from the low $40/barrel level seen as our *Outlook 2016* was published in late November 2015, but not before crashing to the mid-$20/barrel in early 2016. Oil prices today sit at just under $52/ barrel, but goods prices (as measured by the Consumer Price Index [CPI])—though they did accelerate sharply in the second half of 2016—posted a 0.5% year-over-year decline as of November 2016. Driven by higher housing and medical costs, service sector inflation in 2016 exceeded our expectations, posting a 3.0% year-over-year reading as of November 2016, moving from just 0.4% year over year in late 2015 to the 1.7% reading in November 2016.

Looking ahead, if oil and gasoline prices stay in their recent ranges, the CPI for commodities will turn positive in early 2017—for the first time since 2014—and push overall CPI above the Fed's 2% target. We expect oil prices to potentially move modestly higher in 2017 from current levels, based on the recent global production cut agreement and improving global economic growth, which should accelerate the timetable to balance supply and demand.

GDP/RECESSION

"Economy: 2.5–3% Growth: Manufacturing, business capital spending, and net exports are expected to take larger roles in U.S. economic growth, with continued support from consumer spending."

Outlook 2016: Embrace the Routine

"While our view is that the odds of a U.S. recession in 2016 have increased in recent weeks, based on the economic data alone, the odds of a recession in the U.S. remain low, potentially 15–20%. However, the odds of a policy mistake — either at home, or more likely, abroad, by central bankers or central governments enacting fiscal or foreign exchange policies — have increased in the first month of 2016."

Groundhog Day," *Weekly Economic Commentary,* February 2, 2016

In the third quarter of 2016, the U.S. economy—as measured by real gross domestic product (GDP)—posted only a 1.6% year-over-year increase, and is likely to fall far short of our forecast for 2.5 to 3.0% growth. The consumer continued to be a big support to GDP growth, with consumer spending posting a solid 2.7% gain over the past four quarters, as consumer confidence hit a fresh 9-year high. Net exports also added to growth in 2016 aided by a weaker dollar. Business capital spending was a drag on growth in the first three quarters of 2016 however, but signs emerged in the past few months that business capital spending has bottomed out, along with oil production.

Even with the rocky start for financial markets and widespread fears of a recession in the U.S. and globally, the U.S did not enter a recession in 2016, despite the 10.5% peak to trough drop in the U.S. equity market (as measured by the S&P 500) at the start of 2016 (and 14% drop from the 2015 highs), the plunge in oil prices and oil-related manufacturing activity, shocks from the U.K. vote in late June 2016 to leave the European Union (EU), and the surprise results of the U.S. presidential election. In fact, U.S. economic growth, which remains tepid by historical standards, accelerated during 2016, starting the year at just 0.8% (quarter over quarter) in the first quarter, and accelerating to 3.2% by the third quarter of 2016.

Looking out into 2017, we see low odds of a recession in the U.S. as we expect growth to accelerate modestly to near 2.5%, driven by gains in consumer and business spending, supported by potential pro-growth fiscal policies.

WAGES

"Wage growth has been limited but should continue to accelerate in 2016."

Outlook 2016: Embrace the Routine

Wage growth—as measured by the year-over-year change in average hourly earnings—posted a 2.4% year-over-year increase in November 2015 as our *Outlook 2016* was being published, accelerated to a high of 2.8% by October 2016, but slid back to a 2.5% increase in November 2016. Other measures of wage inflation, such as the Atlanta Fed Wage Tracker and the Employment Cost Index, also accelerated in 2016, as the unemployment rate fell from 5.0% in November 2015 to 4.6% in November 2016. The Fed's first Beige Book of 2016, released in January, noted that "districts reported little overall change in wage and price pressures," while the final Beige Book of 2016, released in November 2016, noted that "wage growth was characterized generally as modest, on balance, by district contacts and that staffing firms reported rising wages or difficulty filling positions without wage increases in a majority of the Districts."

Looking out into 2017, we see above-potential GDP growth reducing slack in the economy and labor market and continuing to put upward pressure on inflation. We expect GDP growth to be driven by gains in consumer and business spending, supported by potential pro-growth fiscal policies.

THE FED

"Our view remains that the Fed will raise rates three times (by a total of 75 basis points, or 0.75%) this year."

"FOMC FAQS: Making a Statement," *Weekly Economic Commentary*, January 25, 2016

"Given both the direct and indirect impacts of Brexit on the U.S. economy and financial system, we are now expecting the Fed to raise rates just once this year."

"Midyear Outlook 2016: Believing in the Potential of the U.S. Economy," *Weekly Economic Commentary*, July 18, 2016

The Fed raised rates only once in 2016, so the projection we made at the start of 2016 (first quote above) was not correct, but by midyear (second quote), we had lowered our Fed target to just one hike, and that turned out to be accurate. For most of the year, there was a large disagreement between the fed funds futures market and the Fed. By late January 2016—when the first commentary quoted above was penned—the market was expecting barely one 25 basis point (0.25%) rate hike by the Fed in 2016. In the wake of the Brexit vote in late June 2016, the market wasn't expecting the Fed to hike rates at all in 2016, and had begun to price in a rate cut by the end of the year.

Looking ahead, we expect two or three 25 basis point (0.25%) Fed rate hikes in 2017, as we believe the economy may receive a boost from fiscal policy, potentially leading to greater confidence and economic activity and pushing GDP growth higher. ■

The *Weekly Economic Commentary* will not be published on December 26, 2016. Look for our next publication on January 3, 2017. We wish you all a joyous holiday season!

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