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ECONOMIC TALKING POINTS

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Will confidence in the economic outlook be punctured by the chaos in Washington?

The stock market's non-stop climb to new heights since the election reminds me of a wobbly drunk at the top of a steep hill. You sense that person is going to fall, but you don't know just when or how hard the drop will be.

I say this because since November 8th, investors have been so intoxicated by the mere fumes of pending tax reform, greater spending on infrastructure and defense and of regulatory rollbacks that they pushed equity prices to levels, I believe, have escaped the gravity of common sense. First of all, the timing to carry out campaign promises is vastly different from the timing politicians act.

But in the current environment there is an even bigger drag on progress. In less than a month into his term, President Trump and his aides have become so embroiled by ethical and legal investigations, they seems unable to provide the leadership needed to push through the economic agenda that so excited Wall Street the last two months.

Furthermore, House Republicans and President Trump are deeply divided on the make-up, magnitude and pace of fiscal stimulus. For example, many GOP leaders favor a border adjustment tax, which would bring in substantial revenues, but Trump is not yet sold on the idea. The President wants to spend $1 trillion over 10 years on infrastructure, but that plan appears dead on arrival if you ask House deficit hawks. And the disagreements have even spread into health care. The GOP wants to privatize Medicare, yet the President is firmly opposed to it.

Equally concerning is the how this new Administration already mishandled its relationship with allies like Mexico, Australia, and Germany --- not to mention the

possible illegal conversations Trump aides had with Russian intelligence officials during the campaign.

We are left with a foreboding sense that this inexperienced White House is not just dysfunctional, but will remain the subject of ongoing investigations by Congress and U.S. government agencies.

So does this mean the fumes of promised fiscal stimulus that so powered the stock market higher are about to fade? Will the financial markets react negatively to the emerging paralysis in Washington? Is that drunkard on the hill about to stumble?

This could easily turn into a quandary for the Federal Reserve.

On the one hand, we continue to get reports showing an economy gaining speed. Americans are happily shopping thanks to a vibrant job market and rising household wealth.

- **Retail sales last month jumped 0.4%, double what was expected, and followed an upward revise increase of 1% in December. Take out autos and outlays for gasoline, and retail sales surged 0.7% in January.**

- **It's not just consumers that are giddy. Small and midsize businesses are the most bullish in 14 years, according to the National Federation of Independent Business. Their Index of Small Business Optimism just surged to its highest level since December 2004, which is four years *before* the Great Recession even began.**

- **US firms are also stocking up on goods in anticipation of stronger demand. The government reported that December business inventories rose 0.4% in December and it followed another upwardly revised increase of 0.8% in November.**

- **With the economy starting to sizzle, it's not surprising to see inflation pick up too. January's CPI shot up 0.6%, the largest monthly jump in nearly four years! That lifted the pace of inflation to 2.5% over the last 12 months, the fastest year-over-year gain in nearly five years, with core running slightly below, at 2.3%.**

This is all good news for the Fed. We have argued since January that there is a better than 50% chance the Fed will act in March, double the probability according to CME's Fed Fund futures prices.

Why does March look so probable? Janet Yellen has repeatedly said in testimony this week monetary policy must be based on the latest economic data and their impact on the Fed's two principal mandates – employment and prices. On that basis, we believe another increase in the fed funds rate is fully justified next month. There's no question that inflation pressures are building, as evidenced by the path of both the CPI and the PCE price index. The former has now been accelerating each month since last July, with the latter moving inexorably closer to the 2% threshold. At the same, the economy is operating at full employment, with wages crawling higher.

But you also have a White House in legal and political turmoil --- and a GOP at odds with itself on the structure of tax reform. So, is anything likely to get done this year? Is the positive economic outlook itself in jeopardy?

Well, that will depend on whether the current political maelstrom continues into the spring. If so, that would end up puncturing public confidence in this Administration. The elation that followed the November elections will turn to disappointment, if not disgust. We'll then see a correction in stock prices, along with a retreat in treasury yields. Not only could consumer and business capital spending slide in the US, it could lead to a global economic slowdown too.

We are thus inching closer to a critical moment in the financial markets. Stock prices have gone about as far as they could on the mere fumes of future fiscal stimulus. It's getting close to where investors are calling out "it's show me time."

Thus our view is that the Fed would be perfectly justified in raising rates next month. But given the disarray in Washington, the FOMC will also have to keep an eye on that slaphappy drunk at the top of the hill who ---for now---is convinced that the Trump Administration and the GOP will come through on all that was promised in short order. If not, a painful fall from that hill is certain and it could have global economic implications.

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Key Economic Forecasts

- Actual
- Forecast

United States

	I 2016	II 2016	III 2016	IV 2016	I 2017	II 2017	III 2017	IV 2017	I 2018	II 2018	III 2018	IV 2018
Real Gross Domestic Product (GDP):												
%	0.8	1.4	3.5	1.9	2.4	2.8	2.5	2.7	2.5	2.7	3.0	2.7
Personal Consumption Expenditures:												
PCE	1.6	4.3	3.0	2.5	3.0	3.6	2.8	2.6	2.6	3.5	3.3	2.5
Inflation, end of period, year-over-year:												
CPI %	0.9	1.0	1.5	2.1	2.3	2.5	2.6	2.5	2.5	2.6	2.6	2.8
Unemployment Rate (end of period):												
%	5.0	4.9	4.9	4.7	4.8	4.9	4.9	5.0	4.8	4.7	4.6	4.5
Non-farm Payrolls, monthly avg. thousand:												
	196	164	239	148	223	240	185	190	200	175	150	155
Treasury 10-yr Note Yield % (end of period)												
	1.78	1.49	1.60	2.45	2.60	2.50	2.36	2.70	3.10	3.15	3.15	3.20
Federal funds rate % (end of period)												
	0.38	0.38	0.38	0.63	0.63	0.88	0.88	1.13	1.38	1.63	1.88	2.13

GDP Growth - Global Economy

Country	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
US	1.8	-0.3	-2.8	2.5	1.6	2.2	1.7	2.4	2.6	1.6	2.5	2.7
Eurozone	2.6	0.6	-4.1	1.7	1.4	-0.9	-0.3	1.2	2.0	1.7	1.3	1.7
United Kingdom	3.1	0.6	-5.2	1.7	0.7	0.3	1.8	2.9	2.2	2.0	1.2	1.5
Japan	2.1	-0.7	-5.4	4.6	-0.4	1.6	1.5	-0.1	1.1	1.2	1.2	1.3
Canada	2.7	0.7	-2.8	3.1	3.1	1.7	2.2	2.5	1.2	1.3	2.0	2.5
India	9.1	8.8	6.3	8.4	8.6	6.7	4.9	7.4	7.8	7.3	7.2	7.8
China	14.2	9.6	9.2	10.5	9.5	7.8	7.7	7.3	6.9	6.7	6.3	6.4
Brazil	5.7	5.1	-0.3	7.5	2.7	0.9	2.3	0.1	-3.8	-3.9	0.2	2.2
Mexico	3.3	1.4	-4.7	5.2	4.0	3.9	1.4	2.3	2.5	2.1	1.8	2.4
Australia	4.0	2.3	1.2	2.8	2.6	3.6	2.4	2.6	2.5	2.3	2.5	2.8
Russia	8.1	5.6	-7.9	4.0	4.3	3.4	1.3	0.6	-3.7	-0.2	1.1	1.8
World	5.4	1.6	-1.9	4.2	3.0	2.6	2.9	3.0	2.6	2.4	2.8	3.2