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ECONOMIC TALKING POINTS

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Jerome Powell's Biggest Nightmare: A Wave of U.S. Protectionism

Jay Powell's first semi-annual presentation before Congress as Fed Chief will no doubt be carefully scrutinized. His choice of words tomorrow and Thursday will be sliced, diced and microscopically studied for any nuanced views he holds on inflation and what that may mean for future monetary policy.

But Powell's own primary objective this week is to verbalize that he will pursue the same cautious and deliberative approach to interest rate policy as his immediate predecessor, Janet Yellen. The goals remain the same: Policymakers at the Fed will continue to monitor the latest economic data with the objective of permitting maximum job creation so long as it is within the context of price stability.

Beyond that sentiment, however, is another reality. Powell is also quietly aware that the economic winds have shifted, especially with respect to inflation. The era of quiescent price behavior, which Yellen enjoyed during her term at the Fed, now appears to be over. What threatens to seriously reawaken inflation is not the weak dollar, or the stimulative tax cuts or even the sharp increase in deficits. It is the protectionist leanings of the Trump administration.

Here's why. There are currently three basic elements that will determine the path of inflation the next 12- 24 months. Let's run by them individually.

The first consists of cyclical forces. The business cycle recovery that began mid 2009 and is now in its ninth year has hardly been a barnburner. Growth over the past eight plus years has been the slowest of any recovery since WW II. Europe

and Japan also struggled to get back on their feet most of these years. As a result, global inflation pressures were well muted. The US economy never came close to being overheated. None of the precursors that typically signal accelerating inflation ever materialized in this expansion --- at least not up this point.

That is now in the process of changing. The US, Europe and Japan are finally showing more robust growth. It's the first time in a decade we have a broad-based world economic recovery underway. Not a single major country is now in recession (not even Russia or Brazil). So it is perfectly logical to see global competition for labor, capital and natural resources heat up. These are the cyclical forces that historically cause inflation to percolate. No surprise here.

But here's what is so interesting. While cyclical forces are gradually putting upward pressure on inflation, there is at the same time a powerful force that is having a "deflationary" impact on the economy. Technology, fierce global competition, and the deep integration of the US into world economy have brought a secular change in how prices behave in a business cycle. Nearly half the planet's population, or 3.8 billion people, now has access to the Internet and that has changed how commerce is conducted at both the consumer and B-to-B level. Buyers everywhere can compare prices, evaluate the reliability of vendors, and check on the efficiencies of different supply chain networks.

In other words, even against this backdrop of stronger global growth, companies will still find pricing power limited. This is a sharp departure from the past when companies at this late stage of the business cycle were able to raise prices more freely.

So while cyclical factors are now at work to lift prices higher, we also have secular forces acting to dampen those inflation pressures. It's a fascinating tug of war that highlights a paradigm shift on how prices perform. Our own forecast has headline inflation (PCE price index) hovering between 2% to 2.5% over the next two years, with core holding close to the Fed's own target of 2%. We therefore expect the fed funds rate to peak out at 2.63% and 10 Yr. T-notes yields at 3.15% by the end of 2019.

OK, now for the spoiler. What can suddenly tip the scale and kick inflation to a much higher level?

I mentioned earlier there was a third element that can spoil this delicate balance between the secular and cyclical forces on inflation. This third element is blatant protectionism. Should the Administration act to impose widespread tariffs and/or place import quotas on steel and aluminum, and withdraws from NAFTA, it would be an act of folly that effectively accelerates US inflation, and thus force the Fed to jack up rates much more quickly.

That prospect, I suspect, is what really keeps Jerome Powell up at night.

True, the poorly timed tax cuts and the upcoming tidal wave of budgetary red ink can theoretically heat up inflation pressures. But it won't compare to the

burst in higher prices that would follow from higher taxes on critical imports, since every downstream industry that relies on imported steel, aluminum and lumber (such as auto manufacturers and homebuilders) would have to immediately pass those higher costs on to consumers.

Protectionism is therefore the one looming threat that can seriously fire up inflation. How the new Fed Chairman articulates the dangers of imposing unilateral tariffs and quotas during his testimony, and the manner with which the White House responds to those comments will be most interesting to consumers, CEOs and investors.

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Key Economic Forecasts

- Actual
- Forecast

United States

	I 2017	II 2017	III 2017	IV 2017	I 2018	II 2018	III 2018	IV 2018	I 2019	II 2019	III 2019	IV 2019
Real Gross Domestic Product (GDP):												
%	1.2	3.1	3.2	2.6	2.4	3.2	2.5	2.5	1.9	2.2	2.0	2.4
Personal Consumption Expenditures:												
PCE %	1.9	3.3	2.2	3.8	2.4	2.8	2.4	2.4	2.2	2.1	2.3	2.7
Inflation, end of period, year-over-year:												
CPI %	2.4	1.6	2.2	2.1	2.2	2.2	2.3	2.3	2.4	2.4	2.5	2.7
Unemployment Rate (end of period):												
%	4.5	4.4	4.2	4.1	4.0	3.7	3.7	3.9	4.2	4.4	4.4	4.5
Non-farm Payrolls, monthly avg. thousand:												
	166	187	128	204	190	185	160	160	150	145	140	140
Treasury 10-yr Note Yield % (end of period):												
	2.39	2.30	2.33	2.41	2.90	3.00	3.05	3.05	3.35	3.25	3.10	3.10
Federal funds rate % (end of period):												
	0.88	1.13	1.13	1.38	1.63	1.63	1.88	2.13	2.38	2.63	2.63	2.63

GDP Growth - Global Economy

Country	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
US	-2.8	2.5	1.6	2.2	1.7	2.6	2.9	1.5	2.3	2.7	2.1
Eurozone	-4.1	1.7	1.4	-0.9	-0.3	1.2	1.6	1.7	2.5	2.4	1.7
United Kingdom	-5.2	1.7	0.7	0.3	1.8	2.9	2.2	1.9	1.8	1.0	1.4
Japan	-5.4	4.6	-0.4	1.6	1.5	-0.1	1.1	1.0	1.6	1.7	0.9
Canada	-2.8	3.1	3.1	1.7	2.2	2.5	0.9	1.4	3.2	2.7	2.5
India	6.3	8.4	8.6	6.7	4.9	7.4	7.9	7.1	6.8	7.5	7.5
China	9.2	10.5	9.5	7.8	7.7	7.3	6.9	6.7	6.9	6.6	6.3
Brazil	-0.3	7.5	2.7	0.9	2.3	0.1	-3.8	-3.6	1.2	2.3	2.8
Mexico	-4.7	5.2	4.0	3.9	1.4	2.3	2.7	2.9	2.1	2.0	2.5
Australia	1.2	2.8	2.6	3.6	2.4	2.6	2.4	2.4	2.7	2.8	3.0
Russia	-7.9	4.0	4.3	3.4	1.3	0.6	-2.8	-0.2	1.5	2.1	2.0
World	-1.9	4.2	3.0	2.6	2.9	3.0	2.7	2.4	3.5	3.4	3.2