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Ask an Economist:

A Wait and See Approach

The Federal Reserve forecasts more rate hikes on the horizon, but Trump's White House could complicate things.

By Andrew Soergel | Economy Reporter
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After the Federal Reserve lifted its benchmark interest rate for the first time in nearly a decade in December 2015, America's central bankers projected they'd be able to raise rates four times by the end of the next year.

But that was before Wall Street's worst start to a calendar year on record, an unexpected Brexit decision that sent markets reeling and one of the most contentious presidential elections in recent history.

The Fed will end 2016 with only one rate hike. And although the labor market is approaching full employment and inflation metrics continue to improve, the central bank's path forward is largely unclear – in part because it's still tough to say what kind of legislation will pass through Congress once President-elect Donald Trump moves into the White House in January.

During a press conference Wednesday, Janet Yellen dodged specific questions about Trump's policy proposals – like the effects of corporate and personal tax reform and private-sector deregulation – but acknowledged that she and her colleagues were "operating under a cloud of uncertainty at the moment."

America's central bank was designed to operate independently of political pressure, but Yellen can't exactly ignore fiscal policies that could boost or hinder economic growth. She and her colleagues could be in a tough spot when they meet in 2017, attempting to foretell not only the economy's next move but also the actions of Trump and a GOP-controlled Congress that hasn't been uniformly supportive of the incoming president.

Bernard Baumohl, chief global economist at The Economic Outlook Group, says the economy is likely to hum along next year at a comparable clip to what was seen in 2016 but that there are plenty of risks on the horizon. U.S. News recently spoke with Baumohl to hear his take on where the economy and the Federal Reserve are headed and how that could be impacted by a Trump White House. Excerpts:

The U.S. finally got a rate hike out of the Fed on Wednesday. Yellen's remarks following the announcement touched on a healthy labor market and improving inflation metrics. Looking ahead to 2017, where do you see employment and price pressures going?

The latest move was the correct one, and I think we'll see further progress on both the employment and inflation mandates. The unemployment rate will hover between 4.5 and 5 percent, but I do see a slowdown in payrolls, with the monthly average decelerating from about 185,000 this year to about 130,000 next year.

We're in our eighth year now in this business cycle. It's the fourth-longest ever. We've already had some significant progress on the labor front. And I see the economy still growing at about 2 percent next year – a little more than 2 percent. That's close to the same pace we had this year. Among the reasons we don't see it growing more rapidly is that we have a really strong dollar, which is obviously going to affect exports and increase our trade deficit. A large trade deficit subtracts from GDP growth.

We also have rising long-term [interest] rates, and with the cost of capital increasing, that, too, could impact business spending. We still see lots of weak growth overseas, as well.

And I fully expect that we're going to get a much more diluted fiscal stimulus program next year when Congress finally gets done with it. And finally, we have the issue of demographics. The one-time big spenders of the Baby Boomers are retiring, and usually, they spend less when they reach this stage in their lives. For a variety of reasons, I see the job market slowing down.

What do you see as the biggest economic risks we'll have to keep an eye on?

Sit back for this one. A lot of people are just unaware of the really grave risks that we face in 2017. Among them, and I don't want to assign any probability just yet, is that we end up having a crippled presidency from the start.

I can imagine, for example, that Democrats and even some Republicans are sort of waiting for Donald Trump to take the oath of the presidency, where he promises to preserve, protect and defend the Constitution. And they'll pounce on him right afterwards for defiling the White House because of the way he's enriching his family with all of his business dealings around the world. There's also the possibility that he might be violating the emoluments clause of the Constitution.

To some extent, I think this already has the feel of what it was like building up to the Watergate crisis.

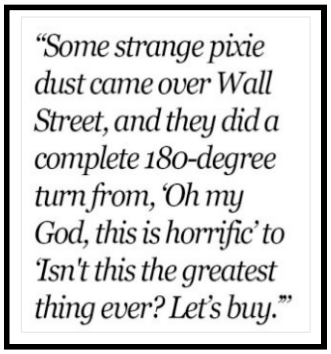
We also have to wonder whether he'll impose stiff tariffs on China and Mexico. You can imagine that those countries will then retaliate in some fashion, and we could see a trade war. When the economy is growing at 2 percent, we don't really have much of a buffer to protect ourselves from a recession.

Geopolitically, if you go around the world, there's certainly no shortage of risk there, with major elections in France and in Germany and the Netherlands. The outcome of those elections will tell us if we're going to see further fragmentation in the European Union and perhaps the eurozone, too. So that's of grave concern.

On a foreign policy front, I think one of the biggest issues is North Korea. That's going to become a much bigger issue, let alone China's illegal grab of the South China Sea and the militarization of those islands. There's Russia's eagerness to take over the Ukraine and its military intimidation of the Baltic States, which are now part of NATO. I could just go on and on.

There's also the destabilization of Saudi Arabia. We're noticing a lot of increased activity by [the Islamic State group] and by al Qaeda and by Iran to undermine the Saudi monarchy and do damage to Saudi infrastructure. Saudi Arabia is one of the most important countries in the world with respect to oil, and if we see a collapse of that regime in 2017, who knows, we could see oil prices climbing back to triple digits in 2017.

And given everything that I just described, to imagine that we have a president who doesn't want to get his intelligence briefings – or even worse, to ignore the findings of our intelligence community – is really very concerning. It borders on presidential negligence. There is a lot in 2017 that can play into how the economy's going to perform, and, therefore, its impact on monetary polic



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It seems like a lot of economists are in tune to at least some of these risks, but that's not what we're seeing at all on Wall Street. Investors seem to have priced in that we'll get a fiscal stimulus package next year that's going to push growth and inflation along. It sounds like you're less bullish on that front.

That's right. And, frankly, I can't explain the glee we have seen on Wall Street. If you remember, overnight during the election, as it became clear that Donald Trump was going to be president, there was an absolute collapse in the futures market. It promised a 1,000-point drop in the Dow the next morning. And what's so interesting is that everything we know now about the kinds of tax cuts and infrastructure spending and regulatory rollback, we knew back then.

It's as if, all of a sudden, some strange pixie dust came over Wall Street, and they did a complete 180-degree turn from, "Oh my God, this is horrific" to "Isn't this the greatest thing ever? Let's buy." It's inexplicable, frankly. And I think the exuberance has been way, way overdone. I do expect to see a significant correction, because we really do not know what kind of fiscal stimulus will ultimately be enacted by Congress.

We know that many conservative Republicans strongly oppose Trump's proposal, because it's going to explode the deficit and add at least another $5 trillion to the national debt over 10 years. And in many ways, in this bizarre Twilight Zone world, Trump is the anti-tea party kind of guy with his policies. So we don't know what kind of stimulus we'll ultimately get.

When you put all of this together, it's really difficult to come to any conclusions that this is going to be the kind of fiscal stimulus that's really going to revive economic growth. And even if most of Trump's proposals are enacted, which is highly unlikely, there is still a risk that Trump pulls the economy in two completely different directions. On the one hand, you'll have the stimulus to help the economy. But then he may still be firm on imposing those tariffs on trade, and that's going to slow the economy. There's a clear tug of war here in his core policies, and the net result might be there won't be much additional growth at all.

Looking at some of the stimulus specifics, Trump's infrastructure plan looks like it's going to rely on private-sector investment. With interest rates going up and business investment already low, does that seem like a reasonable expectation?

This concerns me a little bit. We don't yet know how much the rise in the value of the dollar or the rise in long-term yields is going to affect business capital spending down the road. For the last couple of years, companies have just not done much investment spending at all. They've taken a good chunk of their profits and given it back to their shareholders. And as a result, there's been just a dearth of investment back into the company, which is partly to blame for the dismal productivity growth we've seen in the private sector.

So to jump and say that companies are now going to be eager to participate in more public spending projects just doesn't make sense. I would think they'd have a greater priority, now that we're beginning to see some acceleration in wage inflation, I would think they'd want to invest more internally to improve their efficiencies and improve their productivity. I don't expect much contribution from the private sector just yet.

The Fed walked into 2016 expecting to raise its benchmark interest rate four times, based on its dot plot projections. But it was only able to boost rates once and seemed to have been influenced by market volatility, the U.K.'s Brexit vote and the timing of the presidential election. Based on the latest projections, we could be looking at three hikes in 2017. But with all the uncertainty out there, do you see the Fed taking a more cautious approach?

Let me start by saying I don't give the dot plot much value as a predictor of monetary policy. It's a poor forecasting tool, and if you look at the forecast that came out from the latest FOMC meeting, the median forecast for [GDP] growth is very interesting. They show the economy slowing from 2.1 percent growth to 1.9 percent over the next three years. So I don't see much justification to ramp up the pace of interest rate increases with that kind of outlook.

Keep in mind that Janet Yellen does take a look at a couple of key economic indicators to help guide monetary policy. One of them is wage increases. You really can't get any firm inflation going in the economy if you don't have wage increases. You need wage inflation to get consumer price inflation up. That's the main driving force of retail price inflation is higher wages. It's not commodities, because wages stick. Oil prices and commodities go up and down.

Wage increases have been sort of low when you compare them to historical standards, so I think she is going to be more willing to allow headline inflation to exceed 2 percent before she's willing to engage in monetary policy tightening or tap on the interest rate breaks more firmly.

Look, Janet Yellen, like everybody else, is in the dark as to what kind of fiscal policy will come out. And I think they are most likely going to take a wait and see attitude for at least the next six months before they make a move. We're forecasting, at most, two interest rate increases. And that, we think, is quite aggressive. I just don't see it happening before mid-year.

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