

Why markets could be massively underpricing US rate hikes

Just who's telling the truth, business and consumer surveys or actual activity data? Since Trump's victory, they've diverged dramatically. If we're wrong and the real data starts to reflect the surveys, the path of rate hikes is being massively underpriced

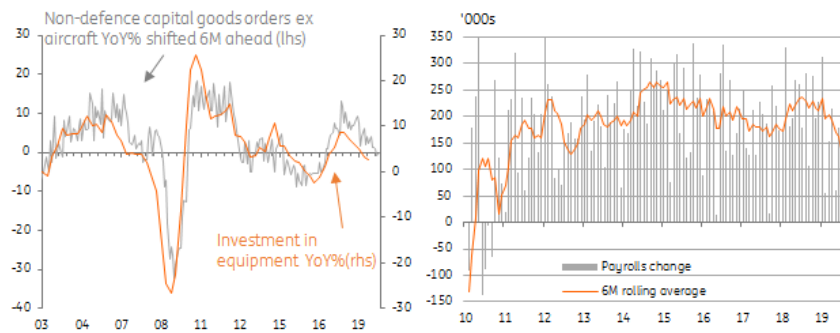


Relationship breakdown

President Trump's promises of tax cuts and reduced regulations with a broad "America First" agenda buoyed both business and consumer sentiment in the wake of his November 2016 election victory. Unfortunately, while actual growth numbers have been very respectable, the situation hasn't been quite as good as the surveys would have historically suggested.

For example, the ISM manufacturing report has been a great guide to the likely pace of overall US economic activity for much of the past 60 years. However, GDP growth is nowhere near the 6% rates the ISM was suggesting possible. Both GDP growth and the ISM survey have moved lower recently, but even so, the US is growing at less than half that rate the ISM survey historically would have suggested.

Since Trump's victory US growth is running at half the rate surveys would have historically suggested



The same phenomenon can be seen in consumer confidence surveys. Since President Trump's election victory rising equity markets, optimism about tax cuts and strong jobs growth have all buoyed sentiment to the extent that the Conference board measure is at levels historically consistent with real consumer spending growth of nearly 6%. However, households have been reluctant to put their money where their mouth is (so far) with spending rising a more pedestrian 2-3%.

If surveys are right, watch out for boom-bust!

The obvious point here is that if the "hard" economic data rebounds to match the optimism in surveys the path for Federal Reserve interest rate hikes is being hugely underpriced by markets. An economy growing at 6% risks generating massive inflation pressures with the Federal Reserve needing to respond in dramatic fashion. Rather than four hikes as is currently priced for the next couple of years, we could be talking upwards of ten. The margin for error would be wafer thin with the odds favouring an inverted yield curve as markets anticipate a boom-bust recession.

The broad assumption is that the surveys are wrong

However, the broad assumption we, the Federal Reserve and financial markets all share is that the surveys are wrong. There has been a break in the series and the relationship has been reset. As such, surveys may not fall back to reflect the actual economic data. Nonetheless, that does not mean that following surveys is a redundant task. They can still tell us which way momentum is swinging, which remains critical in determining how the economy is likely to perform in the future.

Where are the surveys pointing?

The ISM remains the premier manufacturing survey and regional purchasing managers' surveys suggest we should be looking for a bounce in the ISM index next month. There have been strong gains in the Philly Fed index, Richmond Fed and the Empire manufacturing survey already in May while rising oil prices are a boon for the US shale industry. Global growth is in good shape and even

though the US dollar has appreciated over the past couple of months it remains relatively competitive. At the same time, tax cuts are boosting profitability, order books are strong and if President Trump can make headway on his plans for \$1.5 trillion dollars of infrastructure spending then that will act as a further boost to US industry.

Consumer confidence hits an oil slick

Next week we will get consumer confidence numbers from the Conference board and here we are looking a little more nervously. The tax cuts that were passed in December equated on average to around \$900 per household, but a significant chunk of this is being eaten into by rising gasoline prices.

Simple calculations suggest, on average, each car driver consumed 685 gallons of gasoline last year (The Energy Information Administration reported 143.85bn gallons of gasoline were purchased in 2017 divided by the Federal Highway Administration's estimate of 210 million licensed drivers). Based on the price of gasoline at the time of the tax cut (\$2.42/gallon) this worked out as an annualised spend of \$1658. However, at today's price of \$2.93/gallon that is \$349 more at \$2007. For a two-car household that is \$700, meaning only \$200 of the tax cut is left, massively eroding the fiscal stimulus.

\$349 How much more it will cost to fill up with gasoline in 2018

Another issue for households is rising mortgage costs. Both 15Y and 30Y fixed rate mortgage rates are at a 7-year high of 4.2% and 4.8% respectively while interest rates charged on adjustable rate mortgages have moved rapidly higher in recent weeks as government borrowing costs push upwards. This is going to be a more marginal headwind to consumer confidence than gasoline prices, but if it contributes to a slowing real estate market, it could become more of a negative over the next 18 months

Federal Reserve risks still skewed to the upside

While the relationship between the surveys and official activity data has broken down, they still tell us that corporates and households are feeling in great shape. With fears over a trade war having abated given the recent US-China agreement and China's decision to lower tariffs on imported cars, this has further improved the economic environment. While acknowledging

US corporates and households are in great shape

the risks that higher gasoline prices eat up a significant chunk of the income tax cuts given to households we continue to believe wages will respond to the tight jobs market and consumer fundamentals remain strong. At the same time, corporation tax cuts and stronger global demand will keep US industry performing robustly.

Moreover, with the US being such a prolific oil producer these days, a higher oil price is no longer such an unambiguous negative for the economy. Even so, it will be interesting to see whether OPEC chooses to loosen its production cut targets at the semi-annual OPEC meeting at the end of June given how successfully it has supported prices.

We have been more upbeat on the US than consensus for quite some time and currently predict 2018 growth of 3%. We see no reason to change that, nor our call for three further Federal Reserve interest rate hikes this year, but the path of consumer spending is critical. Here we still feel consumer confidence surveys have value.

Of course, while we are more aggressive than the market, no one is really expecting up to ten US rate hikes! Debt levels are high and the economy is late cycle meaning that the transmission between rate increases and slower growth could happen quickly. In any case, there are already clear supply bottlenecks in the US economy that make achieving 6% growth nigh on impossible – for example, where is the labour to do the work going to come from? As such, ongoing “gradual” hikes remain our base case with the Fed funds rate hitting 3% next year.

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