US: Three - the magic number

Bob Dorough and De La Soul both agreed that three is the magic number and it also neatly sums up our economic and market forecasts for the US this year

Source: Shutterstock

We are looking at an economy that is growing 3%, that could see inflation hit 3% in the summer, which will trigger at least three Fed rate hikes and nudge the 10Y Treasury yield up to 3%. The US economy continues to perform very strongly with confidence and stock markets at record highs, unemployment at 17-year lows and domestic demand looking very robust. This was in evidence in the 4Q GDP report where consumer spending, investment and government spending all grew at 3% or more annualised rates.

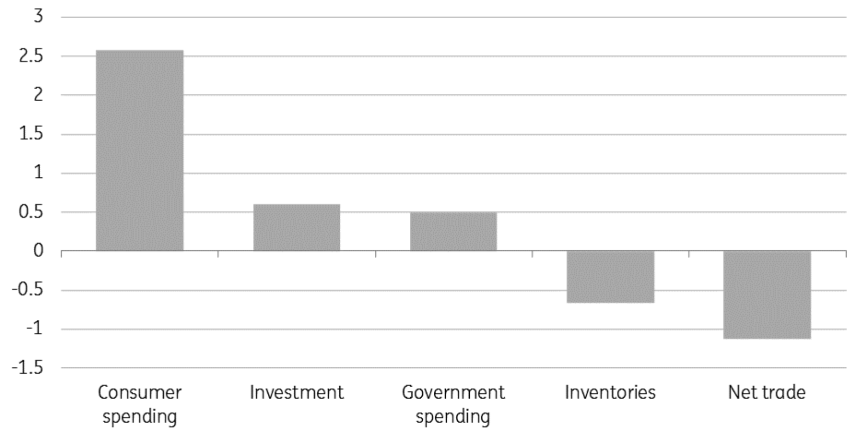
Tax reforms to provide support

December's tax reforms should provide a boost for this year by putting more money in the pockets of households while the corporate sector has responded positively with several announcements on investment projects and the boosting of worker pay. Nonetheless, we still suspect the majority of the windfall for corporates will be spent on share buy-backs and special dividends, which will provide support for equity prices.

Trade was a drag in 4Q17 but US doesn't seem worried

Net trade was a weak spot in the 4Q GDP figure, with imports of goods rising 16.8% on an annualised basis. Exports didn't grow anywhere near as quickly, meaning that trade itself subtracted 1.1 percentage points from headline GDP growth. Interestingly, this wasn't jumped on by President Trump as another reason why the US needs to adopt more protectionist policies. Earlier in the week, new tariffs had been placed on imports of solar panels and washing machines, but by the end of the week, Donald Trump was striking a friendlier tone in his speech at the World Economic Forum in Davos.

Contribution to 4Q GDP by component

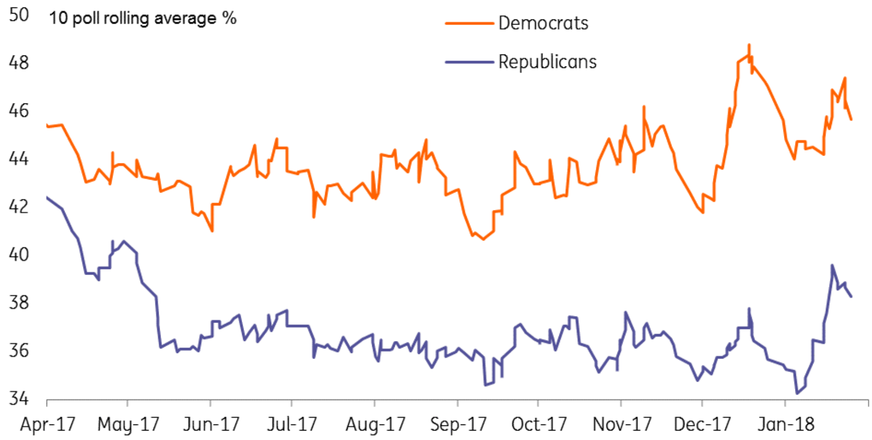


Source: Bloomberg

Dollar weakness to put US in competitive position

In fact, we think that the US is in a great position to benefit from the upturn in global demand given dollar softness has improved international competitiveness. It appears that Trump is becoming more accepting of free trade so long as it becomes "fairer" and is "reciprocal". This suggests to us that NAFTA won't be imminently ripped up. If anything, the more likely scenario is that talks drag on until late 2018 after the US mid-term elections, Canadian provincial elections and the Mexican Presidential election.

Polling support ahead of mid-term elections



Source: ING collated from different polls

Inventories were a drag on 4Q but this will reverse

Inventories were also a weak spot, subtracting a further 0.7 percentage points from headline growth, but as with net trade we expect to see better numbers in coming quarters. It was likely to have been an involuntary run-down and could be the prelude to some very strong manufacturing numbers as businesses look to replenish stock levels.

Inflation is grinding higher and could accelerate

As for inflation, core CPI has picked up to 1.8%YoY and we see it rising further in the next few months. The unwinding of distortions relating to cell-phone data plans will add 0.2-0.3 percentage points by April and the gradual erosion of slack in the economy will also nudge up inflation pressures. Add on the lagged effects of dollar weakness and the ongoing increases in energy costs and we think that we could be looking at headline CPI touching 3% this summer.

1.8 Core inflation

year-on-year %

Fed to stay on tightening path

In this environment we believe the Federal Reserve will carry through with its own projections of three interest rate hikes. However, we are in a minority currently forecasting no hike in 1Q18. Admittedly this is a low conviction call, but we certainly think that the prospect of a rate hike in March is not as cut and dry as market pricing suggests – the implied probability is currently around 90%.

Our reasoning is that we have got a handover at the Fed – March will be Jerome Powell's first FOMC meeting as Fed Chair, while core inflation is unlikely to be above 2% before the 21 March FOMC meeting. We also see some risk to softer activity numbers in January given the bad weather at the start of the year while the potential for another, more serious government shutdown continues to linger. However, should these risks subside we will likely have to put a March hike in our forecasts – potentially as a fourth hike rather than just shifting forward the three 2018 moves we are currently predicting.

US mid-terms could put Trump agenda in doubt

This year will also be a big year for politics and President Trump laid out his plans at the State of the Union Address. Infrastructure spending is the big policy push for 2018, along with tighter border controls. However, his poll ratings remain poor and he may need to move quickly given the potential for the Republicans to lose their majority in the House of Representatives after the mid-term elections. The latest polls show that despite a post-tax reform bounce they are the best part of eight points behind the Democrats. Trump will be hoping the magic of 3% growth can still deliver him victory.

Author

James Knightley
Chief International Economist, US
james.knightley@ing.com

Disclaimer