US ECONOMICS WEEKLY

22nd Jun. 2015

CAPITAL ECONOMICS

Editor: Paul Ashworth

Rates to rise more rapidly than Fed projections imply

- **Our working assumption is still that the Fed will end up raising the fed funds rate three times this year, taking it to a range of between 0.75% and 1.00% by year-end. But we wouldn't be completely flabbergasted if the Fed only hiked twice. Where we differ more substantially from the Fed and the markets is our expectation that the fed funds rate will rise much more rapidly next year, reaching nearly 3.0% by end-2016.**
- That forecast is based entirely on our view that the unemployment rate will fall further than the Fed expects and that, as a consequence, both wage growth and price inflation will accelerate more. The Fed's own projections that the unemployment rate will level out next year make little sense to us, unless officials are banking on an implausible rebound in the participation rate. Even then, wage growth is likely to accelerate to nearly 3.5% by next year. We suspect that would be enough to prompt the Fed to abandon its current plans for a very gradual tightening cycle. (See pages 2-5.)
- We estimate that both new and existing home sales strengthened considerably in May. In addition, we anticipate some much stronger gains in monthly consumption and income last month. If we are right in expecting a robust increase in May's core durable goods orders and shipments too, then all that data would support our view that second-quarter GDP growth will be close to 3.0% annualised. Finally, the third estimate of first-quarter GDP growth is expected to show that, thanks to a big upward revision to services consumption, the economy didn't contract after all.

North America
2 Bloor Street West, Suite 1740
Toronto, ON
M4W 3E2
Canada
Tel: +1 416 413 0428

Europe
150 Buckingham Palace Road
London
SW1W 9TR
United Kingdom
Tel: +44 (0)20 7823 5000

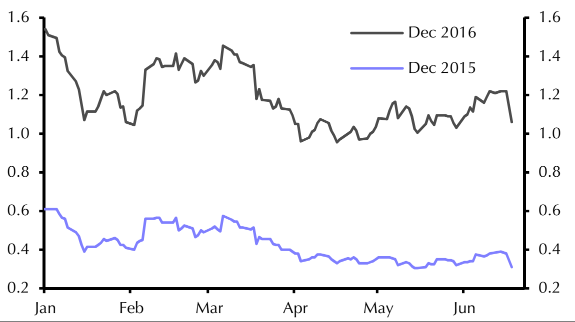
Asia
#26-03 Income at Raffles
16 Collyer Quay
Singapore, 049318
Tel: +65 6595 5190

Executive Chairman — Roger Bootle (roger.bootle@capitaleconomics.com)
Chief US Economist — Paul Ashworth (paul.ashworth@capitaleconomics.com)

Rates to rise more rapidly than Fed projections imply

While we still think that the Fed is on track to begin raising interest rates this September, the updated interest rates projections submitted by Fed officials at last week's FOMC meeting prompted a further downward revision to market rate expectations. (See Chart 1.) Taken at face value, fed funds futures are not fully pricing in a single 25 basis point rate hike this year, even by December.

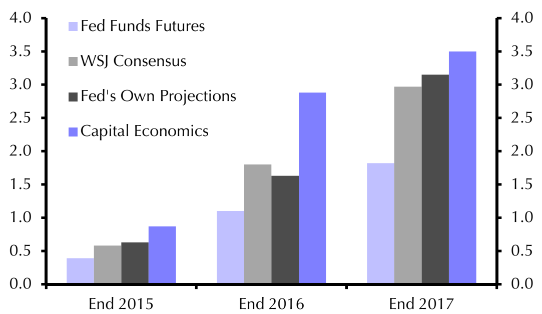
CHART 1: FED FUNDS FUTURES RATE EXPECTATIONS (%)



Source – Thomson Datastream

In contrast, the average forecast from other economists has tended to closely track the Fed's own projections, suggesting that futures prices may not accurately reflect expectations. (See Chart 2.)

CHART 2: FED FUNDS RATE EXPECTATIONS (%)



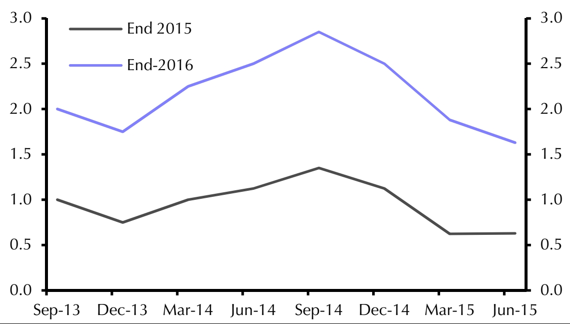
Source – Fed, WSJ, Bloomberg

The median rate projection from Fed officials was unchanged at 0.63% last week. But markets still interpreted the new "dot plot" projections as dovish because seven officials now anticipate only one single 25 basis point (bp) rate hike this year. Five officials think there will be two 25bp hikes and five more think there will be three.

Our working assumption is still that the Fed will end up raising the fed funds rate three times this year, taking it to a range of between 0.75% and 1.00% by year-end. But we wouldn't be completely flabbergasted if the Fed only hiked twice.

Where we differ more substantially from the Fed and the markets is our expectation that the fed funds rate will rise much more rapidly next year, reaching nearly 3.0% by end-2016. We aren't too worried about having a forecast that differs significantly from the Fed's current projections. As Chart 3 shows, over the past year the Fed has raised and then lowered its own projections quite significantly. What matters is not the Fed's current rate projections, but how the economy evolves over the next couple of years.

CHART 3: FOMC FED FUNDS RATE PROJECTIONS (%)

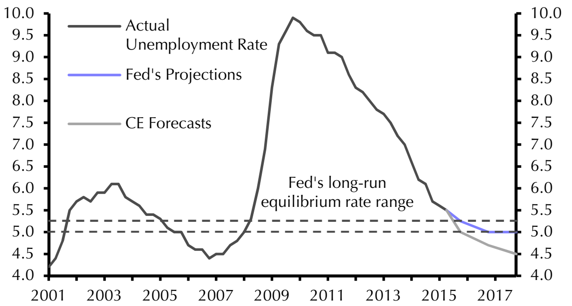


Source – Thomson Datastream

Our forecast that rates will rise much more rapidly is based entirely on our view that the unemployment rate will fall further than the Fed expects and that, as a consequence, both wage growth and price inflation will accelerate by more.

The Fed's latest projections suggest that the unemployment rate, which was 5.5% in May, will still be as high as 5.2% in the final quarter of this year. (See Chart 4.) The projections then show the unemployment rate levelling out at 5.0% in 2016 and 2017, which coincidently matches the bottom of the Fed's 5.0% to 5.2% estimated range for the long-run equilibrium rate. In contrast, we expect the unemployment rate to fall to 5.0% by end-2015, 4.7% by end-2016 and 4.5% by end-2017.

CHART 4: UNEMPLOYMENT RATE (%)



Source – Thomson Datastream

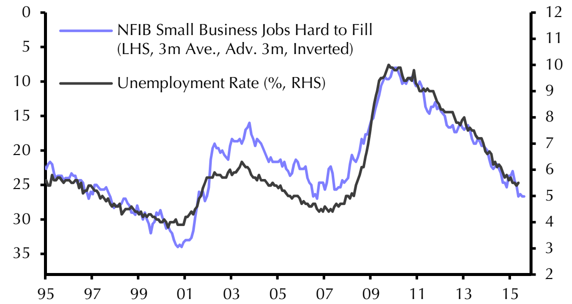
The Fed's unemployment rate projections for 2016 and 2017 look misplaced for several reasons.

For a start, the Fed's own forecasts also show GDP growth running at about 2.5% in 2016 and 2.3% in 2017, which would be above the Fed's 2.1% estimate for the economy's potential growth rate. The relationship between changes in the unemployment rate and GDP growth (known as Okun's law) can vary for any number of reasons. But it would be very unusual for the economy to grow at an above potential pace without any decline in the unemployment rate whatsoever.

Over the first five years of this recovery, annual GDP growth averaged 2.2% and the unemployment rate fell by an average of 0.7% points per year. Now suddenly we're expected to believe that GDP growth will average 2.4% in 2016 and 2017, but the unemployment rate will not fall at all.

Most of the survey evidence suggests that the unemployment rate will continue to decline. As Chart 5 shows, the increasing proportion of small firms saying that jobs are hard to fill indicates that the unemployment rate will fall to 5.0% within the next few months. Note too that if jobs are getting harder to fill, then the unemployment rate would appear to be an accurate gauge of labour market slack. There is plenty of other evidence that slack is shrinking too, with an increasing net proportion of households surveyed saying that jobs are plentiful, the job openings rate at a record high and, as we'll show later, signs of a pick-up in wage growth.

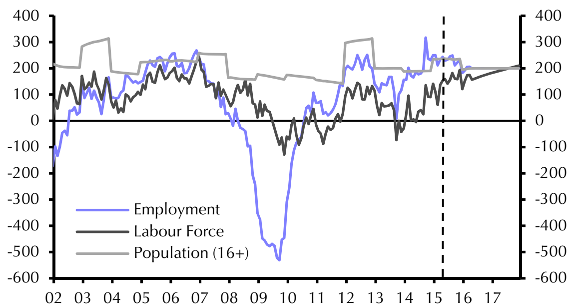
CHART 5: UNEMPLOYMENT RATE & JOBS HARD TO FILL INDEX



Source – Thomson Datastream

The only way to square the circle of the Fed's GDP growth and unemployment projections is to allow for a large number of the disillusioned job seekers who left the labour force to come flooding back. If we assume that employment continues to increase by an average of 200,000 per month over the next couple of years then the Fed's unemployment rate projections would imply an acceleration in the monthly gains in the labour force to 200,000 per month too. (See Chart 6.)

CHART 6: EMPLOYMENT, LABOUR FORCE & POPULATION: MONTHLY CHANGE (000S, 12M AVERAGE)



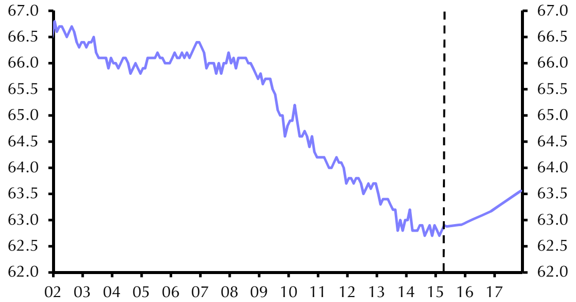
Source – Thomson Datastream

Admittedly, employment growth could slow. But, even allowing for a pick-up in productivity growth, it is hard to see the average monthly gain in employment dropping much below that 200,000 level if the Fed is correct about its projected acceleration in GDP growth to an above potential pace.

A pick-up in the average monthly increase in the labour force to 200,000 isn't completely implausible. The monthly gains averaged close to 200,000 between 2005 and 2007 and the recent trend has been upwards. Given that the monthly gains in the size of the overall adult population will probably continue to run at no more than 200,000, however, the implied rise in the participation rate required to keep the labour force expanding at 200,000 per month just doesn't look realistic to us.

As Chart 7 shows, if both the labour force and the adult population increased at around 200,000 per month over the next couple of years, the participation rate would rebound from 62.9% in May to 63.6% by end-2017. That would be a dramatic change as the participation rate has been on a downward trend since it peaked in 2001.

CHART 7: PARTICIPATION RATE (%)

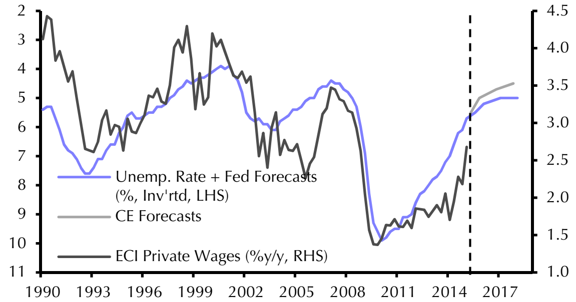


Source – Thomson Datastream

It did temporarily stabilise between 2005 and 2007, but there was no major rebound. With the baby boomer generation now hitting retirement age (men born in 1950 hit 65 in 2015) the structural downward trend isn't going to fade for some time yet. We agree that there will be some cyclical improvement. Indeed, our own forecasts also implicitly assume that the participation rate rebounds, but to a more believable 63.2% by end-2017. The rebound implied by the Fed's unemployment rate projections is simply too big.

Even if Fed officials are right and the unemployment rate levels out at 5.0% in 2016 and 2017, that would still imply a pretty sharp acceleration in wage growth. It is very popular at the moment, not least among regional Fed economists, to dream up new reasons why the normal Philips curve relationship between the unemployment rate and wage growth has broken down temporarily. As Chart 8 shows, however, at 2.7% in the first quarter, the employment cost index measure of wage growth is pretty much exactly where we would expect it to be based on the historical relationship.

CHART 8: WAGES & UNEMPLOYMENT RATE



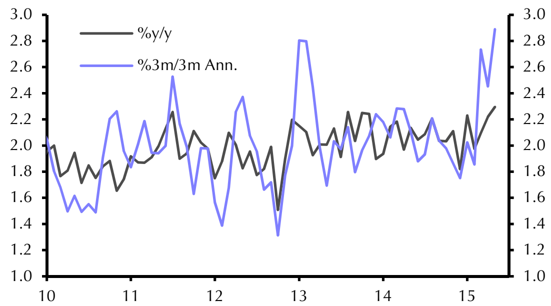
Source – Thomson Datastream, CE, Fed

The Fed's unemployment rate projections imply that wage growth will peak at about 3.4% in 2016, whereas our forecasts imply a peak of nearer 3.6%. Either way, in an environment where productivity is growing by less than 1% per year, wage growth of more than 3% is not consistent with a 2% price inflation target.

Last week Fed Chair Janet Yellen claimed that while there were "tentative" signs of a rebound in wage growth, she was not willing to concede that the pick-up was "definitive". We would argue that the pick-up in the employment cost index measure is fairly definitive. The acceleration in the average hourly earnings measure of wage growth has been more modest but, as Chart 9 shows, even the pick-up in that measure in recent months has been a lot more clear cut.

All things considered, if the unemployment rate continues to decline and wage growth continues to accelerate then we simply don't see the Fed sticking to its current plan to raise interest rates only very gradually. That is why we are comfortable in expecting interest rates to rise more rapidly, particularly next year.

CHART 9: AVERAGE HOURLY EARNINGS



Source – Thomson Datastream

A final argument put forward is that the Fed can afford to allow the economy to gather pace, and even to allow wage growth and price inflation to accelerate above target before beginning to raise rates. We agree those arguments are good reasons why the Fed should maintain an accommodative stance of policy - i.e. keeping interest rates below their neutral level. But they are not good reasons for keeping interest rates at the ultra-accommodative level of near-zero for much longer. Even if our much higher rate forecasts prove correct, the Fed would still be running a slightly accommodative monetary policy at the end of next year. It wouldn't more to a neutral stance until 2017, by which time inflation may have been running above target for more than 12 months.

Paul Ashworth

Data Preview – Existing/New Home Sales (May)

10.00 Mon. 22nd/Tue. 23rd Jun.

Forecasts	**Previous**	**Median**	**Capital Economics**
Existing Home Sales	5.04m	5.28m	5.30m
New Home Sales	517,000	520,000	540,000

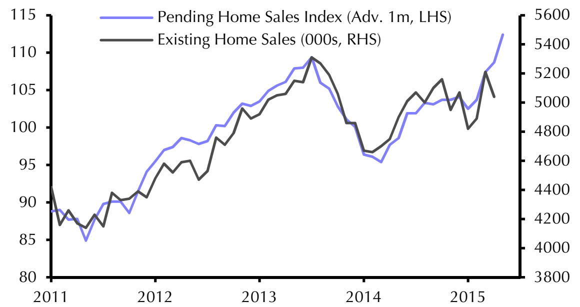
Sales continuing upward trend

Sales of new and existing homes probably increased strongly in May, in a sign that the renewed strength in jobs growth and an easing in lending standards are boosting the housing market.

The jump in pending home sales to a nine-year high suggests that, after falling 3.3% m/m to 5.04m in April, existing sales rebounded by at least 5.3% m/m to 5.30m annualised in May. (See Chart 1.) That would leave sales close to a six-year high and, although existing sales probably won't rise too much more in the near term, there is scope for further gains in the months ahead.

New home sales have also been on a clear upward trend and, unlike existing sales, they are still well below the long-run average. We have pencilled in another healthy rise to 540,000 annualised in May, from 517,000.

CHART 1: EXISTING & PENDING HOME SALES



Source – Thomson Datastream

Data Preview – Durable Goods Orders (May)

08.30 Tue. 23rd Jun.

Forecasts	**Previous**	**Median**	**Capital Economics**
Headline Orders	-1.0%	-0.5%	-2.3%
Core Orders (Ex. Transport)	-0.2%	+0.6%	+1.0%

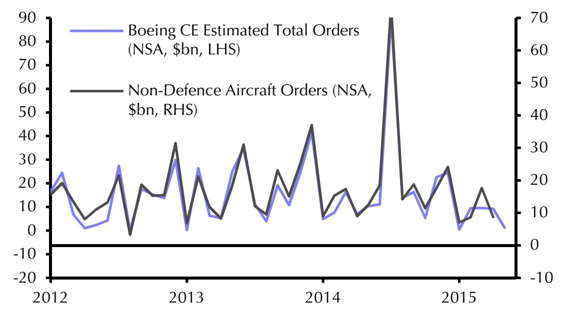
Held back by lower aircraft orders

Durable goods orders probably fell by 2.3% m/m in May, due to a sharp fall in aircraft orders. But a rise in core orders should add to the evidence that the economy is getting back on track.

Boeing received just eleven orders in May, which suggests that even after seasonal adjustment, non-defence aircraft orders more than halved. (See Chart 2.) While the production data suggest that motor vehicle orders rose slightly, we estimate that overall transport orders fell by 9% m/m in May.

Excluding transportation, we suspect that, following a small contraction in April, orders started to regain their stride in May. With the rapid appreciation of the dollar easing over recent months and the domestic economy strengthening, the survey evidence suggests that conditions in the manufacturing sector are improving. Accordingly, we have pencilled in a rise in core orders of 1.0% m/m in May.

CHART 2: BOEING ORDERS & NON-DEFENCE AIRCRAFT ORDERS



Sources – Thomson Datastream, Boeing, Capital Economics

Data Preview – Personal Income & Spending (May) 10.00 Thu. 25th Jun.

Forecasts	Previous	Median	Capital Economics
Personal Income	+0.4%	+0.5%	+0.5%
Personal Spending	0.0%	+0.7%	+0.8%

Consumption comes surging back

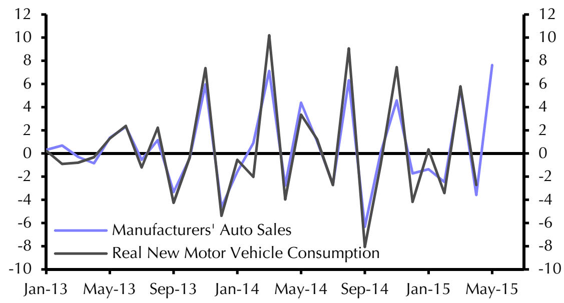
May's increase in consumption is going to be big, the only question is exactly how big? We have pencilled in a 0.8% increase in nominal spending, which should equate to a 0.5% m/m increase in real terms.

The manufacturers' unit sales figures point to a near 8% m/m increase in real motor vehicle consumption. (See Chart 1.) In addition, the robust retail sales figures for last month point to a 1% m/m increase in spending on other goods.

Services consumption is a little harder to estimate, not least because the latest quarterly services survey points to some big upward revisions to the growth of spending on physician services in March and April, which the BEA may or may not extrapolate into May.

Finally, the bigger 280,000 increase in non-farm payrolls last month, together with a 0.3% m/m increase in average hourly earnings suggests that personal income increased by a robust 0.5%m/m in May.

CHART 1: MOTOR VEHICLE SALES (%M/M)



Source – Thomson Datastream

LATEST US ECONOMIC INDICATORS

Monthly Indicators %m/m(%y/y) unless stated	Mar	Apr	May	Jun
Consumer Prices	+0.2%(-0.1%)	+0.1%(-0.2%)	+0.4%(0.0%)	-
Core Consumer Prices (Excluding Food & Energy)	+0.2%(+1.8%)	+0.3%(+1.8%)	+0.1%(+1.7%)	-
Core PCE Deflator (Excluding Food & Energy)	+0.1%(+1.3%)	+0.1%(+1.2%)	-	-
Producer Prices	+0.2%(-0.8%)	-0.4%(-1.3%)	+0.5%(-1.0%)	-
Change in Non-Farm Payrolls	119,000	221,000	280,000	-
Unemployment Rate (%)	5.5%	5.4%	5.5%	-
All Employee Average Hourly Earnings	+0.3%(+2.1%)	+0.1%(+2.2%)	+0.3%(+2.3%)	-
ISM Manufacturing Index	51.5	51.5	52.8	-
Industrial Production	0.0%	-0.5%	-0.2%	-
Retail Sales	+1.5%(+2.1%)	+0.2%(+1.5%)	+1.2%(+2.7%)	-
Core Retail Sales (Excluding Autos)	+1.0%(+1.0%)	+0.1%(+0.4%)	+1.0%(+1.3%)	-
Uni. of Michigan Consumer Confidence Index	93.0	95.9	90.7	94.6
International Trade Balance ($bn)	-50.6	-40.9	-	-
House Prices (Case-Shiller, s.a.)	+0.1%(+4.1%)	-	-	-
Quarterly Indicators %q/q ann(%y/y) unless stated	**Q2 2014**	**Q3 2014**	**Q4 2014**	**Q1 2015**
GDP	+4.6%	+5.0%	+2.2%	-0.7%
Consumption	+2.5%	+3.2%	+4.4%	+1.8%
Productivity, Non-Farm	+2.9%	+3.9%	-2.1%	-3.1%
Current Account ($bn, as a % of GDP)	-92.0(-2.1%)	-97.9(-2.2%)	-103.1(-2.3%)	-113.3(-2.6%)

LATEST MARKET DATA*

Instrument/rate		1 mth ago	1 week ago	Latest*	Instrument/rate		1 mth ago	1 week ago	Latest*
Official Rates	US	0-0.25	0-0.25	0-0.25	Global Yields	Euro 10yr	0.60	0.83	0.77
	ECB	0.05	0.05	0.05		Japan 10yr	0.42	0.52	0.43
	Japan	0-0.10	0-0.10	0-0.10		Canada 10yr	1.77	1.81	1.79
	Canada	0.75	0.75	0.75	Equity Indices	S&P 500	2126	2094	2121
Fed Funds Futures	Dec 2015	0.35	0.38	0.31		NASDAQ	5089	5051	5133
	Dec 2016	1.10	1.20	1.04		DJIA	18232	17899	18116
	Dec 2017	1.79	1.88	1.70	Currencies	$/€	1.10	1.13	1.13
Treasury Yields	2yr	0.61	0.73	0.63		¥/$	121.5	123.4	122.9
	10yr	2.21	2.39	2.31		$ Broad TWI	114.6	114.9	114.9
Inflation-indexed	10yr	0.31	0.52	0.39	Oil Price ($pb)	Brent	65.4	63.9	64.2
Corporate Bond (BAA)		4.95	5.09	5.08	Gold ($/oz)		1206	1182	1199

***Latest as at 04.00 EST 19th Jun. 2015.**

MAIN ECONOMIC & MARKET FORECASTS

%q/q ann. (%y/y) unless stated	Q1 2015	Q2 2015	Q3 2015	Q4 2015	Q1 2016	Q2 2016	2014	2015	2016
GDP	-0.7	+3.0	+3.0	+3.0	+2.9	+2.7	(+2.4)	(+2.3)	(+2.8)
CPI Inflation	(-0.1)	(+0.2)	(+0.4)	(+1.1)	(+2.4)	(+2.1)	(+1.6)	(+0.4)	(+2.2)
Core CPI Inflation	(+1.7)	(+1.8)	(+2.0)	(+2.1)	(+2.3)	(+2.4)	(+1.7)	(+2.0)	(+2.4)
Unemployment Rate (%), Period Ave.	5.6	5.4	5.2	5.0	4.9	4.8	6.2	5.3	4.8
Fed Funds Rate, End Period (%)	0-0.25	0-0.25	0.25-0.5	0.75-1.0	1.25-1.5	1.75-2.0	0-0.25	0.75-1.0	2.75-3.0
10 Year Treasury Yield, End Period (%)	2.00	2.30	2.75	3.00	3.25	3.25	2.17	3.00	3.50
S&P 500, End Period	2090	2120	2110	2100	2125	2150	2059	2100	2200
$/€, End Period	1.05	1.13	1.08	1.00	1.00	1.05	1.21	1.00	1.10
¥/$, End Period	120	123	125	130	132	135	120	130	140

Economic Diary & Forecasts

United States

Date	Country		Release/Indicator/Event	Time EST	Time (BST)	Previous*	Median*	CE Forecast*
Mon 22nd		US	Existing Home Sales (May)	10.00	(15.00)	5.04m	5.28m	5.30m
Tue 23rd		US	Durable Goods Orders (May)	08.30	(13.30)	-1.0%	-0.5%	-2.3%
		US	Core Durable Goods Orders (May)	08.30	(13.30)	-0.2%	+0.6%	+1.0%
		US	FHFA House Prices (Apr)	09.00	(14.00)	+0.3%	+0.5%	-
		US	Markit Manufacturing PMI (Jun, Prov.)	09.45	(14.45)	54.0	54.1	-
		US	New Home Sales (May)	10.00	(15.00)	517,000	520,000	540,000
Wed 24th		US	GDP (Q1, Final)	08.30	(13.30)	-0.7%p	-0.2%	0.0%
Thu 25th		US	Personal Income (May)	08.30	(13.30)	+0.4%	+0.5%	+0.5%
		US	Personal Spending (May)	08.30	(13.30)	0.0%	+0.7%	+0.8%
		US	PCE Deflator (May)	08.30	(13.30)	0.0%(+0.1%)	+0.3%(+0.2%)	+0.3%(+0.2%)
		US	Core PCE Deflator (May)	08.30	(13.30)	+0.1%(+1.2%)	+0.1%(+1.2%)	+0.2%(+1.3%)
		US	Initial Jobless Claims (20th Jun)	08.30	(13.30)	267,000	-	-
Fri 26th		US	Uni. of Mich. Consumer Confidence (Jun, Final)	10.00	(15.00)	94.6p	-	94.5

*m/m(y/y) unless otherwise stated; p = provisional estimate

Key Forthcoming Events/Data

30th June	Consumer Confidence Index (Jun)	2nd July	Employment Report (Jun)
1st July	ISM Manufacturing (Jun)	29th July	Fed Policy Announcement

Selected Recent Publications

Date	Publication	Title
Mon 15th	Capital Daily	How stretched is the valuation of the US stock market?
	Bank of Japan Watch	Growth deceleration to trigger more easing by October
	UK Economics Update	Most sectors have scope for productivity rebound
	Commodities Focus	An introduction to Rare Earth Elements
	Emerging Europe Update	Russian MPC hints at smaller rate cuts ahead
	Canada Data Response	Manufacturing Sales (Apr.)
	US Data Response	Industrial Production (May)
Tue 16th	Capital Daily	Contagion from Greek crisis likely to boost gold price further
	Australia & New Zealand Economic Outlook	Policymakers have more work to do
	Global Markets Update	Further big falls in EM currencies unlikely, but expect volatility
	European Economics Update	Italy still not ready to pay down its debt
	Latin America Economics Update	A closer look at Chile's current account improvement
	Precious Metals Markets Monitor	Investors turn even more negative on PMs
	US Housing Data Response	Housing Starts (May)
	European Economics Update	Is Cyprus a blueprint for Greece?
	European Economics Update	Greece's default options
	Industrial Metals Update	Support for iron ore prices to wane
Wed 17th	Capital Daily	EM financial markets shrug off concerns about Greece
	India Economics Update	Is the government's FDI policy bearing fruit?
	UK Economics Update	MPC unlikely to follow the US Fed closely this time
	Global Markets Update	How would euro-zone equities fare after a "Grexit"?
	Commodities Markets Chart Book	Commodity markets come off the boil again
	US Economics Update	Fed on track for a September lift-off
Thu 18th	Capital Daily	A Grexit might not drag euro-zone equities down for long
	China Chart Book	Debt swap helping to boost credit growth
	India Economics Update	Modest rise in MSP strengthens case for another rate cut
	Emerging Markets Economics Update	Fed tightening and EMs: risks revisited
	European Economics Update	SNB has more work to do in its fight against the franc
	Emerging Markets Trade Monitor	Weak EM exports keep concerns over global demand alive
	Emerging Asia Economics Update	Rate cuts likely in Indonesia before year-end
	Global Markets Update	Fed tightening unlikely to trigger a re-run of 1994 EM crash
	Middle East Chart Book	Foreign investment into Egypt showing signs of a revival
	US Data Response	Consumer Prices (May)
	Global Economics Update	Global financial conditions loose despite prospect of Fed hikes
	US Economic Outlook	Fed on track for September lift-off
	Commodities Update	Why commodity investors shouldn't fear the Fed
	Global Economics Update	Reviewing the lessons from past devaluations
Fri 19th	Capital Daily	What does the outlook for US interest rates mean for commodities?
	Australia & NZ Economics Weekly	RBA still has more work to do
	Japan Economics Weekly	Deflationary threat from cheaper oil far from over
	UK Economics Weekly	-
	European Economics Weekly	-
	Emerging Asia Economics Weekly	Indonesia heading in the wrong direction
	US Economics Weekly	Rates to rise more rapidly that Fed projections imply
	Canada Economics Weekly	-

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