Economics from Washington

SECOND THOUGHTS

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- *The tax cut is likely to be signed into law by Christmas.*
- *With the economy operating near full capacity, any boost to growth will be small and may be offset by tighter monetary policy.*
- *Strong economic data and an uptick in inflation pressure supports the Fed's intention to raise rates in December and continue increasing them in 2018. The tax cut raises the probability of more than three increases next year.*
- *The Treasury's net new borrowing was likely to double in 2018, without a tax cut. The increase in the supply of Treasury securities will now be larger. This argues against continued flattening in the yield curve.*

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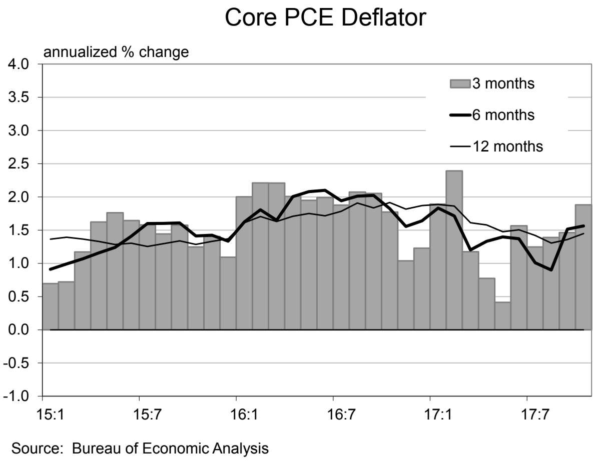
Two weeks ago, we thought it unlikely the Senate would pass the tax bill. Over the past two weeks, Republican leadership has worked very hard to secure votes from the half dozen or so senators who had serious problems with the bill. As a result, they not only obtained the support of all but one Republican senator, they also moved the Senate bill closer to the version which had already passed the House. While there are still important differences, bridging the gap between the two bills now looks very doable. The next step would normally be to appoint a conference committee to work out the differences, but the leadership wants to move the legislation quickly, so they may bypass this step. One option is for the House to pass the Senate bill, but the more likely option is for the leadership of both houses to work out a compromise. It is likely a final tax bill will be ready for the President's signature before Christmas.

While it is clear the tax cut will boost corporate profits and allow earnings held abroad to be repatriated, it is not clear the tax cut will boost economic growth. The Republican thesis is that lower corporate taxes will increase investment. The economy went through a period following the financial crisis when investment was quite weak, despite exceptionally low interest rates. We have now entered a period where business investment is strengthening significantly, despite the fact lower taxes have not yet become effective. The cost of capital does not appear to be the major force driving these decisions.

There is also the issue of how monetary policy will respond to incremental fiscal stimulus. Pres. Dudley has publicly stated this would be a factor in his thinking and other members of the FOMC will have a similar view. Recent economic data have supported the Fed's plan to increase rates at the December FOMC meeting and continue with steady increases in 2018. The Beige Book prepared for the upcoming meeting noted price pressures have strengthened and more input costs are being passed through to consumers. This is an important shift in inflation rhetoric from the district banks. The latest PCE deflator bolsters the view that the slowdown in inflation in the first half of 2017 will prove temporary – although the 12 month change in the core measure is only 1.4%, both the 3 and 6 month changes have moved closer to the 2% target. Members of the FOMC are



now looking at the tax package and deciding whether to add another rate increase to the three they had projected for 2018.

Other reports have generally been favorable for the growth outlook. Corporate profits were strong in the third quarter, and the increase in capital spending is on firm ground. Although the ISM index of manufacturing activity slipped slightly, this was because hurricanes caused a backup in deliveries in August and September, which is now clearing. Measures of orders and production remain strong. There was also a surge in new home sales in October. While some of this may have been a bounce from sales depressed by bad weather, the regional distribution shows strength was broadly based. Lean inventories have been a constraint on sales and builders are trying hard to address this problem, but buyers are snapping up houses before they can be built. Of course, this means builders will keep trying. The most recent consumption report showed an increase of 0.5% in September and 0.1% in October. November auto sales moved down from an 18 million unit rate to 17.1 million. Nevertheless, consumer optimism is testing new highs and labor market indicators suggest employment posted another solid month of growth in November. Nowcasts for the current quarter continue to track near 3% growth.

Despite favorable signs for continued growth, some investors continue to ask if the flattening in the yield curve means this expansion's days are numbered. With the Fed increasing short rates, some expect a very flat curve by the end of next year. We do not expect the expansion to end soon and have discussed several reasons (having little to do with the economic outlook) the yield curve has flattened recently. Passage of a tax cut raises another point relevant for this discussion. Without a tax cut, the Treasury's net new borrowing was estimated to roughly double between 2017 and 2018 – increasing from about $500 billion to about $1 trillion. Another $1 trillion was projected for 2019. CBO's estimates show the tax cut adding a little to borrowing in 2018 and more thereafter. In addition, the Fed plans to reduce its balance sheet about $230 billion in 2018. This will be happening at the same time other central banks are likely to be reducing their asset purchases. We are skeptical such a large increase in the supply of Treasury securities can be absorbed without an increase in long term interest rates. If inflation moves up over the next year, this too will put some upward pressure on long rates. As a result of these factors, we do not expect the yield curve to continue flattening and would not be surprised if it is a little steeper at the end of 2018, compared to the end of 2017.

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