ECRI
U.S. Cyclical Outlook
ESSENTIALS

Cyclical Clarity Cuts Through Policy Uncertainty

ECRI's leading indexes clearly indicate that the inflation and growth rate cycle upturns will persist, despite confusion about the nature, timing and impact of presidential policies.

Escalating Expectations The Fed will be spurred to hike rates more than most believe. That is the inescapable logic of the current state of the economic cycle.

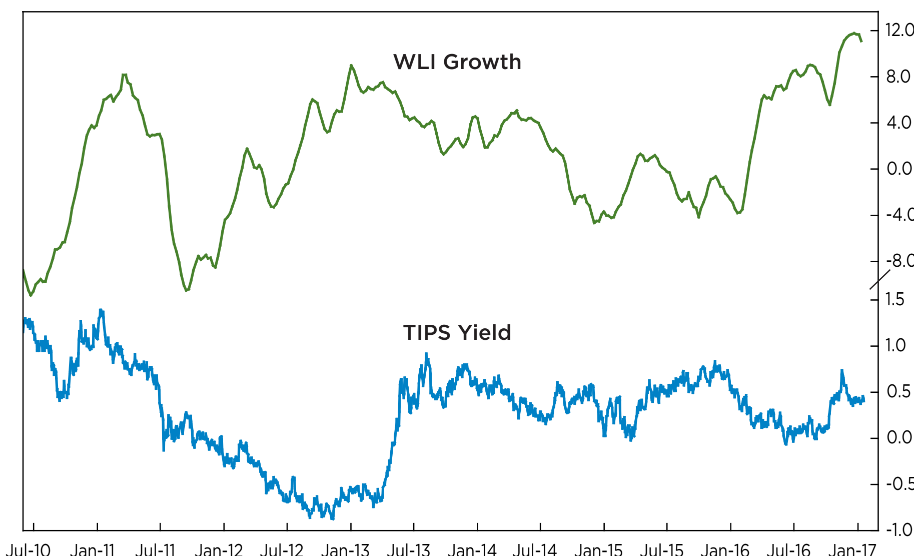
Over a year and a half ago, we asserted that the "Fed's rate hike plans are on a collision course with the economic cycle" (↗*USCO Essentials, July 2015*). However, when the Fed finally raised rates in December 2015, it was widely expected to follow through with "multiple additional rate hikes" in 2016. We strongly disagreed, correctly anticipating that, given a growth rate cycle (GRC) downturn "set to deepen, a full-blown rate hike cycle remains improbable" (↗*USCO Essentials, December 2015*).

Those headwinds have since reversed course, with the ongoing inflation cycle upturn – which we first flagged nearly a year ago (↗*USCO Essentials, March 2016*) – being joined by the GRC upturn that started coming into focus last summer (↗*USCO Essentials, August 2016*) and was confirmed in due course (↗*USCO Essentials, December 2016*). The resulting cyclical tailwinds have already lifted year-over-year (yoy) nominal GDP growth to a 1½-year high and yoy nominal retail sales growth to its highest reading in nearly five years (not shown).

Growth in our Weekly Leading Index (WLI), which remains near its recent 350-week high (Chart 1, top line), tends to lead the real interest rate – specifically, the yield on 10-year Treasury Inflation Protected Securities (TIPS). The TIPS yield has increased noticeably from last year's lows (bottom line). In fact, having dipped

Reduced legal immigration — or massive deportation of undocumented immigrants — could significantly diminish potential GDP growth.

Chart 1: WLI Growth and Real Interest Rates (%)



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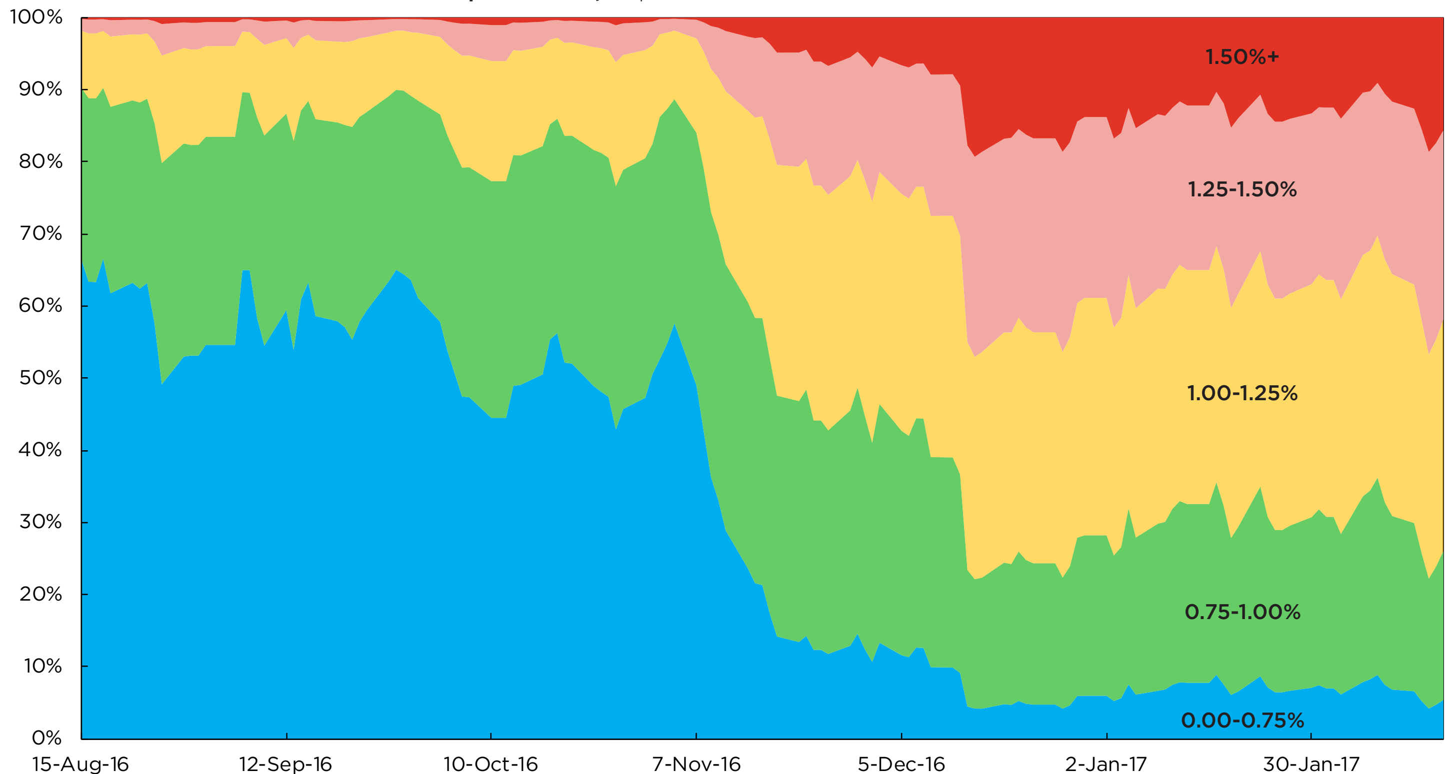
below zero last summer, it was hovering above that threshold in the days before the November election, and rose to ¼% the day after. By early December, it was approaching ½%, and spurted further to ¾% following the Fed rate hike. By around mid-January, with markets reassessing probable policy shifts, it had reversed almost all of its entire post-election pop. However, it crept back up to almost ½% this week following Fed Chairman Janet Yellen's congressional testimony.

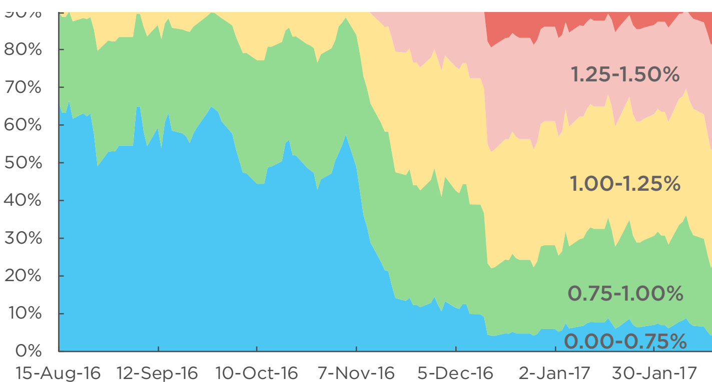
The point of the chart is that the ongoing WLI growth upturn predicts a continued GRC upturn, which is supportive of rising real rates. Corroborating the WLI's upbeat message is the rise in U.S. Long Leading Index growth to a

Separately, inflation expectations – which had already surged to their highest readings since 2014 following the upturn in our U.S. Future Inflation Gauge (USFIG), as highlighted last month *(↗USCO Essentials, January 2017)* – remain near those highs. The USFIG is hovering near November's 8½-year high. In turn, yoy CPI inflation has shot up to its highest reading since the spring of 2012, while yoy core CPI inflation is a hair's breadth away from its highest reading since the fall of 2008 (not shown).

Not only is inflation on the rise, but also the unemployment rate remains in the vicinity of what the Fed considers "full employment." Given the GRC upturn, "we

Chart 2: December 2017 Rate Expectations, Implied Probabilities





are likely to see the jobless rate falling below" that mark. In combination with rising inflation, we warned earlier this month, a "falling jobless rate could spur faster rate hikes than many expect" *(↗USCO Focus, February 2017)*.

At the time – in the days following the latest jobs report – the markets were factoring in two rate hikes this year, which would take the fed funds rate to the 1.00%-1.25% range. As Chart 2 shows, those probabilities have shifted up lately, with the average expectation now being two to three rate hikes this year.

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