FEDERAL RESERVE BANK *of* ST. LOUIS

The U.S. Economy Three Months into 2018

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Arkansas Bankers Association & Arkansas State Bank Department's Day with the Commissioner

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Any opinions expressed here are my own and do not necessarily reflect those of the Federal Open Market Committee.

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Introduction

Key themes in this talk

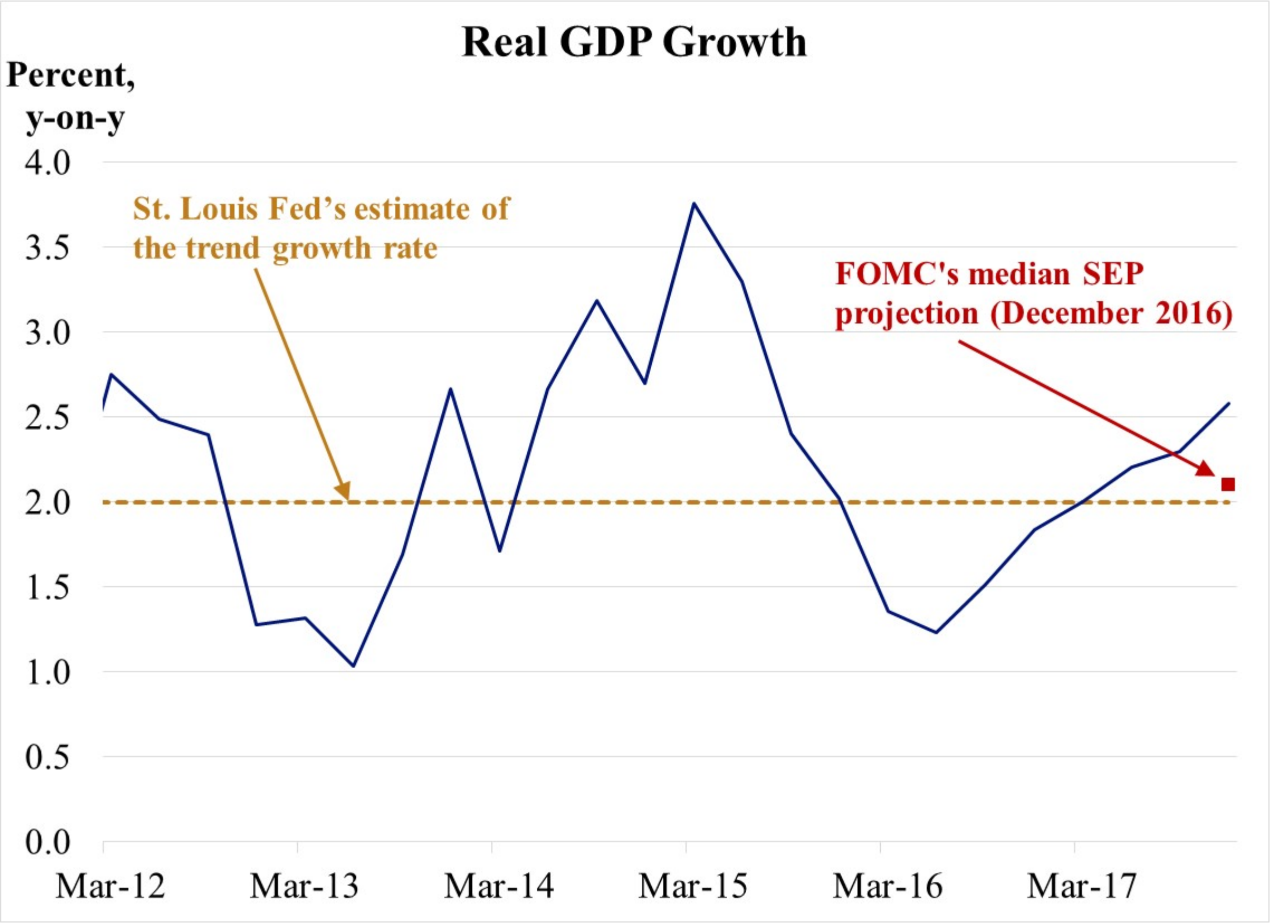
- Global real GDP growth surprised to the upside during 2017, driving U.S. equity markets higher.
- The growth rate of U.S. real GDP looks uncertain in the first quarter of 2018, possibly due to seasonal effects.
- Inflation remains low, but inflation expectations have generally moved more in line with the 2 percent inflation target of the Federal Open Market Committee (FOMC).
- Yield curve inversion remains a possibility later this year.
- Monetary policy is close to neutral today.

The 2017 Economic Growth Surprise

The effects of the 2017 global surprise have stalled

- The U.S. was joined by other large economies in achieving better-than-expected growth in 2017.
- This fed into the profits of U.S. multinationals, which helped U.S. equity prices rally in 2017.
- The effects from this surprise have stalled so far in 2018:
  - U.S. real GDP growth looks uncertain in the first quarter.
  - Markets are trying to discern the direction of U.S. trade policy.
  - U.S. interest rates are higher.
  - Markets are contemplating possible tech sector regulation.

The 2017 U.S. economic growth surprise



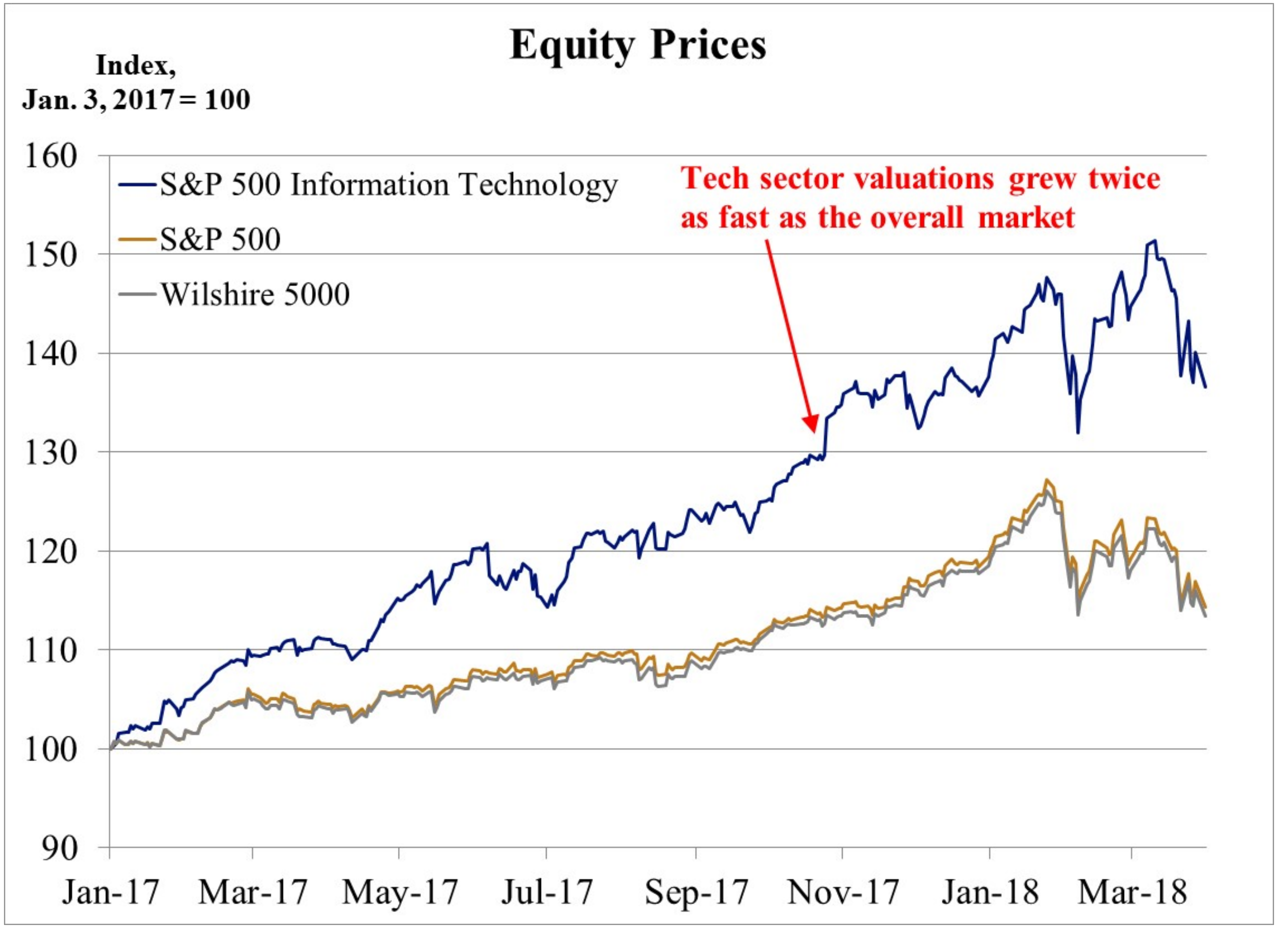
Sources: Bureau of Economic Analysis and Federal Reserve Board. Last observation: 2017-Q4.

The 2017 global growth surprise

Country	IMF Projection for 2017 as of October 2016	2017 Q4-on-Q4	Growth surprise (percentage points)
United States	2.2%	2.6%	+0.4
Euro area	1.5%	2.7%	+1.2
United Kingdom	1.1%	1.4%	+0.3
Japan	0.6%	2.1%	+1.5
China	6.2%	6.8%	+0.6

Sources: International Monetary Fund World Economic Outlook, October 2016*; Bureau of Economic Analysis; Eurostat; Economic and Social Research Institute (Government of Japan); National Bureau of Statistics of China and author's calculations.*

Equity valuations rally on global growth



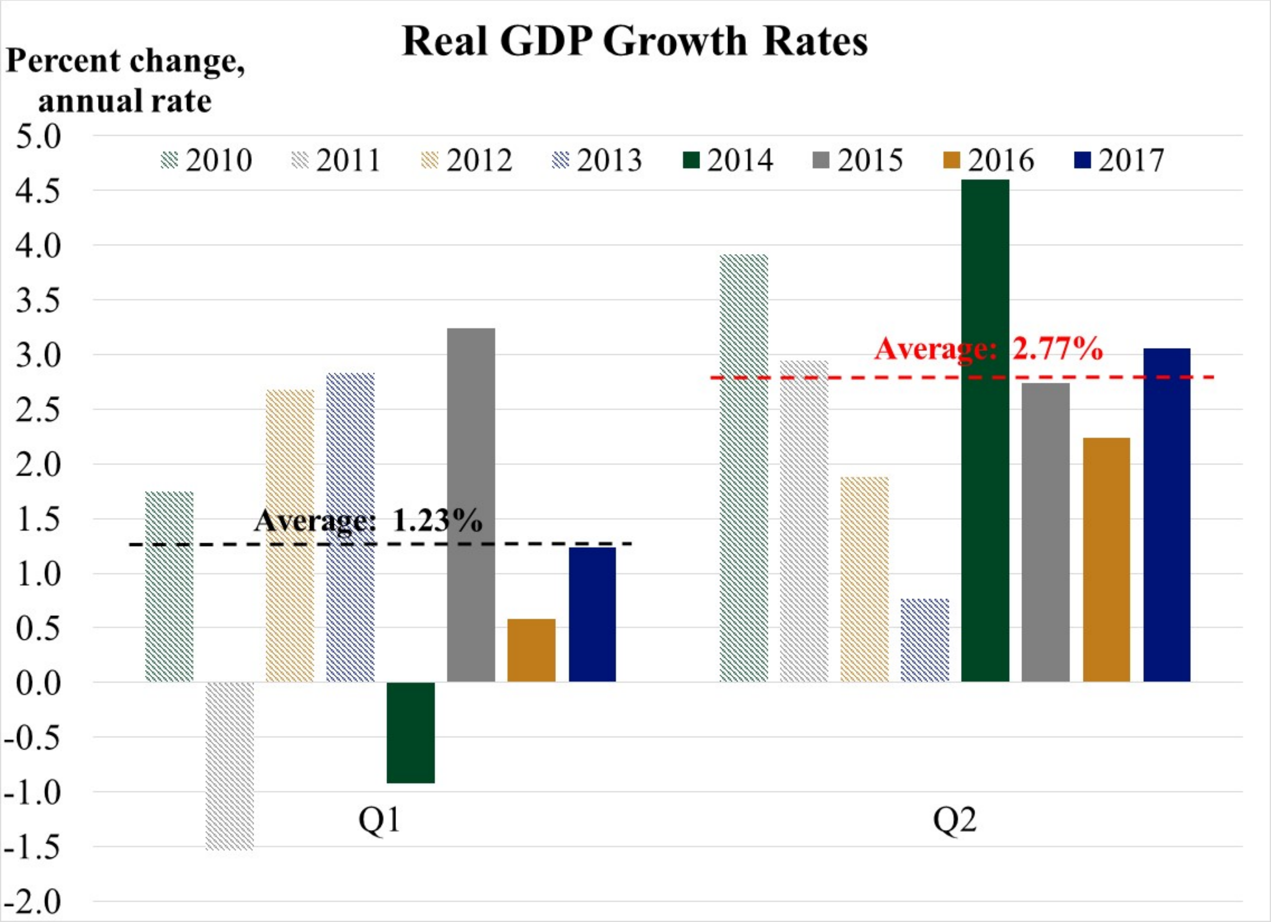
Sources: Bloomberg and author's calculations. Last observation: Apr. 2, 2018.

Tracking estimates for 2018-Q1 U.S. real GDP growth

Source	Date	Estimate*
Blue Chip Consensus	Mar. 10	2.5%
St. Louis Fed Economic News Index	Mar. 30	3.6%
FRBNY Staff Nowcast	Mar. 30	2.7%
Macroeconomic Advisers	Apr. 2	1.7%
CNBC Moody’s Consensus (median)	Apr. 2	2.1%
Atlanta Fed GDPNow	Apr. 2	2.8%

* *percent change from the previous quarter, annualized*

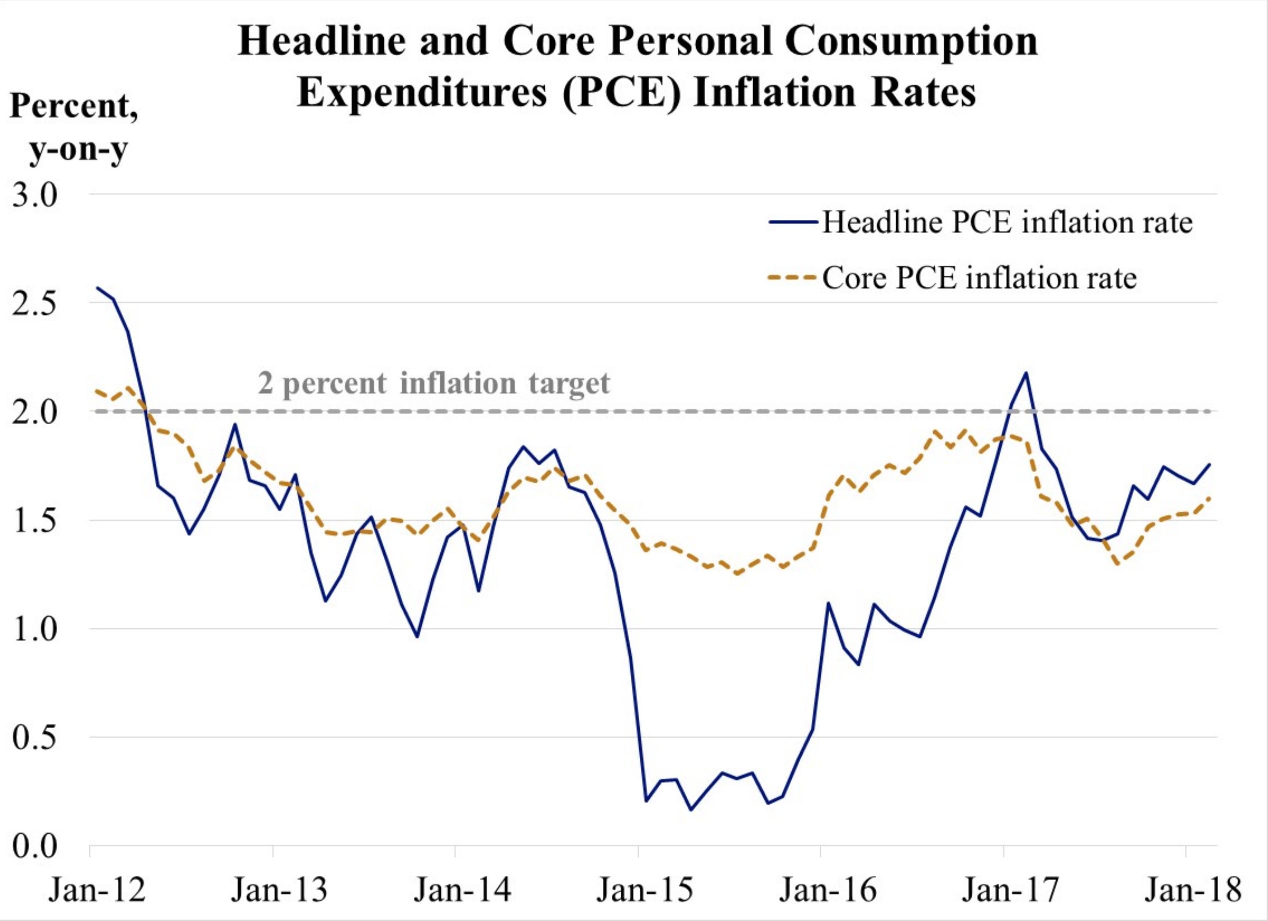
Residual seasonality?



Sources: Bureau of Economic Analysis and author's calculations. Last observation: 2017-Q2.

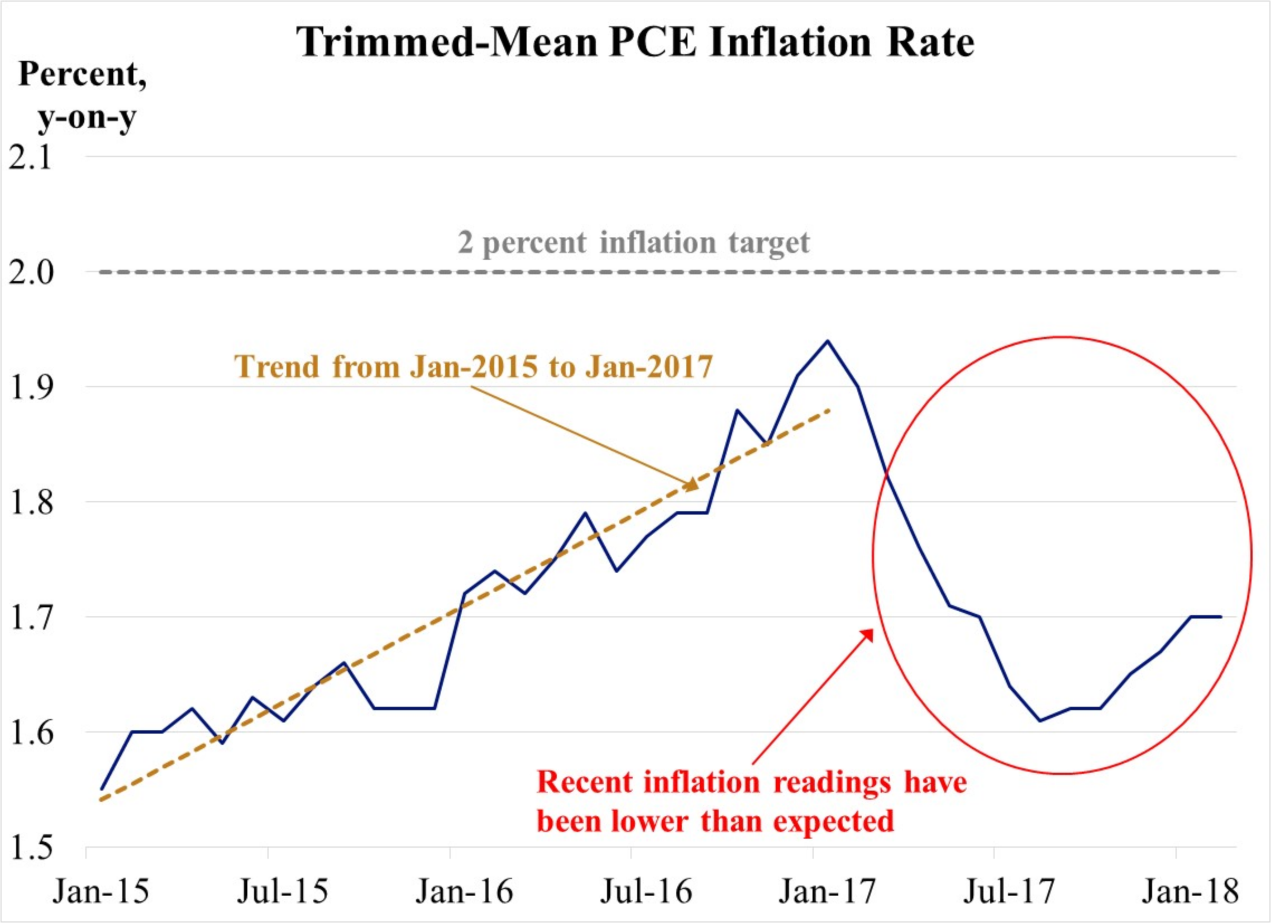
Inflation Remains Low

U.S. inflation has been mostly below target since 2012



Source: Bureau of Economic Analysis. Last observation: February 2018.

Trimmed-mean PCE inflation lower than expected in 2017

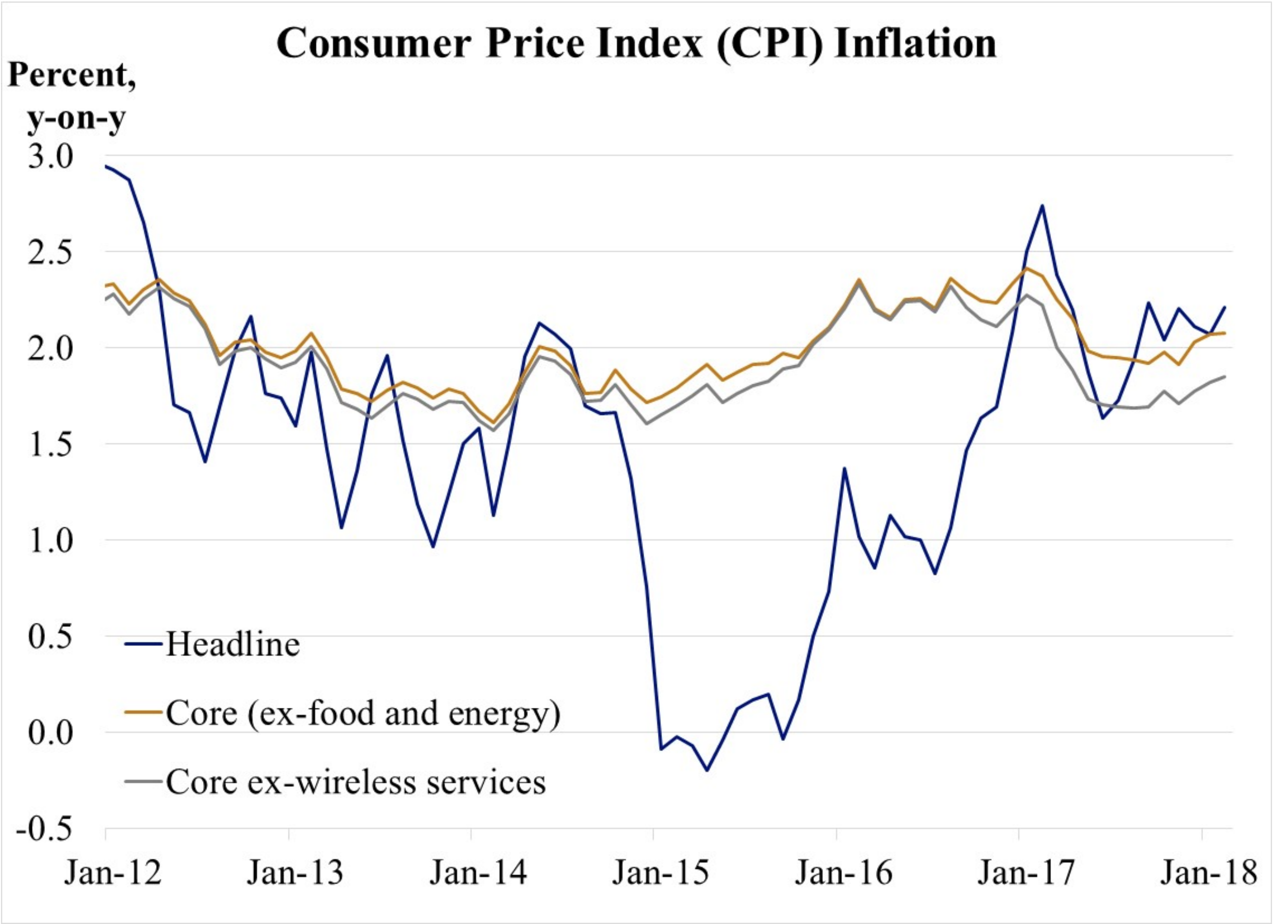


Sources: FRB of Dallas and author's calculations. Last observation: February 2018.

The outlook for inflation

- The low readings on inflation during 2017 occurred against a backdrop of relatively good labor market performance and a still historically low policy rate.
- This is why the inflation performance was particularly surprising.
- Special factors are expected to drop out of the year-over-year comparisons soon, likely suggesting that inflation is somewhat closer to target.

Cell phone charges' effect on the CPI

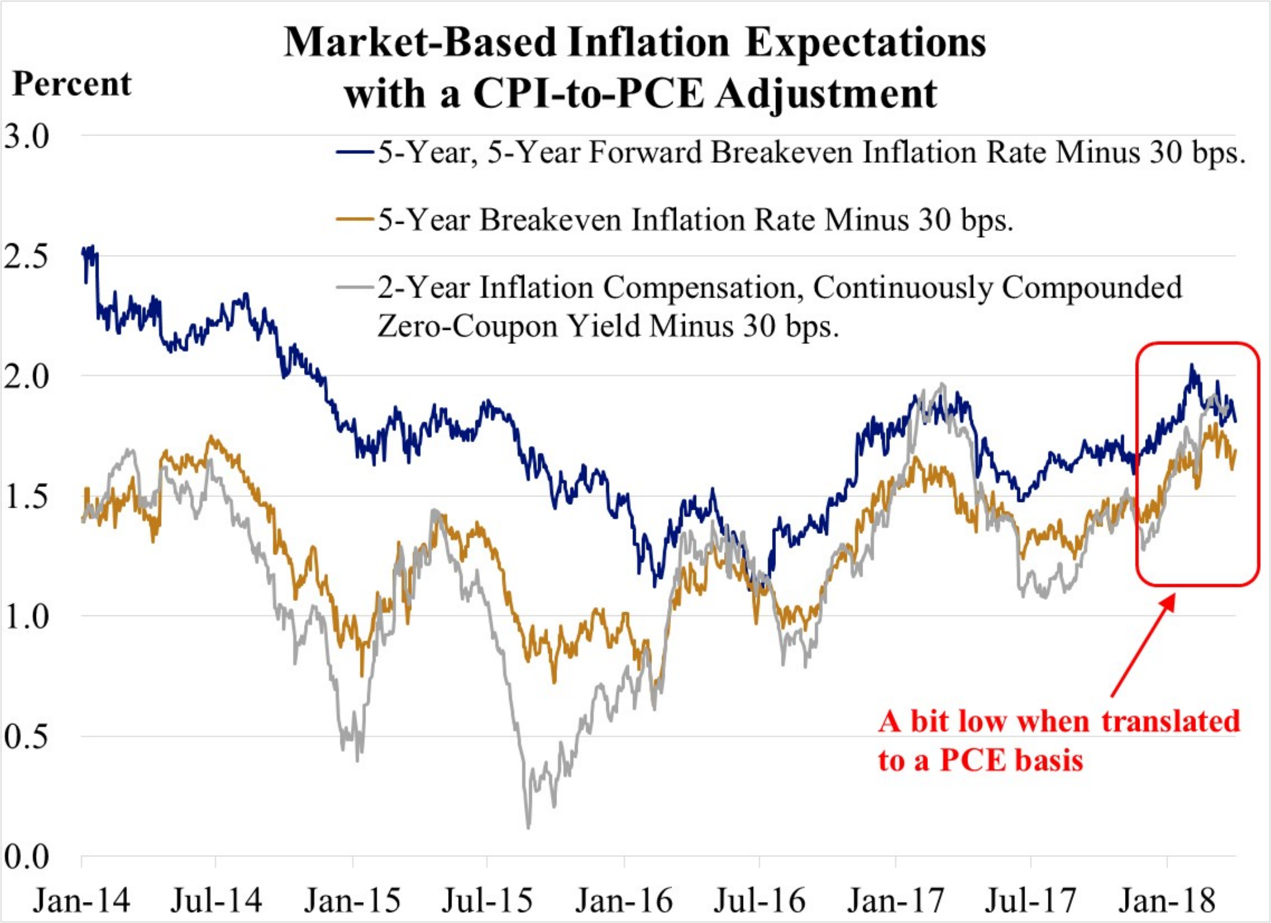


Sources: Bureau of Labor Statistics and author's calculations. Last observation: February 2018.

Inflation expectations have increased but remain a bit low

- According to modern theory, a variable that may give a signal of future inflation is inflation expectations.
- Market-based measures of inflation compensation have moved higher recently.
- The measures today are closer to being in line with the FOMC's 2 percent inflation target, but remain a bit low.
- The market-based measures are for CPI inflation, and so we adjust them downward somewhat to roughly translate into PCE inflation.
  - Historically, PCE inflation has run somewhat lower than CPI inflation.

Inflation expectations remain a bit low



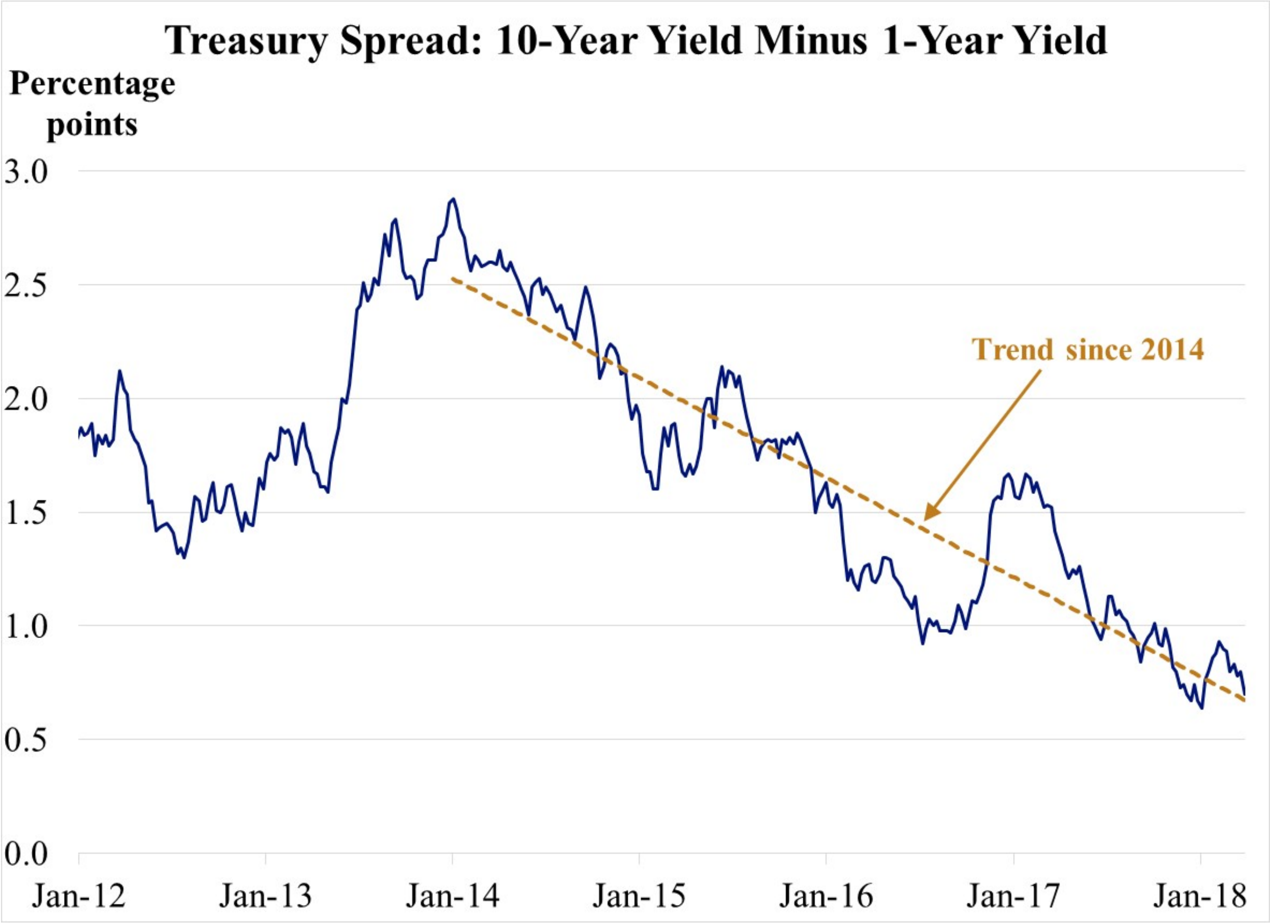
Sources: Federal Reserve Board and author's calculations. Last observations: April 2 (breakeven inflation rates) and March 23, 2018.

The Yield Curve

The slope of the yield curve

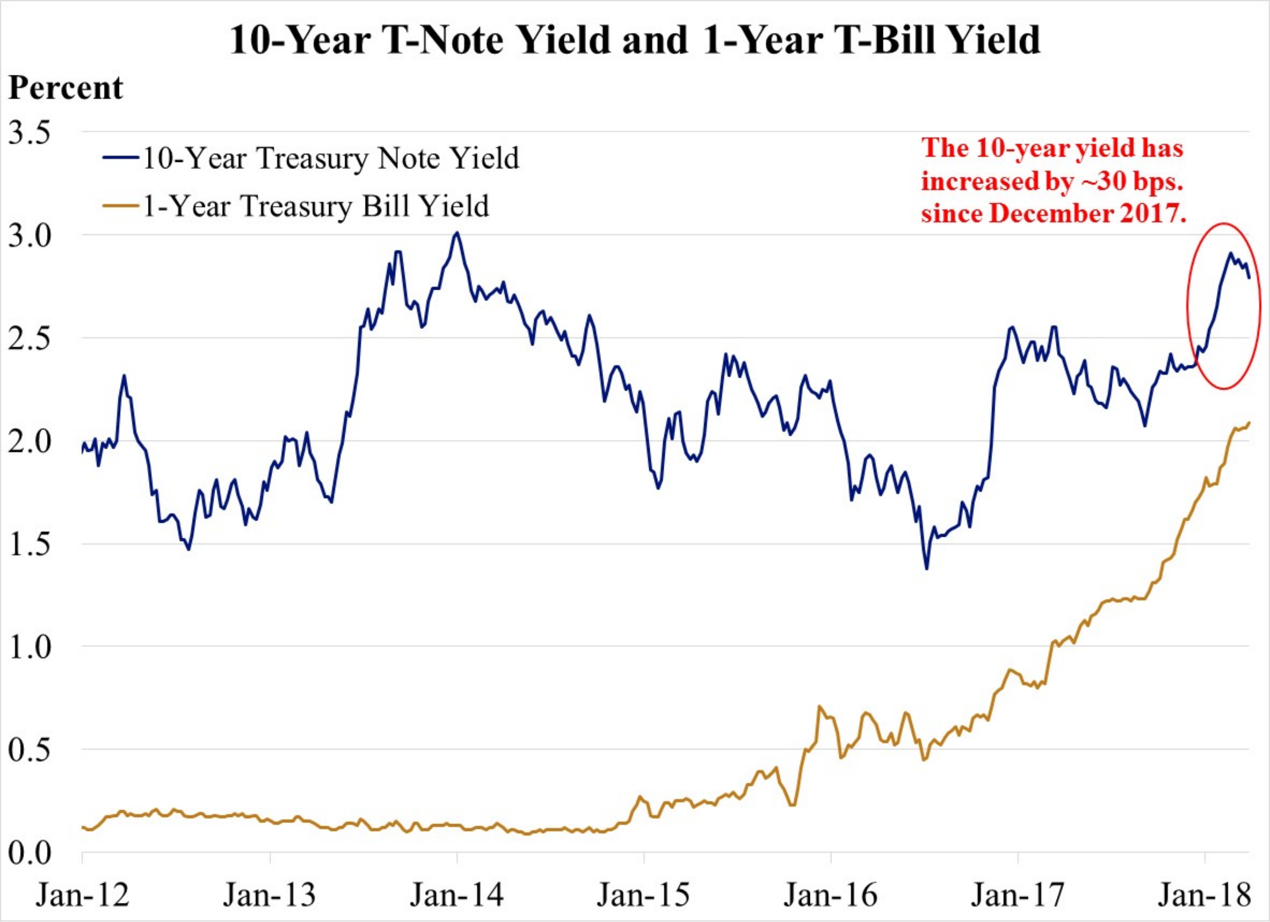
- The U.S. nominal yield curve has been flattening since 2014.
  - The spread between 10-year and one-year Treasury yields was close to 300 basis points at the beginning of 2014.
  - That same spread is currently (week of March 28) only 70 basis points.
- The flattening is due to rising short-term rates vis-à-vis relatively stable long-term rates.
- It is possible that the nominal yield curve will invert sometime in the next year, but recently the 10-year yield has increased enough to keep pace with the FOMC’s rate increases.

Nominal yield curve flattening



Sources: Federal Reserve Board and author's calculations. Last observation: Week of Mar. 28, 2018.

Flattening due to rising short-term rates



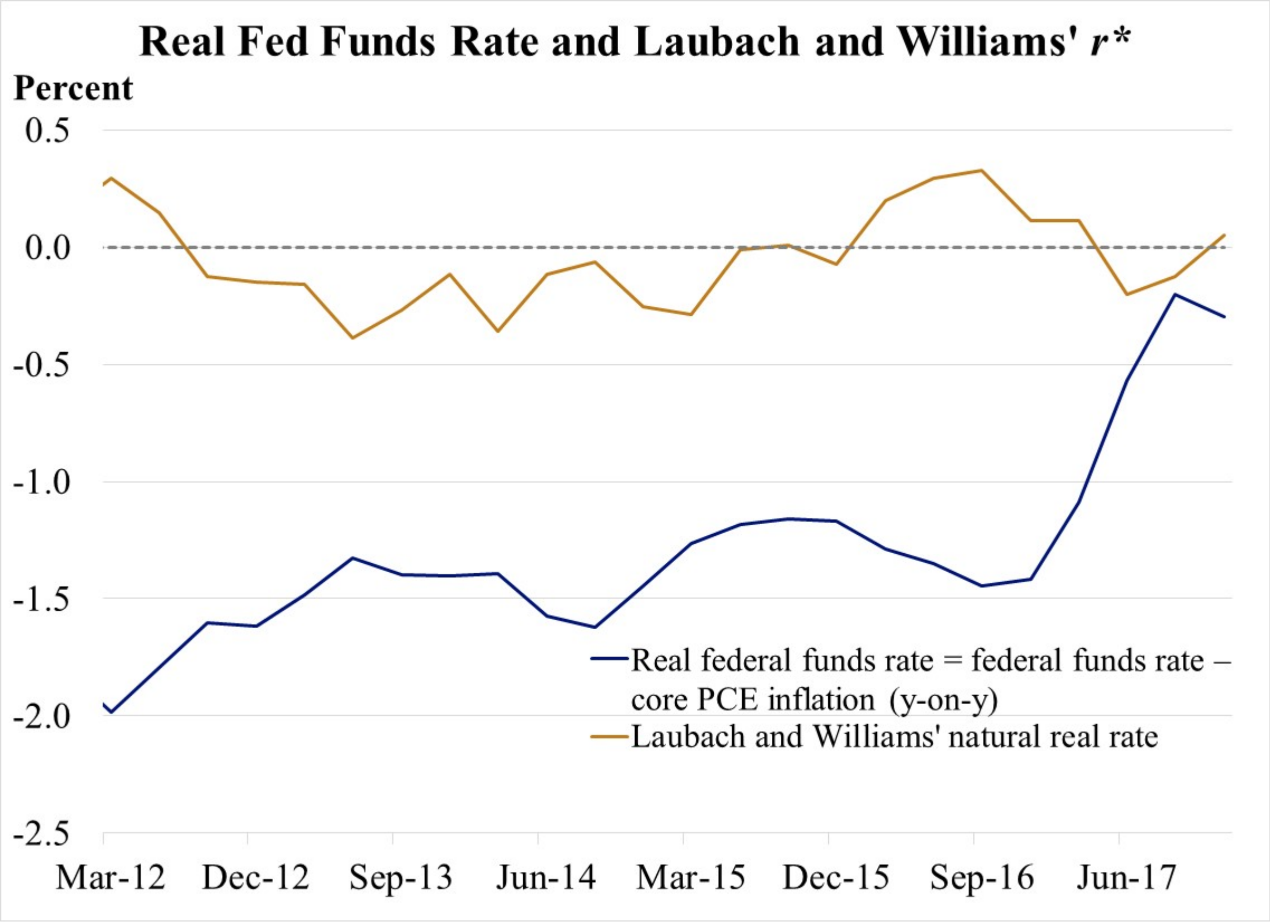
Sources: Federal Reserve Board and author's calculations. Last observation: Week of March 28, 2018.

Monetary Policy

The monetary policy stance

- The FOMC has begun to reduce the size of the Fed's balance sheet, gradually reversing the quantitative easing programs that characterized U.S. monetary policy while the policy rate was near zero.
- The policy rate range has been increased gradually and now stands at 1.50 to 1.75 percent.
- Current estimates of the neutral real rate, commonly called r^*, are near zero.
- With core PCE inflation at 1.6 percent, the current policy rate setting minus PCE inflation is near r^*, suggesting the current policy setting is closer to neutral than in previous years.

Monetary policy closer to neutral



Sources: Federal Reserve Board, Bureau of Economic Analysis, FRB of San Francisco and author's calculations. Last observation: 2017-Q4.

The consequences of a neutral policy

- The neutral setting of the policy rate is a value that puts neither upward nor downward pressure on inflation, given everything else that is occurring in the economy.
- This is appropriate for the current situation, in which inflation is not far below target and is expected to rise.
- It is not necessary in this circumstance to raise the policy rate further in order to put downward pressure on inflation, since inflation is already below target.

Conclusion

Conclusion

- The global growth surprise drove global financial market developments during 2017.
- The effects of the surprise seem to have abated during the first months of 2018 in the face of uncertain first-quarter U.S. real GDP growth along with other factors.
- Inflation remains low but is expected to move somewhat higher during 2018.
- Yield curve inversion later this year remains a possibility.
- Current monetary policy settings are close to neutral, which is appropriate for the current macroeconomic situation.

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