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Monthly Economic Outlook

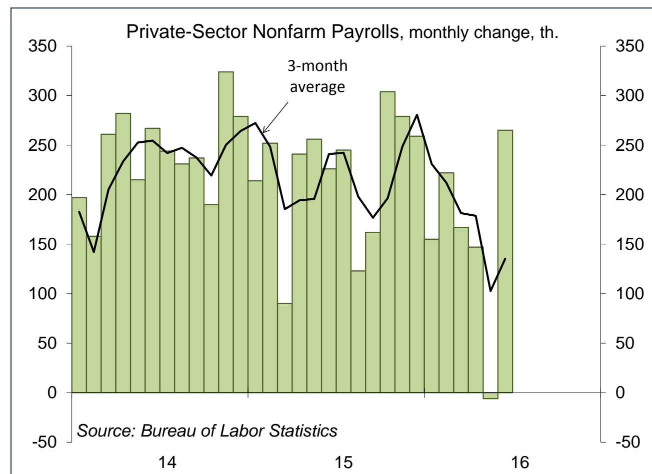
Brexit Wounds

- *Brexit will be bad for the U.K. economy, but should have a very limited impact on U.S. growth.*
- *Recent data reports have been consistent with mixed, but moderate growth in the U.S. Payroll numbers have been choppy, reflecting noise in the data, but the trend has slowed, signaling both business caution and a tighter job market.*
- *The Fed remains in tightening mode, expecting to resume policy normalization at some point. However, officials should not be in any hurry to raise rates.*

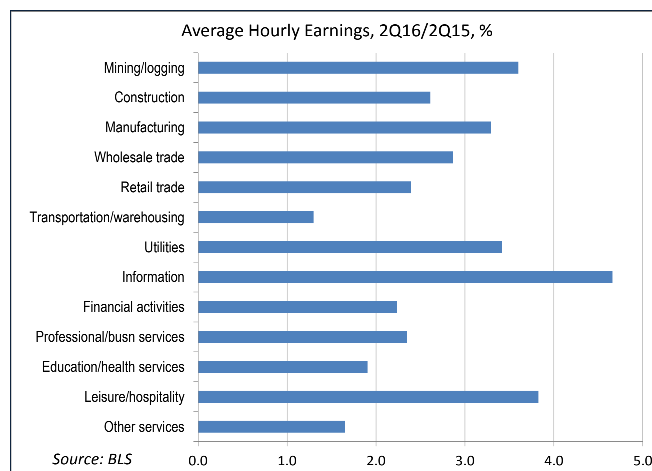
On June 23, the United Kingdom voted to leave the European Union. Global financial markets, which had increasingly priced in a "remain" victory ahead of the vote, were caught leaning in the wrong direction. Adding to the markets' anxieties, neither campaign appeared to have a plan for how to deal with the result. Prime Minister Cameron, who had allowed the referendum in the first place, resigned, effective on the setting of a replacement. Most leaders of the "leave" campaign left after the vote.

The Brexit process will be long (two years once the sorting out officially gets underway) and uncertain (there's a lot of negotiating to be done). It's clear that Brexit will be bad for the U.K. economy – it's just a question of how much. The best case scenario is the adoption of the "Norway" model of limited tariffs, which might subtract about 2% from GDP/capita over the next two years. If negotiations are tougher, the U.K. may end up the same as other non-EU trading partners, a result that might subtract 7% from GDP/capita. A weaker pound may help to offset some of that, but that means higher inflation and lower real wages (and slower spending). Bank lending is expected to contract and the ongoing uncertainty should continue to restrain business investment. The bigger impact may come through a contraction in the financial services industry. London, a major international financial center, is expected to lose status (rivals are already courting many of the city's financial firms with tax incentives and special deals). On the positive side, the transition to a new prime minister (Theresa May) has taken place months sooner than expected and a general plan of action is beginning to take shape. The Bank of England left monetary policy unchanged in July, but is expected to ease on August 4.

The impact of Brexit on the U.S. economy is expected to be small, perhaps a tenth of a percentage point from GDP growth over the next year or two. The U.K. accounted for 3.7% of U.S. exports in 2015 and 2.6% of imports (note: new trade agreements with the U.S. will likely be needed once the U.K. leaves the EU). Still, a weaker U.K. is not going to help the global economic outlook and there are downside risks.



Nonfarm payrolls were reported to have risen by 287,000 in the initial estimate for June. That strength followed an unusually weak number for May (revised to +11,000, and -6,000 for the private-sector). The payroll figures for the last two months likely reflect noise in the numbers – large swings are unusual, but they do happen from time to time. The three-month average slowed to +147,000 (from +196,000 in 1Q16 and a +221,000 average in 2015). The Fed's Beige Book, the summary of anecdotal reports from around the country, noted *"cautious hiring activities"* in a couple of Fed districts, but *"several districts reported strong demand for skilled labor, with challenges filling positions in fields such as IT, biotechnology, and healthcare services."* Average hourly earnings rose 2.5% (2Q16/2Q15), but results varied across industries.



ADP, a payroll processing firm, noted continued strength in hiring by small and medium-sized businesses through June. That is a good sign. Business formation was especially hard hit during the economic downturn, but appears to have improved considerably in the last couple of years. New firms account for much of the job growth in an economic expansion.

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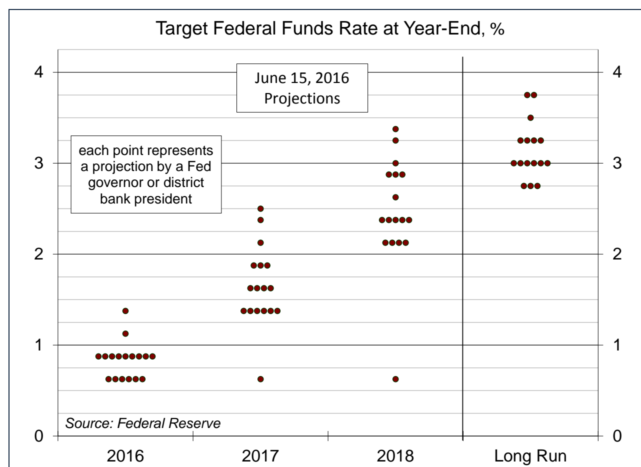
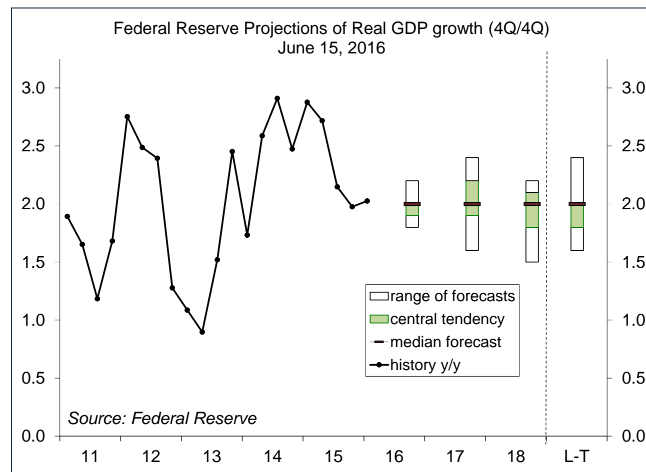
In June (even after the poor payroll figure for May), all 17 senior Fed officials (5 governors and 12 district bank presidents) expected at least one increase in short-term interest rates by the end of the year, and most expected two. Just ahead of the June 15 Federal Open Market Committee meeting, half of the Fed's district banks had requested a 25-basis-point increase in the discount rate, the rate the Fed charges banks for short-term borrowing (the Fed's Board of Governors did not approve the request). Officials differed in their views of the likely path of short-term interest rates over the next few years, but all agreed that the decision to tighten would remain data-dependent and they could afford to wait for more information before resuming policy normalization.



While the Fed expects rate increases to occur gradually, the financial markets perceive an even shallower glide path (less than a one-in-three chance of a hike by the end of the year). The Fed expects the labor market to tighten further and inflation to move toward the 2% target (as measured by the PCE Price Index). However, unsettled global financial conditions may keep the Fed on hold this autumn.

Last month, Federal Reserve officials generally lowered their expectations of GDP growth for 2016 and 2017. Longer-term, the Fed anticipates non-inflationary GDP growth of 2.0% (median forecast). Labor force growth is expected to average about 0.5% over the next 10 years. Hence, the Fed's GDP outlook implicitly assumes that productivity growth will be about 1.5% per year. Yet, growth in output per work-hour has averaged just 0.6% per year over the last five years. Outside the U.S., productivity growth has also slowed, and labor force growth in many countries, including China, is now negative.



A more moderate growth outlook is not necessarily bad for the stock market. Wage pressures may build, resulting in higher inflation or perhaps eating into corporate profits (if wage increases cannot be passed along). Long-term interest rates will generally be lower than in past decades.

In the near term, consumer spending is likely to lead overall growth. Business fixed investment should pick up, as energy exploration bottoms. A key risk for global growth is the potential spread of protectionist trade policies.

	3Q15	4Q15	1Q16	***2Q16***	***3Q16***	***4Q16***	***1Q17***	***2Q17***	***3Q17***	***4Q17***	2015	***2016***	***2017***
GDP (↓ *contributions*)	2.0	1.4	1.1	***2.9***	***2.2***	***2.2***	***2.2***	***2.2***	***2.2***	***2.1***	2.4	***2.0***	***2.2***
consumer durables	0.5	0.3	-0.1	***0.8***	***0.2***	***0.2***	***0.2***	***0.2***	***0.2***	***0.2***	0.4	***0.3***	***0.3***
nondurables & services	1.6	1.4	1.4	***2.0***	***1.4***	***1.3***	***1.3***	***1.3***	***1.2***	***1.2***	1.7	***1.6***	***1.3***
bus. fixed investment	0.3	-0.3	-0.6	***0.1***	***0.2***	***0.2***	***0.2***	***0.2***	***0.3***	***0.3***	0.4	***-0.1***	***0.2***
residential investment	0.3	0.3	0.5	***0.2***	***0.2***	***0.2***	***0.2***	***0.2***	***0.2***	***0.2***	0.3	***0.3***	***0.2***
Priv Dom Final Purchases	3.2	2.0	1.2	***3.5***	***2.4***	***2.4***	***2.3***	***2.2***	***2.2***	***2.1***	3.3	***2.4***	***2.4***
government	0.3	0.0	0.2	***0.1***	***0.3***	***0.2***	***0.2***	***0.2***	***0.2***	***0.2***	0.1	***0.2***	***0.2***
exports	0.1	-0.3	0.0	***0.2***	***0.2***	***0.2***	***0.2***	***0.2***	***0.3***	***0.3***	0.2	***0.1***	***0.2***
imports	-0.4	0.1	0.1	***0.1***	***-0.3***	***-0.3***	***-0.3***	***-0.2***	***-0.2***	***-0.2***	-0.8	***-0.1***	***-0.2***
Final Sales	2.7	1.6	1.3	***3.3***	***2.2***	***2.2***	***2.2***	***2.2***	***2.1***	***2.1***	2.3	***2.3***	***2.2***
ch. in bus. inventories	-0.7	-0.2	-0.2	***-0.5***	***-0.1***	***0.0***	***0.0***	***0.0***	***0.0***	***0.0***	0.2	***-0.3***	***0.0***
Unemployment, %	5.1	5.0	4.9	***4.9***	***4.7***	***4.7***	***4.7***	***4.8***	***4.8***	***4.8***	5.3	***4.8***	***4.8***
NF Payrolls, monthly, th.	192	282	196	***147***	***155***	***150***	***145***	***140***	***135***	***130***	229	***162***	***138***
Cons. Price Index (q/q)	1.4	0.8	-0.3	***2.6***	***2.3***	***2.0***	***2.1***	***2.1***	***2.0***	***1.9***	0.1	***1.3***	***2.1***
excl. food & energy	1.8	2.2	2.7	***2.1***	***1.9***	***1.9***	***1.9***	***1.9***	***1.9***	***1.9***	1.8	***2.3***	***1.9***
PCE Price Index (q/q)	1.3	0.3	0.2	***2.0***	***1.9***	***1.9***	***2.0***	***1.9***	***1.9***	***1.8***	0.3	***1.1***	***1.9***
excl. food & energy	1.4	1.3	2.0	***1.7***	***1.7***	***1.7***	***1.7***	***1.7***	***1.7***	***1.7***	1.3	***1.7***	***1.7***
Fed Funds Rate, %	0.14	0.16	0.36	***0.37***	***0.38***	***0.42***	***0.67***	***0.90***	***1.15***	***1.42***	0.13	***0.38***	***1.04***
3-month T-Bill, (bond-eq.)	0.0	0.1	0.2	***0.3***	***0.4***	***0.4***	***0.7***	***0.9***	***1.2***	***1.4***	0.1	***0.3***	***1.1***
2-year Treasury Note	0.7	0.8	0.8	***0.8***	***0.8***	***1.0***	***1.3***	***1.6***	***1.8***	***2.1***	0.7	***0.9***	***1.7***
10-year Treasury Note	2.2	2.2	1.9	***1.8***	***1.7***	***1.9***	***2.3***	***2.4***	***2.7***	***2.8***	2.1	***1.8***	***2.5***

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