4Q17 Economic Summary

The fourth quarter of 2017 was all about the Fed and tax reform. After much ado, President Trump nominated Jerome Powell as Chairman of the Federal Reserve in November. Powell is a current Fed governor and was a popular choice among market participants as he is expected to continue the Fed's baby-steps approach to policy normalization. With the Fed Chair nomination decided, market focus returned to tax reform. After much political wrangling, Congress came through on their promise and passed a sweeping tax bill in December. Getting the legislation passed before year-end was a big win for the GOP and the Trump administration. Equity markets soared to new highs on the news while Treasury yields backed up in anticipation that stronger growth would green light further rate increases from the Fed. Short-term rates rose more than long-term rates, resulting in a flatter yield curve at year-end.

The burgeoning US growth story continued to unfold during the fourth quarter. Elevated consumer and business sentiment along with improving global demand for US goods led to another solid quarter for manufacturing, capping the strongest year for factories since 2004. The services sector also continued to expand as holiday cheer brought higher retail sales. Labor market conditions remained favorable during the quarter as companies stepped up hiring to support the increased demand for goods and services. All told, the US added over 2 million jobs in 2017, and the unemployment rate ended the year at a low 4.1%. The steady job market and higher household wealth also led to a pickup in housing demand. Home sales rose during the quarter despite tight inventory conditions and rising prices. Pent-up demand and lack of inventory bodes well for residential construction and should lead to a stronger contribution to GDP going forward.

The pickup in economic activity was not limited to the United States. Countries around the world benefited from an uptick in growth as low unemployment and benign inflation led to a surge in consumer demand for goods and services across the globe. The IMF is forecasting that the world economy grew at a rate of 3.6% in 2017, the fastest pace since 2011. Growing confidence in the global economic recovery has caused central banks in many developed countries to reevaluate their quantitative easing policies. The Bank of Japan and the European Central Bank have both recently signaled potential shifts in their bond buying programs. As more central banks join the US in removing the monetary punchbowl, global interest rates should continue to rise.

The US Federal Reserve took another step on its path to normalization at the December FOMC meeting by increasing the federal funds rate an additional 25 basis points to a target range of 1.25%-1.50%. The December statement held no surprises, and the dot plot remained relatively unchanged with Committee members projecting another three hikes in 2018. The Committee agreed that "the labor market has continued to strengthen and that economic activity has been rising at a solid rate." While they acknowledged that inflation remains below their 2% target, many members expected that the tightening labor market will lead to higher inflation over the medium term. At the time of the December meeting, the tax bill was still a work in progress, but the Fed did raise its 2018 GDP growth forecast to 2.5% in part due to expectations of the tax plan passing. Given the stronger growth forecast, markets are currently forecasting a greater than 85% chance that the Fed will raise rates again at the March FOMC meeting.

All said, 2017 was a good year for the US economy, and all signs are pointing to the positive momentum continuing into 2018. The tax cuts are expected to boost GDP growth further; however, how much of a boost will depend on how the tax savings are spent. Given the decrease in the corporate tax rate, corporate profits are expected to rise. If corporations use the additional profits for increased capital expenditures and wage increases, the contribution to GDP should be meaningful, and we could finally see the uptick in inflation that the Fed has been looking for. However, if profit growth is used for share buybacks and debt pay downs, the economic impact will be lessened. Either way, optimism is high that 2018 will be another strong year for the US economy.