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Special Edition

Focus on the Economy

CRF's Annual Economic Projections for 2017

From 5 Economic/Financial Professionals

Changes Coming from New Administration

By Mark Zandi
Moody's Analytics

The economic outlook has meaningfully changed due to the election of Donald Trump as president of the United States. Significant changes are likely in tax law and government spending, trade and immigration policies, and regulation.

Precisely what economic policies President Trump implements and when are highly uncertain, and it will take time to nail things down as he works to assemble his government. Once he does, he will be able to move quickly given the president's substantial authority. He can make many decisions unilaterally, and while they will almost certainly be challenged in the courts, it will all take years to sort

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out. A Republican-controlled House and Senate will also smooth the way for more policy becoming law, particularly since the Senate filibuster is no longer the legislative handcuff it used to be.

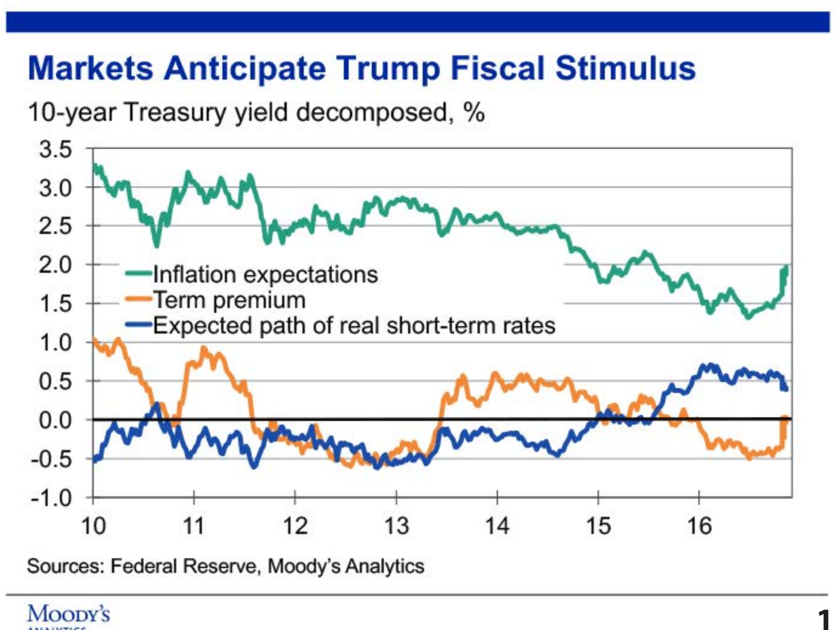
Markets react

Financial markets are already discounting the coming policy changes. Stock prices are up over 5% since Election Day to a record high, with the biggest gains in the shares of financial institutions, and energy and industrial companies. Long-term Treasury yields have also risen sharply, with 10-year yields up almost 80 basis points to near 2.6%. This has pushed fixed mortgage rates back up to well over 4%. Corporate credit spreads have narrowed, thus borrowing costs for businesses have not risen nearly as much.

The value of the U.S. dollar has also appreciated, particularly vis-à-vis the Japanese yen and the euro. The euro/$ is near parity. On a broad trade-weighted basis, the dollar is as strong as it has been since Y2K. Oil and metals prices are also up since the election, although this may also reflect other factors, such as the recent OPEC deal to rein in its production.

Consistent with the higher stock prices and narrower credit spreads are investor expectations of corporate tax reform. Mr. Trump has proposed a 15% top marginal corporate rate, down from its current 35%, and the adoption of a territorial taxation system with a one-time 10% rate on repatriated foreign earnings. His strong support of deregulation has also cheered investors. Financial stocks have gotten a pop in anticipation of changes to Dodd-Frank, as have healthcare stocks given the likely "repeal" of the Affordable Care Act. Energy and environmental deregulation seem near certain, which is a plus for energy producers and related industries.

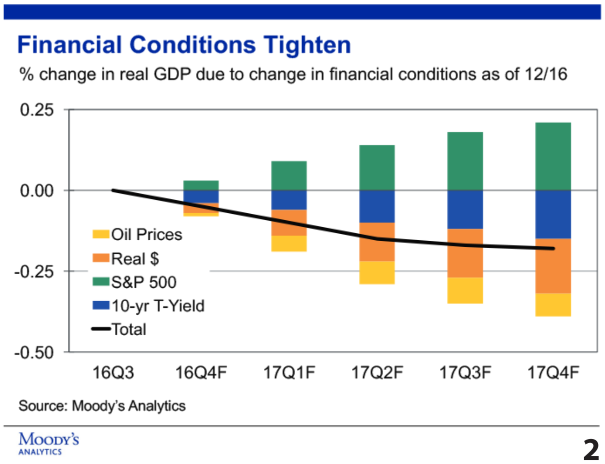
Investors also appear to be anticipating fiscal stimulus—deficit financed tax cuts and increases in government spending. This is clearest in the rise in long-term Treasury yields, which can be traced to increases in inflation expectations, expected real short-term rates which reflect anticipated future monetary policy, and the term premium, or the yield compensation that investors require for the risk of investing in a long-term security (see Chart 1).



Investors understand that stimulus applied to a full-employment economy—an apt description of the economy next year—will result in more wage and price pressures and a faster normalization of monetary policy. The big swing from negative to positive since the election in the term premium—which is sensitive to expectations regarding the government's future fiscal situation—says investors also appear to believe Trump's policies will add to future budget deficits.

Tighter financial conditions

Financial markets' strong reaction to the election net out to a tightening in financial conditions, which if sustained as anticipated, will ding economic growth next year (see Chart 2). It will still be a very good year, as President Trump will inherit an economy that is fundamentally strong. Job creation is robust, the economy is near full employment, and wage growth is accelerating. With a record number of open job positions and few layoffs, it would take a severe shock to derail the economy. But it won't be quite as good a year.

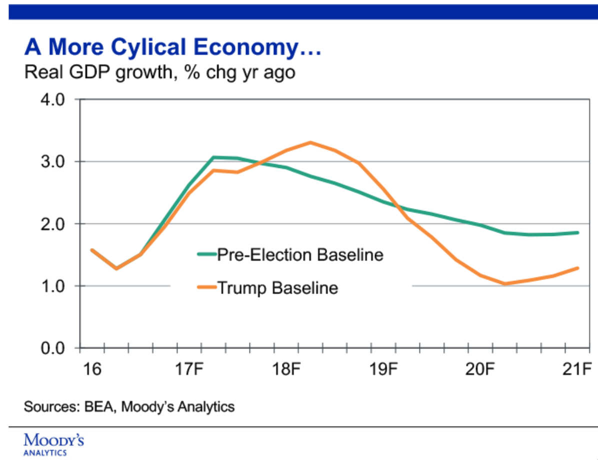


Higher stock prices are a clear plus for growth, primarily via the wealth effect on consumer spending. Household stockholdings are worth about $1 trillion more since the election. If sustained, that should prompt more spending and be a meaningful add to growth in 2017. But this will be largely washed out by the stronger U.S. dollar and the resulting widening in the trade deficit. The higher interest rates will also bite. With fixed mortgage rates back over 4%, refinancing activity has already been curtailed, since the average coupon on outstanding mortgages is close to 4%. Home sales and house prices will also feel it, as more trade-up buyers will have to pay a higher rate on their new mortgage than on their old one. This is a big change, since homebuyers have enjoyed more-or-less declining mortgage rates since the early 1980s.

Other potential near-term fallout from the election includes heightened policy uncertainty as the new administration struggles to articulate its policies. This could cause businesses to delay investment and perhaps hiring decisions, and consumers will pause (at least for a while) to see how things are proceeding. However, consumer and business confidence may get a lift given the prospects for change. Judging from recently stronger sentiment surveys, frustration over gridlock in Washington may have been weighing on confidence. It is hard to know the upshot of all this, but it is likely these cross-currents will eventually cancel out.

More cyclical economy

Like financial markets, we expect President Trump to implement an expansionary fiscal policy of deficit-financed tax cuts and greater government spending. This will result in stronger growth over the next 2-3 years as the stimulus ramps up, but weaker growth by the end of his term when the stimulus fades. There will thus be bigger ups and downs in the business cycle (see Chart 3).



The expected tax cuts will not be nearly as large as Mr. Trump proposed during the campaign, but the price tag is still expected to be sizable at close to $1 trillion over the next decade. This includes cuts to both personal and corporate income taxes. Government spending also seems set to increase substantially, by at least $500 billion over the next decade. This will include more government spending on veterans' benefits and the military, and while more infrastructure spending is not as sure given skepticism among some congressional Republicans around the costs, President-elect Trump appears all-in on it.

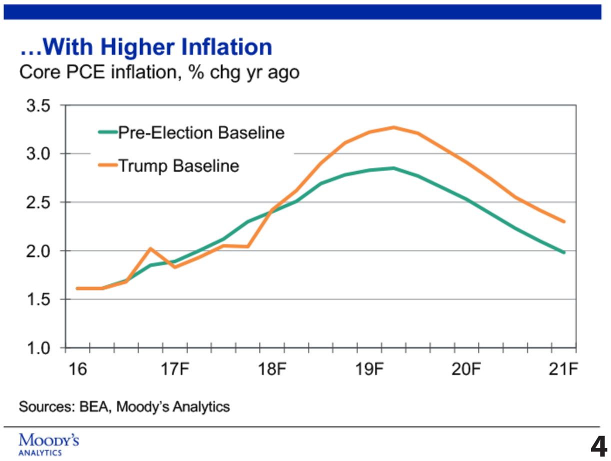
Economic growth should peak by mid-2018, when the tax cutting and spending increases are in full swing. Negating the economic benefit of the Trump stimulus is the full-employment economy. The tax and spending multipliers—the growth due to the stimulus—are much smaller than they would be if the economy was struggling with high unemployment, as it was in the Great Recession when the highly effective 2009 Recovery Act was implemented.

Indeed, in a full-employment economy, the expansionary fiscal policy is quickly crowded out by a less accommodative Federal Reserve and global investors, so-called bond vigilantes, who push up long-term interest rates in anticipation of more inflation and bigger deficits. Higher inflation and interest rates are indeed part of our baseline scenario, with core consumer price inflation breaching 3% on a sustained basis, well above the Fed's inflation target (see Chart 4 on next page). The Fed responds by increasing the federal funds rate to nearly 4% by early 2020, and the vigilantes push the 10-year Treasury yield to as high as 4.5%.

These are the classic symptoms of an overheating economy, which have historically ended in recession. We do not expect a recession, but the economy comes unnervingly close by the end of President Trump's term.

2% growth, not 4%

While President Trump will mean big changes for the economy, his policies aren't expected to materially change long-term growth prospects. Prior to the election, long-run potential real GDP growth—that rate of growth consistent with stable unemployment—was projected to be 2% per annum. Post-election, our estimate of the economy's potential has not changed.



To be sure, long overdue corporate tax reform should provide a meaningful boost to the economy's potential. Lower marginal rates and the adoption of a territorial tax system will lower the cost of capital for businesses and prompt greater investment. More investment and a larger capital stock will lift labor productivity growth and the economy's growth potential. But this boost will need time to develop, much longer than Trump's term as president, and although it will be a meaningful addition to growth in the long run, it is not the game changer that the new president is hoping for. The economy's growth potential may increase from 2% to 2.25%, not Mr. Trump's stated 4% goal.

Moreover, President Trump's anti-globalization stance will eventually catch up to the economy. It will lead to a smaller workforce as some undocumented workers leave the country and fewer legal immigrants come. Global trade also suffers as the nation pulls away from trade deals and skepticism increases around our trading relationships, all of which impedes competition and productivity growth.

Economic policy during the Trump presidency can take many alternative paths, and Moody's Analytics will consider many of them. However, under most scenarios the economy is more cyclical and its long-run growth potential is unchanged.

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Dr. Zandi is a co-founder of Economy.com, which Moody's purchased in 2005.

Dr. Zandi conducts regular briefings on the economy for corporate boards, trade associations, and policymakers at all levels. He is often quoted in national and global publications and interviewed by major news media outlets, and is a frequent guest on CNBC, NPR, CNN, Meet the Press, and various other national networks and news programs.


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Economic Outlook Symposium: Summary of 2016 results and 2017 forecasts

by William A. Strauss
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Federal Reserve Bank of Chicago

According to participants in the Chicago Fed's annual Economic Outlook Symposium, the U.S. economy is forecasted to grow at a pace slightly above average in 2017, with inflation moving higher and the unemployment rate edging lower.

The Federal Reserve Bank of Chicago held its 30th annual Economic Outlook Symposium (EOS) on December 2, 2016. More than 100 economists and analysts from business, academia, and government attended the conference. This *Chicago Fed Letter* reviews the forecasts for 2016 from the previous EOS, and then analyzes the forecasts for 2017 (see Figure 1 on next page) and summarizes the presentations from the most recent EOS.

The U.S. economy entered the eighth year of its expansion in the third quarter of 2016. While the nation's real gross domestic product (GDP) is at its highest level in history, the rate of economic growth since the end of the Great Recession in mid-2009 has been very restrained. During the 29 quarters following the second quarter of 2009, the annualized rate of real GDP growth was 2.1%—just slightly above what is considered the long-term rate of growth for the U.S. economy. Additionally, the annualized rate of real GDP growth over the first three quarters of 2016 was 0.3 percentage points below the average of the current expansion.

The biggest drags on growth during 2016 were weak investment (both business and residential) and government spending. Real business fixed investment fell by an annualized rate of 0.8% in the first three quarters of 2016. Possible culprits for this weak performance were moderate growth in the overall economy; excess capacity remaining in the industrial sector; the collapse of energy prices lowering investment in the industrial sector; the strong international value of the U.S. dollar; and economic uncertainty during this past presidential election year. After growing at an annualized rate of 7.1% between the middle of 2010 and the end of 2015, real residential investment dropped to an annualized growth rate of 2.3% during the first three quarters of 2016. Even though residential spending declined, the annualized rate of housing starts increased to 1.17 million for the first 10 months of 2016—up 6.6% relative to the same period in 2015. The level of real government spending was unchanged during the first three quarters of 2016—well below the 1.2% it has averaged over the past twenty years.

Energy prices remained quite low in 2016. Specifically, the price of West Texas Intermediate oil averaged $45.73 per barrel in November—above the $42 it averaged in the fourth quarter of 2015, but still well below the nearly $80 per barrel it averaged in the ten years before the collapse of oil prices in the middle of 2014.

Consumer spending expanded at a solid pace last year: Real personal consumption expenditures grew at an annualized pace of 2.9% during the first three quarters of 2016. In particular, light vehicle sales (car and light truck sales) remained very strong in 2016, with sales averaging 17.3 million units in the first 11 months of the year, 0.2% above the same period a year earlier. Given energy prices continued to stay low in 2016, more consumers chose to purchase larger and less fuel efficient vehicles than in the year before: Sales for light trucks (including sport utility vehicles) were up 6.8% over the first 11 months of 2016 compared with the same period a year earlier, while sales for passenger cars were down 8.4%. This dramatic shift in consumer demand led to a record setting share for light trucks of 60.4% of overall light vehicle sales in the first 11 months of 2016.

Against this backdrop, the economy continued to increase employment in 2016: 2.0 million jobs were added in the first 11 months of the year. Moreover, in November of 2016, the unemployment rate stood at 4.6%—a rate that would normally be considered at or below full employment. However, other measures of the labor market suggest that slack is still present. For instance, by historical standards, there remains an outsized number of part-time workers who desire full-time employment and a large percentage of unemployed workers who have been out of work for more than six months.

Inflation, as measured by the Consumer Price Index (CPI), had increased from an extremely low 0.4% in 2015 to a still quite low year-over-year rate of 1.7% by November 2016.

Economic outlook for 2017

The forecast for 2017 is for the pace of economic growth to be just above the long-term average. In 2017, the growth rate of real GDP is expected to be 2.2%—an improvement from the projected 1.8% rate for 2016. The quarterly pattern reveals a fairly steady performance for real GDP growth throughout 2017. Given that the economic growth rate is forecasted to be only slightly above its historical average, the unemployment rate is expected to edge lower to 4.8% in the final quarter of 2017. Inflation, as measured by the CPI, is predicted to increase from an estimated 1.4% in 2016 to 2.0% in 2017. Oil prices are anticipated to increase, but still remain fairly low; they are predicted to average $51.53 per barrel in the final quarter of 2017. Real personal consumption expenditures are forecasted to expand at a rate of 2.3% in 2017. Light vehicle sales are expected to ease to 17.3 million units this year. The growth rate of real business fixed investment is anticipated to rebound to a solid 3.2% in 2017. Industrial production is forecasted to grow by 1.9% this year—below its historical average rate of growth.

The housing sector is predicted to improve and continue its slow march toward normalization in 2017. The growth rate of real residential investment is forecasted to be a solid 4.5% in 2017. And housing starts are anticipated to rise to 1.20 million units in 2017—but still well below the 20-year annual average of roughly 1.34 million starts.

The one-year Treasury rate is expected to rise to 1.33% in 2017, and the ten-year Treasury rate is forecasted to increase to 2.36%. The trade-weighted U.S. dollar is predicted to rise an additional 4.7% in 2017, and the nation's trade deficit (i.e., net exports of goods and services) is anticipated to increase to $563.5 billion in the final quarter of 2017.

Conclusion

In 2016, the U.S. economy expanded at a pace roughly in line with the historical average. The economy in 2017 is forecasted to grow at a slightly faster rate than it did in 2016. Business investment and the housing sector are predicted to rebound in 2017. The unemployment rate is expected to edge down by the end of 2017, and inflation is predicted to rise to 2%.

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His research papers include analysis of the manufacturing sector, the automotive sector, the Midwest regional economy, the trade-weighted dollar, business cycles, and Federal Reserve payments operations.

Mr. Strauss has been interviewed on numerous television and radio shows and quoted in the major business magazines and newspapers. He has also provided testimony concerning manufacturing issues to the U.S. Senate.

Figure 1 - Median forecast of GDP and related items	**2015 (actual)**	**2016 (forecast)**	**2017 (forecast)**
Real gross domestic product[a]	1.9	**1.8**	**2.2**
Real personal consumption expenditures[a]	2.6	**2.6**	**2.3**
Real business fixed investment[a]	0.8	**0.1**	**3.2**
Real residential investment[a]	13.1	**-1.1**	**4.5**
Change in private inventories[b]	56.9	**23.4**	**44.2**
Net exports of goods and services[b]	-566.6	**-537.4**	**-563.5**
Real government consumption expenditures and gross investment[a]	2.2	**0.3**	**1.1**
Industrial production[a]	-1.6	**0.1**	**1.9**
Car and light truck sales (millions of units)	17.4	**17.4**	**17.3**
Housing starts (millions of units)	1.11	**1.15**	**1.20**
Unemployment rate[c]	5.0	**4.9**	**4.8**
Consumer Price Index[a]	0.4	**1.4**	**2.0**
One-year Treasury rate (constant maturity)[c]	0.46	**0.71**	**1.33**
Ten-year Treasury rate (constant maturity)[c]	2.19	**1.90**	**2.36**
J.P. Morgan trade-weighted dollar index[a]	11.6	**1.8**	**4.7**
Oil price (dollars per barrel of West Texas Intermediate)[c]	42.02	**47.93**	**51.53**

[a]Percent change, fourth quarter over fourth quarter.
[b]Billions of chained (2009) dollars in the fourth quarter at a seasonally adjusted annual rate.
[c]Fourth quarter average.
Note: These values reflect forecasts made in November 2016.
Sources: Actual data from authors' calculations and Haver Analytics; median forecast from Economic Outlook Symposium participants.

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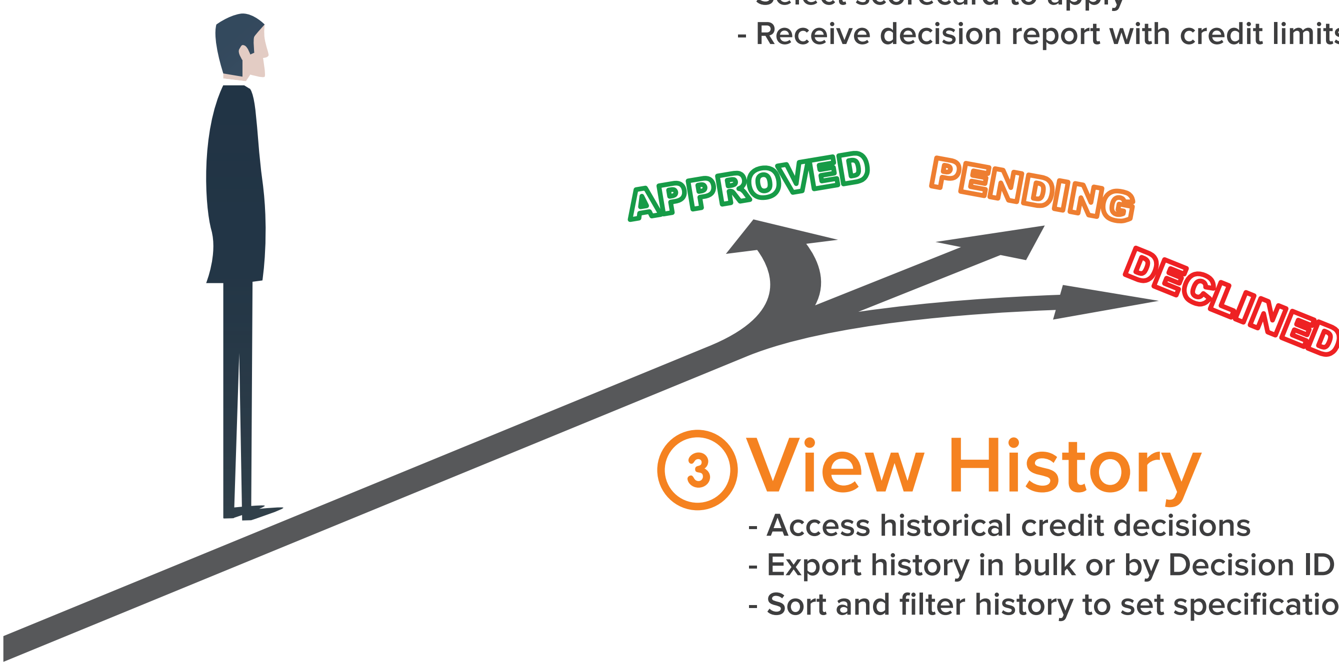

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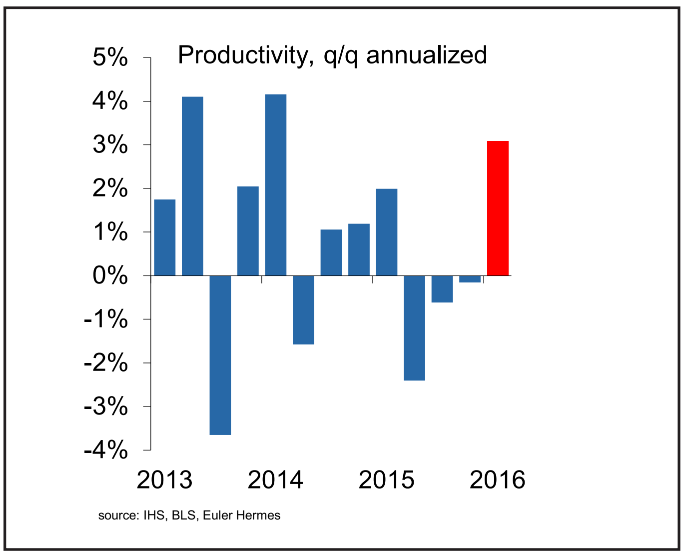
The Outlook for 2017 Sure Feels Better, but Don't Expect Fireworks

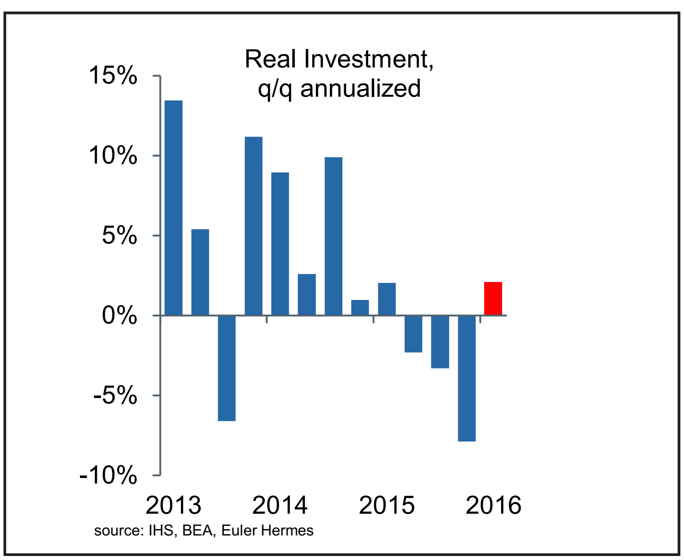
By Dan North
Euler Hermes

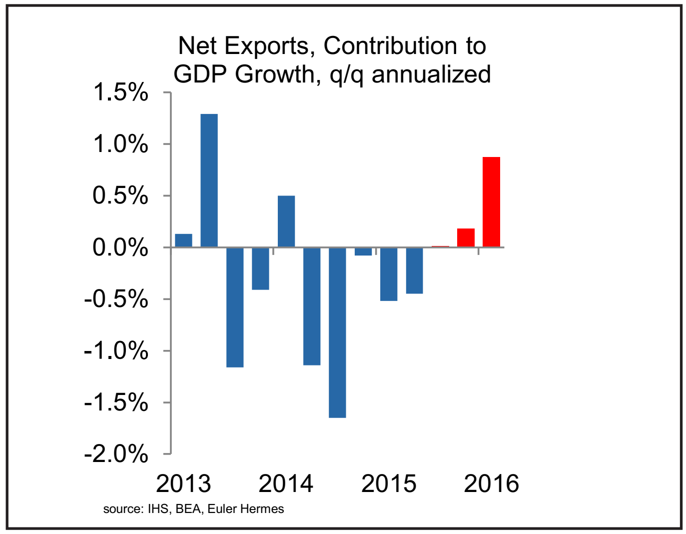
The U.S. Outlook

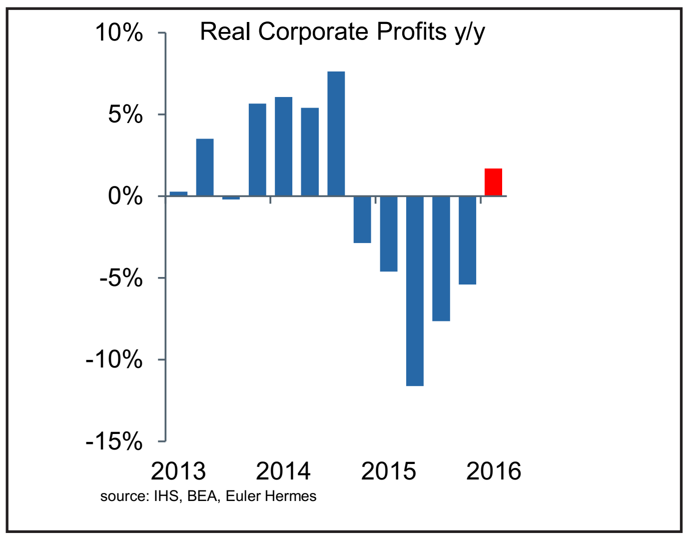
Last year in these pages we wondered, plaintively, when economic growth would return to historically stronger levels, and we concluded that unfortunately it wouldn't be in 2016. Unfortunately it won't be in 2017 either, but the outlook is certainly much better than it was last year. We expect GDP to grow 2.4% in 2017 as compared to an estimated 1.6% in 2016.

Our more positive forecast stems from a string of recent improvements in the real economy which started before the election, the surge in consumer and business confidence that started after the election, and the President-elect's pro-growth agenda.









Much of the recent data on the economy has taken a firmer tone. While the economy was barely creeping along in the first half of the year, there have been some significant improvements in the past few months, all of which point to a stronger 2017. GDP grew at an annualized rate of 3.2% in Q3, the highest in two years, after having drooled out a measly 0.8% in Q1 and only 1.4% in Q2. And the source of the growth in Q3 puts strong conditions in place to stimulate growth in 2017. Productivity, which is essential to economic growth, rose for the first time in a year, increasing at a healthy 3.1% annualized rate. Net exports contributed to GDP growth for the third consecutive quarter. Investment, a key to future economic growth, gained 2.1%, the first increase in a year. Real after-tax corporate profits finally turned positive on a year/year basis for the first time in six quarters. The upturn in investment and profits together was most welcome, because when they are both negative, which they had been for three consecutive quarters, the combination often presages a recession, and now it's forecasting an expansion.

Other measures point to future growth as well. Services, which account for 80-85% of the U.S. economy, are on solid footing. The Institute of Supply Management non-manufacturing (services) index has been in expansionary territory (above 50) every month since February 2010. In November the index gained 2.4 points to 57.2, the highest in 14 months. The index is comprised of 10 components, all of which are above 50. The critical new orders component is running at a robust 57.0 points. Separately, residential construction, which slipped in April and May, has since recovered to a y/y growth rate of +4.6%, which although substantially slower than it has been during most of the recovery, is still faster than overall GDP growth.

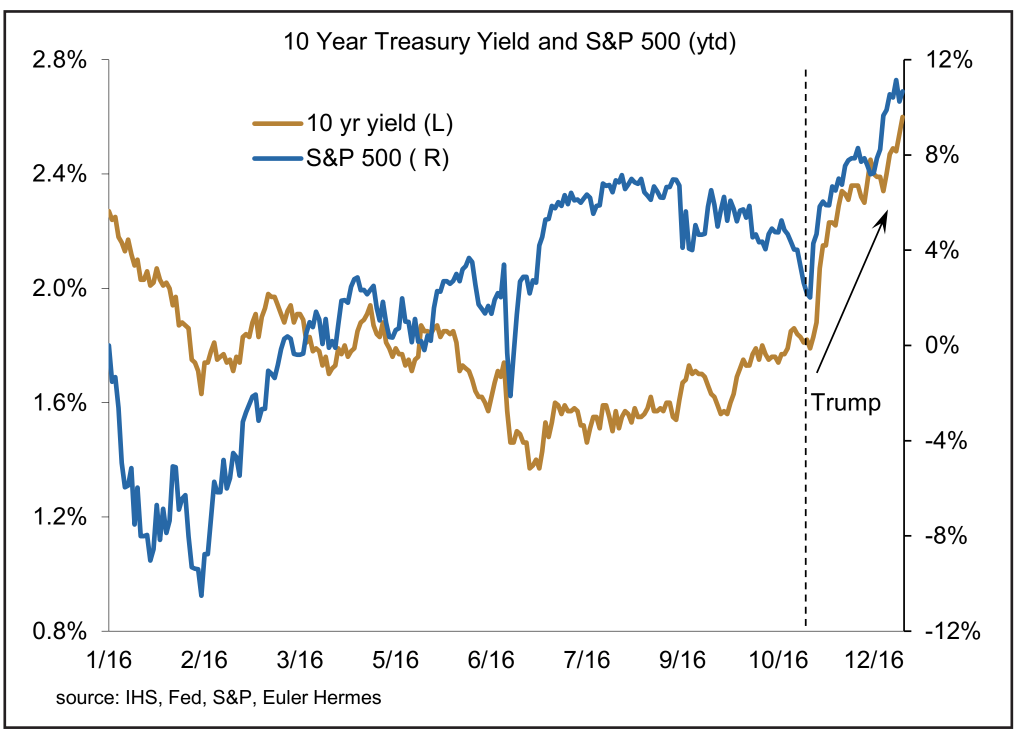
Productivity, exports, investment, profits, services, and construction are all shifting into a higher gear, suggesting that 2017 will be brighter than 2016.

And all of that happened before the presidential election. While Donald Trump's victory has upset much of the population, his proposed agenda of tax cuts, increased government spending, and deregulation are definitively pro-growth. And while we do expect these measures to contribute to GDP growth in 2017, we also think their effects will be more muted than many are expecting, in part because of the practical details of politics.

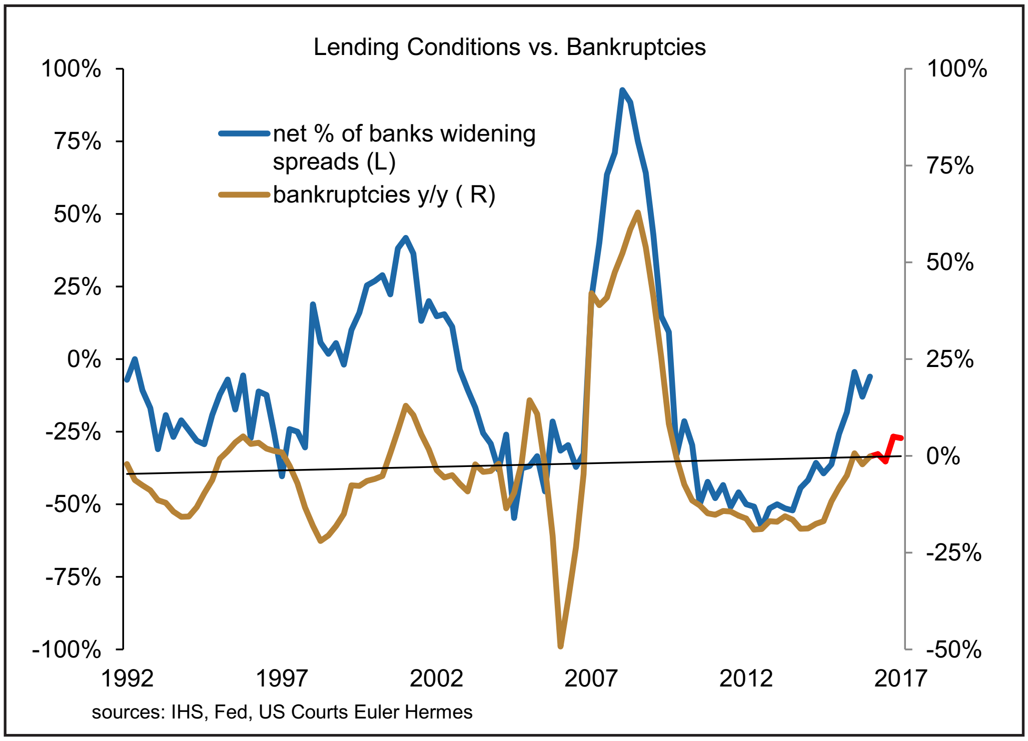
Like anyone seeking office, Trump made extravagant promises to get elected. And like any politician, he will not be able to deliver on all of them. The first major obstacle he will face is the 46 Democrats in the Senate who could hold up any measure indefinitely by filibustering, a procedure which only takes 41 votes. Most likely then, Trump will have to compromise, and his "yuge" promises on the campaign trail will have to be whittled down. Perhaps more importantly, it will take some time for his proposals to take effect. For instance, his plans to change the tax code may not come up for a vote until later in 2017, and opinions are split as to whether or not those changes will become retroactive to January 1st 2017. Similarly, his proposal to spend $1 trillion over ten years on infrastructure amounts to 0.5% of GDP per year, which would surely be welcome in a 2% GDP world, but again it will take time to legislate, appropriate, and fund actual projects.

Nonetheless, there are other more immediate ways the Trump election can affect the economy. Business optimism has risen sharply as the stock market continues to set new highs. The S&P 500 has risen 6% since the day before the election, the equivalent of a staggering annualized rate of 73%. That optimism could unleash much-needed investment, which could provide a quick boost to the economy. Consumer confidence, as measured by the Conference Board's survey, also leapt after the election, gaining 6.3 points to a very strong 107.1 in November. That's the highest level of the entire recovery and the highest since July of 2007, six months before the recession started. And since consumer spending accounts for 70% of all economic activity, there could be a positive effect on the economy immediately. Overall we expect to see a modest boost to GDP growth in 2017 to 2.4%. However, we are concerned that if his threats about global trade do come to fruition, it could damage growth in 2018 and beyond.

Other effects of his proposals include rising inflation due to increased government spending and proposed curbs on trade, which will make cheap imports scarce. The prospect of higher inflation has already caused the Fed to accelerate its pace of rate hikes in 2017 from two to three, and has strengthened the U.S. dollar. It has also caused TIP spreads to widen and sent the yield on the 10 year Treasury note soaring.



But that's also where the downside of Trump's proposals comes into play. His plan to cut taxes and raise spending would not only raise interest rates, but it would also pile on more government debt at a time when it has already reached post-WWII highs. This situation would create two major risks. First, more debt and rising interest rates are simply a bad policy combination, which would put a burden on future tax payers and impede future growth. Second, the government would have to roll over a higher amount of debt at a higher interest rate, further straining the budget. And finally, higher interest rates drive debt prices down, posing a risk to creditors whose investments in government securities would fall in value. For example, the recent increase in the yield on the 10 year Treasury note from 1.9% to 2.7% translated into an approximately 6% loss on the price of the note.



It's the same situation with private sector debt, which is also near record highs, but there is also an extra risk here - higher rates could cause a debtor to default, impairing their operations and imposing a loss on creditors. Similarly, rising rates negatively affect trade debt, especially as bankers tighten lending conditions, making it more difficult for debtors to access financing and thus leading to an increase in bankruptcies. Bankruptcies will also increase in 2017 simply because in Q3-16 they fell to a record low (except when bankruptcy laws changed in 2005 and 2006) as a result of a sharp drop in insolvencies in the oil patch. That lucky circumstance is unlikely to repeat itself, and as a result, we forecast bankruptcies to rise a modest 5% in 2017.

There are also some other negatives outside of the Trump plan. First, problems with seasonal adjustments appear to have artificially suppressed GDP readings in the first quarter during this recovery, and this problem may present itself again in 2017. Second, significant structural employment issues, such as the ageing workforce, the skills gap, and weak productivity will hamper growth in the longer term.

But the negatives in the macroeconomy and the Trump plan are surely outweighed by the positives in 2017. Improvements in productivity, exports, construction, investment and profits will all contribute to growth next year. The stable services sector will provide a firm foundation for 2017 as well. And on top of all that comes the pro-growth measures of the Trump plan, and the soaring consumer and business confidence they have inspired. It's clearly a more hopeful outlook, which we think will result in solid growth in 2017, but we just don't expect fireworks.

The Canadian Outlook

The last two years have been challenging for Canada, and yet it has remained remarkably resilient in the face of collapsing oil prices, devastating wildfires and shrinking exports. But it is these very obstacles that will set the stage for a rebound in GDP growth in 2017 to 1.9%, well above 2016's estimated 1.3% and closer to the 2.4% average over the past 30 years. In fact, the most recent data show some of this resurgence already. On a monthly basis, GDP has risen for four consecutive months through September. And after job losses in June and July, employment grew in each of the following four months for a very strong total of 148,000 jobs.

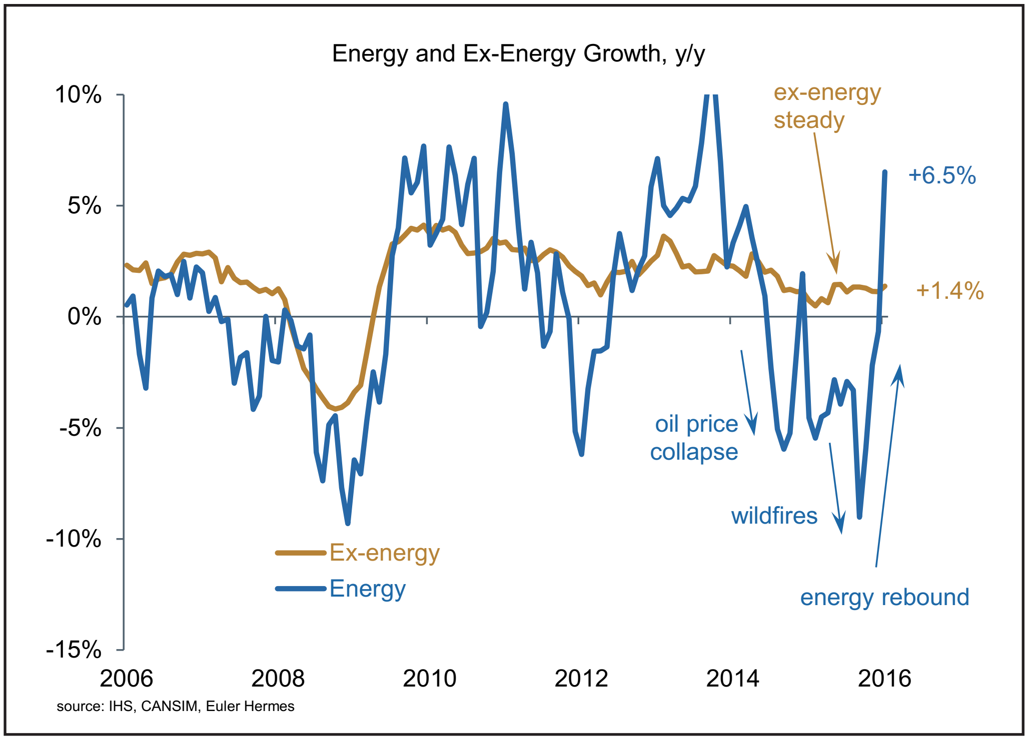
Major sectors of the economy are actually quite stable and running at reasonable growth rates. The services sector, which accounts for 70% of all economic activity, has been growing at a relatively strong +2.3% rate over the past four quarters, and more importantly has also been very steady, running between +1.6% and +2.3% over that period. Growth in personal consumption (55% of GDP) has also remained smooth during the recovery and is currently running at a +2.2% y/y rate. Similarly, the 90% of the economy which is outside of the energy sector has also been stable, growing in every month since the end of the Great Recession, and running +1.4% y/y in September. The stability of these sectors will form a strong foundation for 2017. And now the energy sector itself is making a sharp rebound (albeit form a low base), and positive growth in this sector may continue as oil prices firm.

A further boost in 2017 will be provided by the recovery from the Alberta wildfires, which whipsawed oil production in the middle of the year. While the loss of property was devastating, the Alberta government estimates that as a result of reconstruction efforts, the local economy will grow an extra 1% in 2017, or around +0.2% of GDP for all of Canada.

Like the setbacks in the oil patch, disappointing exports through the middle of 2016 set the stage for a two-pronged recovery. First, a pickup in demand in 2017 is expected from the U.S. economy, where 80% of Canada's exports land. Second, The Bank of Canada will likely keep interest rates low since inflation appears to be on the wane, and as the U.S. Fed continues to raise rates, the Canadian dollar will remain weak and may fall even further, helping to boost exports.

The economy may also receive a lift from fiscal stimulus as the Trudeau administration has proposed deficit spending of $C30bn over each of the next two years, and a total of $C120bn over the next six years. Analysts predict that the stimulus measures will add 0.5% to GDP growth in 2017-2027. Trudeau has also signed the Comprehensive Economic and Trade Agreement (CETA) with Europe, which may provide a small impact in 2017, but is more likely to contribute to growth in 2018.

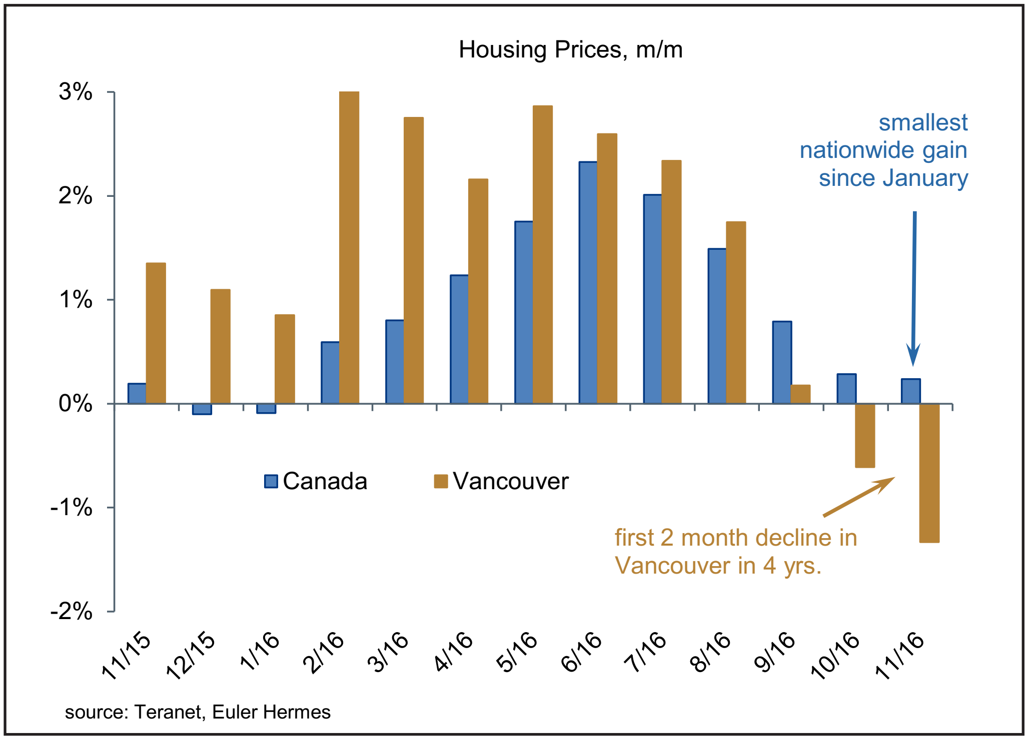
One minor risk to the forecast is that, like in the U.S., it's unlikely insolvencies can stay at their current historical lows, especially since lending conditions are tightening, making it more difficult for businesses to get funding and survive a cash flow squeeze. Therefore we expect a slight pickup in insolvencies of +2% in 2017.



However there is also a major risk lurking. Housing prices have been growing so fast that a bubble may have been formed, and if it were to burst, it could present significant risks, especially since Canadians carry such high personal debt levels. In fact, in October the Canadian Mortgage and Housing Corporation (the equivalent of Freddie Mac and Fannie Mae in the U.S.) issued a "red" warning meaning a strong risk of "problems on the horizon", but not a "crash." So in an effort to prevent a bubble from inflating, the government has recently taken measures to cool the market.

The riskiest market is Vancouver, where according to Teranet, prices rose a remarkable 24% y/y through July, or $C1,000 per day, driving the price of the average house to $C1.8 million, well out of the reach of most Vancouver natives. The rapid increase in prices appears to be driven by Chinese investors parking money offshore, so to cool the Vancouver market, the British Columbia government imposed a 15% tax on foreign buyers in August. Then in October, the federal government issued nationwide measures to tighten access to mortgages.

Those measures appear to have been effective so far. In November, prices rose an average of only +0.2% m/m in 11 major cities nationwide, the smallest increase since January. The October increase was the next smallest at only +0.3%, although on a y/y basis, prices are still growing at a steep +11.9% rate. Prices in Vancouver fell for the second consecutive month in November, losing -1.3% m/m. It was only the second time prices have fallen there in two



consecutive months in almost four years. On a y/y basis, Vancouver prices are now growing +19.3%, down from 25.8% in August. This situation should be carefully watched, as it will be tricky to slow the housing market without making it crash and damaging the economy.

Despite the risk in the housing market, the Canadian economy is poised for a rebound in 2017, driven by growth in employment and consumption, stable services and ex-energy sectors, and supportive government policies. It's not quite as bright an outlook as in the U.S., but it's certainly an improvement over the past two years.

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2017 – A Year That's Hard to Predict After the Election

By Chris Kuehl
Managing Director, Armada Corporate Intelligence

It is a good thing that nobody really expects that much from an economist when it comes to forecasting. After all, we compete with the weather people for the distinction of being wrong. After this election, we can at least assert that we are far better than the pollsters. This election has also made the task of looking deeply into the economic future that much harder. This is a whole new ball game and one that few really prepared for – even the Trump supporters were shocked at their ultimate success.

What can we say about 2017 that will make sense for more than a few days? It will come down to three sets of assertions. There are the economic developments that were going to take place no matter who won the election, the developments that are more likely to take place because the GOP now controls the White House and Congress (as well as the majority of states), and the developments that will only take place if absolutely everything goes strictly according to plan.

The first set is perhaps the easiest to identify, as many of these started already and are simply expected to continue. The interest rates set by the Fed are going to go up. They went up in December as expected and they will keep going up in the next year – probably to between 1.5% and 2.0% by the end of 2017. Along with that hike in rates there will be a hike in inflation that will be driven mostly by wage pressure, but by some commodity price pressure as well. The latter moves will be subtle and halting, but once wages start to rise they will accelerate. In recent weeks we have seen the first sign that the oil producing states are willing to start to reduce their output enough to affect prices. The shortage of skills plays into the rise in wages as companies are required to pay more to get the people they need, and to hang onto those they already have.

The third thing you can count on is a higher valued dollar. The gains will accelerate in part due to the hike in interest rates. More and more global investors will take an interest in the US market, and they will need dollars to get in. That boosts demand and soon the dollar begins a surge that will have a negative impact on any sector in the US that relies on export demand. That includes the manufacturing sector and the farm sector. In point of fact, it will be the dollar rise that creates the most threat to the growth projections for next year. We often forget that the US relies on exports for about 14% of the national GDP (in comparison, Japan relies on exports for about 14.7% of their annual GDP).

The second set of developments are due to the change in power at the federal level. We know there will be changes, but for the moment we are not altogether sure what these will look like – precisely. Three important economic targets will be regulation, tax reform and infrastructure development. These have all been discussed for years but no real progress has been made. This may change in the new administration but not as fast as many had hoped.

Regulations rank as one of the highest priority areas for reform. The top of the priority list is the Bank Reform Act, as this 3500 page monstrosity has been the bane of the small bank's existence. The pledge has been to overhaul it and strip away the provisions that have most vexed the small and community banks that small manufacturers depend on. There will also be efforts to get bureaucracies as varied as the EPA, NLRB, OSHA and many others to back off on the kind of regulations that really serve no other purpose than to slow growth and expansion. The mood of the Trump team was made clear with the selections of an EPA head who has sued the agency repeatedly for overstepping its bounds and a Labor Secretary that has lobbied against everything from a higher minimum wage to various proposals that support unions.

Tax reform is always easier to talk about than to execute but the idea is to cut taxes on those that will spend, and on business so that there is more investment. The tax system now really favors the very rich and those that don't pay taxes at all, and the burden falls on the middle class and the small business community. Tax reform will be the responsibility of Congress and there is no more agreement now than there was last year, but there is a strong feeling that now is the time to tackle some of the longer standing issues. Look for lower corporate taxes and an attack on the maze of tax breaks and exemptions that allow major companies to avoid taxes and leave the burden on the small and medium businesses.

The infrastructure boost has been discussed for years but there is always the same issue – how to fund it. The need is for an investment of over a trillion dollars, but that would be a monumental budget buster. The plans are to somehow engage the private sector investor in this effort, but that means prioritizing projects that have revenue connected – toll roads and bridges, and projects where there can be fees charged. There is also talk of providing business a deal so that they will be encouraged to repatriate their overseas funds. There is one idea that would allow them to bring 75% of that money back tax free if they spent the remaining 25% on an infrastructure bond that would create a fund that could be drawn upon for these projects.

The third set of developments will rely on many things going just right. New trade deals may be hammered out that are better for the US and there may be more cooperation from countries that want to keep working with the US. It is also possible that trade wars break out and everybody loses. The most important factor as far as manufacturing growth is a workforce that is ready to take the sector to the next level, and it is not something that can happen overnight. If there is a commitment to filling the jobs we already have available, it will advance the economy far more than creating new ones that we can't find people for.

The workforce development issue is perhaps the most vexing and the real wild card. Throughout the campaign there was incessant commentary on the need to "create jobs" when the real issue is filling the jobs that already exist. Right now it is estimated there are close to a million available in manufacturing alone, 300,000 in trucking, and another 300,000 in construction. The fast growing medical sector is short of physical therapists, occupational therapists, nurses of all description and even doctors. There are very few sectors that are not seeking new entrants, and once these employees are added, there is a struggle to keep them. Fixing this will be anything but simple as it will require cooperation between businesses, the educational sector and the people that will be expected to train for these new jobs.

This will be a tumultuous year – that much is certain. The verdict on the last eight years was essentially negative and there will be a mandate to change things. The problem is that few are really certain what needs to be changed and what should be expected to replace it. The economy at the end of 2016 was strong, and that provides some momentum for 2017. How long this can be sustained will be the big question.

In terms of the more common indicators of whether the economy is performing well or not, there are important caveats with each of them. Many use the GDP numbers to assess whether the economy is healthy or not, but bear in mind, it takes months to really know the final number – there are always revisions as data becomes clearer and starts to replace the estimates. We are ending 2016 with decent growth of around 3.0% and that is likely to be the case through most of 2017. The other important caveat is that the country is huge as compared to any other in the world. Each state compares to a country as far as GDP is concerned – California has the same GDP as France, and in most years it ranks as the sixth largest economy in the world. Texas has a GDP the size of Canada. The fact is that each region of the country is experiencing different rates of growth and expectations.

The same issue applies as far as employment is concerned. The official U-3 rate at the end of 2016 was 4.8%, but the U-6 version is closer to 10%; and if one adds in the workers that dropped out more than four years ago, the rate is around 17%. Then there is the fact that some states have rates well below the national average and others are well above. In the last few years, the lowest rates have been in the middle of the country – in states that have largely rural populations. This is significant as it is due to the fact that people without jobs in the rural communities are far more likely to leave for places that may have better job prospects than those in urban areas.

As mentioned earlier, there is inflation now and it is due primarily to the hike in wages. This will not be a commodity led surge in inflation but rather one that is due to the shortage of workers in select areas. There has been plenty of focus on the number of workers needed in manufacturing, transportation and even construction, but there are shortages of physical therapists, occupational therapists, veterinarians, dentists and pharmacists. The fact is that many schools are struggling to get students graduated as quickly as these professions and many others require. The shortage means that people are being paid more in order to attract them, and most importantly, people are getting paid more so that they do not elect to go work somewhere else.

The stock market has been a source of wonder this year and many expect something bad to happen – a bubble burst that causes a rapid decline. At the moment there does not seem to be this kind of bubble forming in any of the traditional sectors, but it is very clear that the US markets are surging due to the influx of foreign investment. The opportunities are limited in Europe or Asia and that has attracted those investors to the US. This is the reason for the stronger dollar as well. The long term fear is that Europe gets its act together and that money supporting the US economy begins to flow back to the places it came from. If that happens too fast, the markets will lose a lot of value very quickly. For the moment it doesn't appear the Europeans are poised to turn things around, but it is worth paying attention to.

There is one last thing to be aware of and it is perhaps the most fluid. The growth that has been noted in the latter part of 2016 and the enthusiasm for the coming year has been due in part to an expanded sense of consumer and business confidence based on the outcome of the election. The expectation is that Trump and the GOP will fix everything that was assumed to be broken during the last eight years. This is the usual honeymoon period following a change in political power. Given the grand promises and weak specifics in the campaign, there will be many that will be disappointed with reality. Many changes will not come at all and others will take far longer than people have patience for. The expectation is that the honeymoon lasts maybe six months and then there will be mounting frustrations and complaints that will erode that good mood.

Politically the divides are as intense as ever and the Democrats have already geared up to block as much of the GOP agenda as possible as the GOP tried to do when Obama was in office. Those that did not like the gridlock of the last few years will not like the coming gridlock any better.

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Armada's clients include YRC Worldwide, TranSystems, Spencer Fane Britt and Browne, KPMG, Hallmark International, Weitz Industrial among others.


A Data-Inspired Decision
A Growth-Inspired Team

The New Normal is Here to Stay in 2017

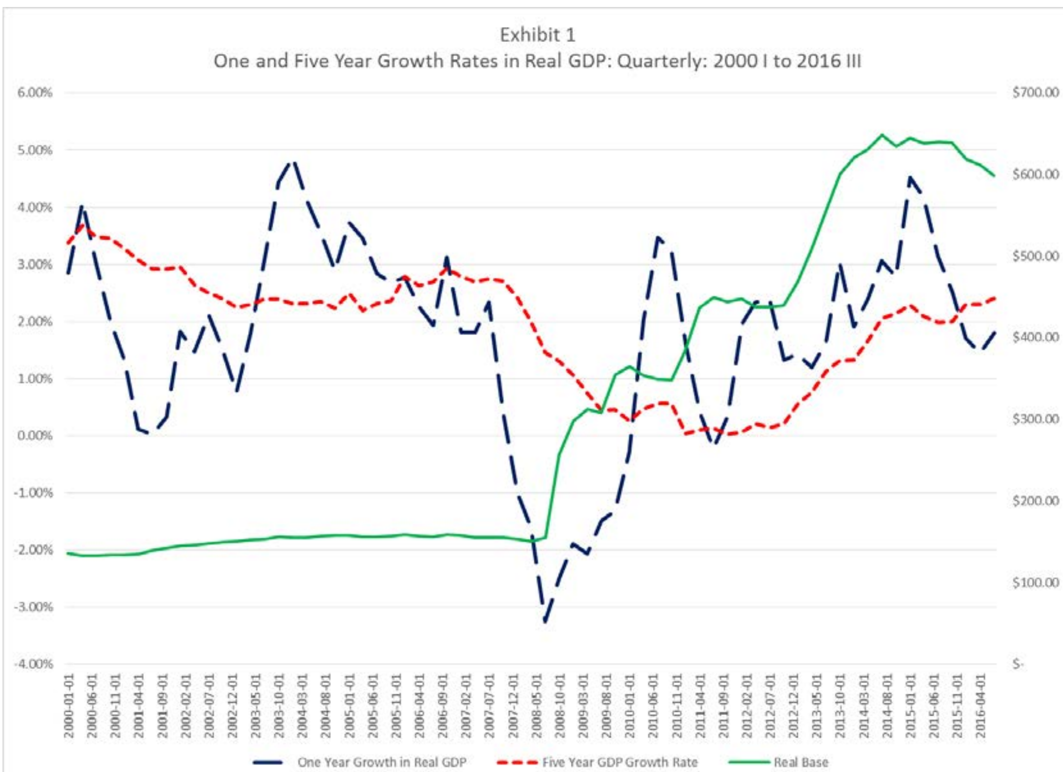
By Steven C. Isberg, Ph.D
Senior Research Fellow
Credit Research Foundation

The new economic "normal" has unpacked its bags and settled in for the long haul. The two key questions to follow this year are: 1) What will be the impact of the Federal Reserve's return to a "normal" monetary policy characterized by higher interest rates and less monetary growth? 2) What will the new presidential administration be able to do while it operates with a "friendly" Congress over the next two years, but more specifically, within the first 100 days of its term?

Here is what to watch for in 2017, and what it might all mean.

What to watch: Gross Private Domestic Investment

At least part of the downshift in economic growth can be attributed to decreases in real gross private domestic investment over the same period of time. As can be seen in Exhibit 2 (next page), the five-year growth rate in real gross private domestic investment, which includes private residential housing investment, peaked in the third quarter 2014, and has steadily fallen as the Federal Reserve has reduced the size of the monetary base and increased interest rates.

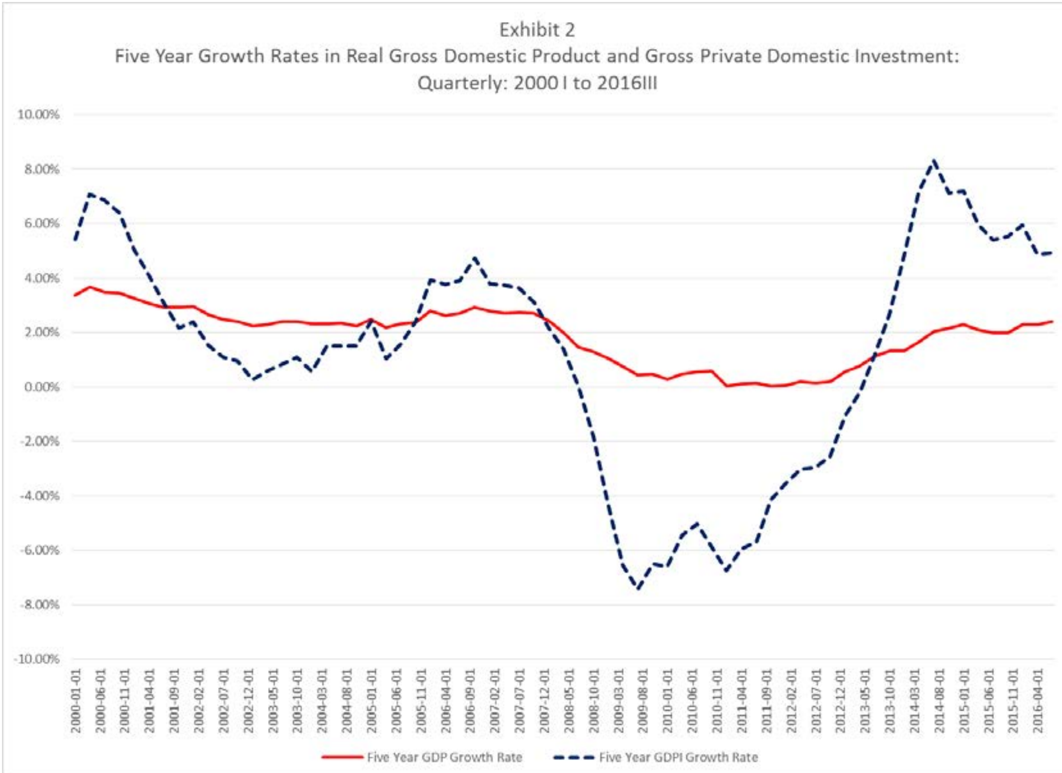


The primary character of the new economic normal is quite simple: lower and slower growth. As can be seen in Exhibit 1, as the Federal Reserve slowly shuts down the monetary spigot by phasing out its policy of quantitative expansion in 2014, the one-year growth rate in real GDP fell steadily from the first quarter of 2015 through the second quarter 2016. As can also be seen, this squelched the momentum observed in the five-year growth rate in real GDP, which seems to have stabilized at about 2.3% in the past two years.[1]

As a result, gross private domestic investment will be a key indicator of the direction in which the economy will head in 2017 and beyond. The impact of the most recent Federal Reserve interest rate increase on investment will become evident over the next ten to twelve months. The national average interest rate on 30-year mortgage loans, which stood at 3.44% in July 2016, is now at 4.30%[2]. As can be seen in Exhibit 3 (next page), neither housing prices nor total

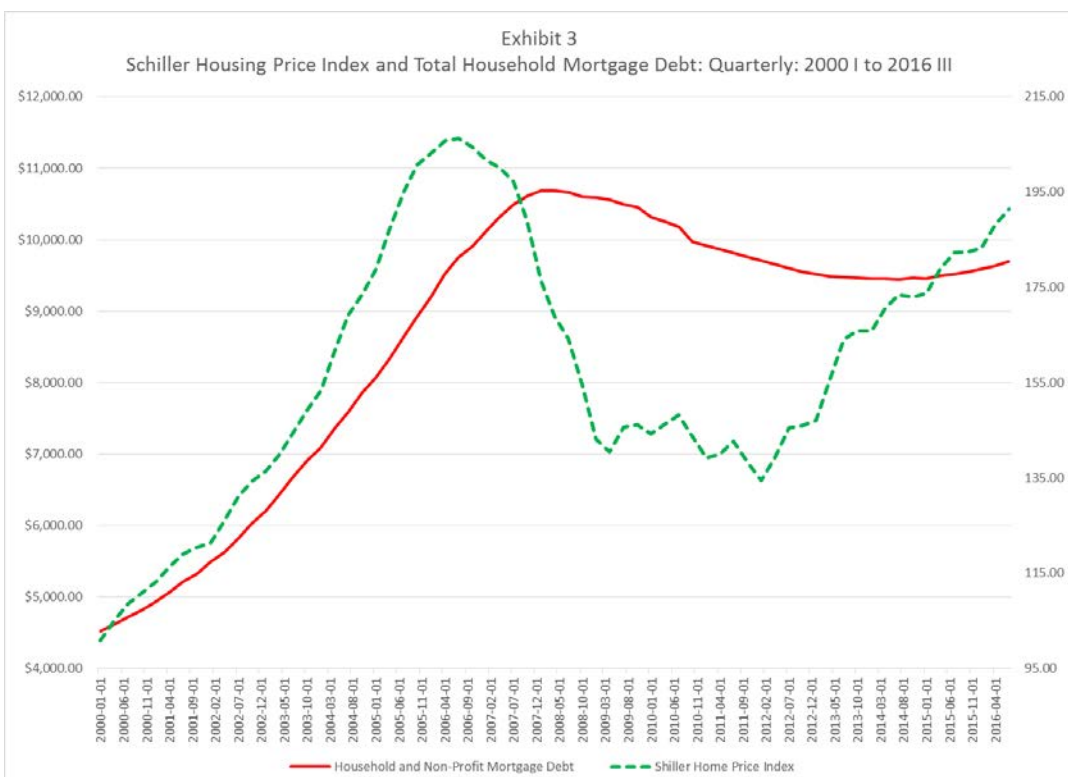
1 Data source: Federal Reserve Bank of St. Louis, Economic Database

2 *Wall Street Journal*, 28 December 2016



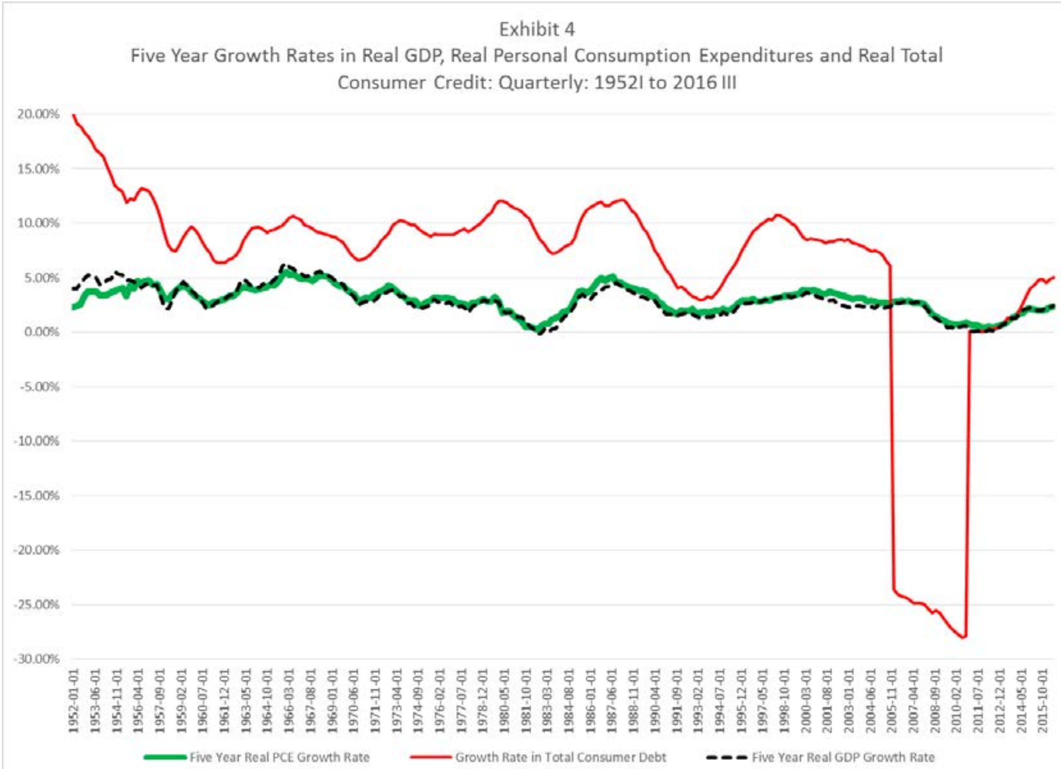
mortgage debt outstanding have returned to levels reached prior to the real estate and financial market meltdowns of 2006-2008. This may slow potential growth in the housing market over the next 12 to 18 months.

Housing has always been a key element of gross private domestic investment, and therefore a key driver of economic growth, especially since the turn of the century. From the first quarter 2000 through the third quarter 2005, the ratio of real private residential investment to private non-residential investment grew from 31% to 53%. From there, it fell to a low of about 20.3% between third quarter 2010 and second quarter 2012. While it has grown back to about 30%, it has leveled off since interest rates have increased. Higher and/or rising rates do not bode well for prospective growth in the housing market this year.[3]



3 Data sources: Federal Reserve Bank of St. Louis, Economic Database

Rising corporate borrowing rates may also result in elimination of lower returning private investment projects, as investment hurdle rates increase as a result of Federal Reserve policy changes. The prime rate has already increased by 50 basis points in the past year.[4]



Whether the new administration will be able to implement policy aimed at increasing gross private ***domestic*** investment will depend upon a variety of political factors yet to be experienced. President-elect Trump is different from any individual ever elected to the presidency in that none of his prior professional experiences relate to politics. Efforts on the part of Congress and the administration may be hampered by a stronger US dollar, which will lower the cost of offshore investment and increase the tendency for the US to import rather than consume domestically produced goods. Raising tariffs as a way to keep production in the United States will yield higher prices at a time when consumer budgets continue to be constrained (more on this below). Lowering taxes as a way to keep production in the United States may put more pressure on federal and state governments to manage increasing budgets and avoid further indebtedness (more on this below). Back in the 1980s, President Reagan was able to enact tax reform and grow the US military, but could only do so by the largest expansion of federal government borrowing up to that point in time. To wit: many of the incoming administration's policy ideas are easier said than done.

What to watch: Consumer spending and debt

As prior research has shown, much of the post-World War 2 growth in US real GDP has been fueled by the use of consumer credit. Likewise, at least part of the reason that the new normal for the economy is characterized by lower GDP growth is that the growth in and structure of consumer credit have changed substantially dating back to the turn of the century. [5]

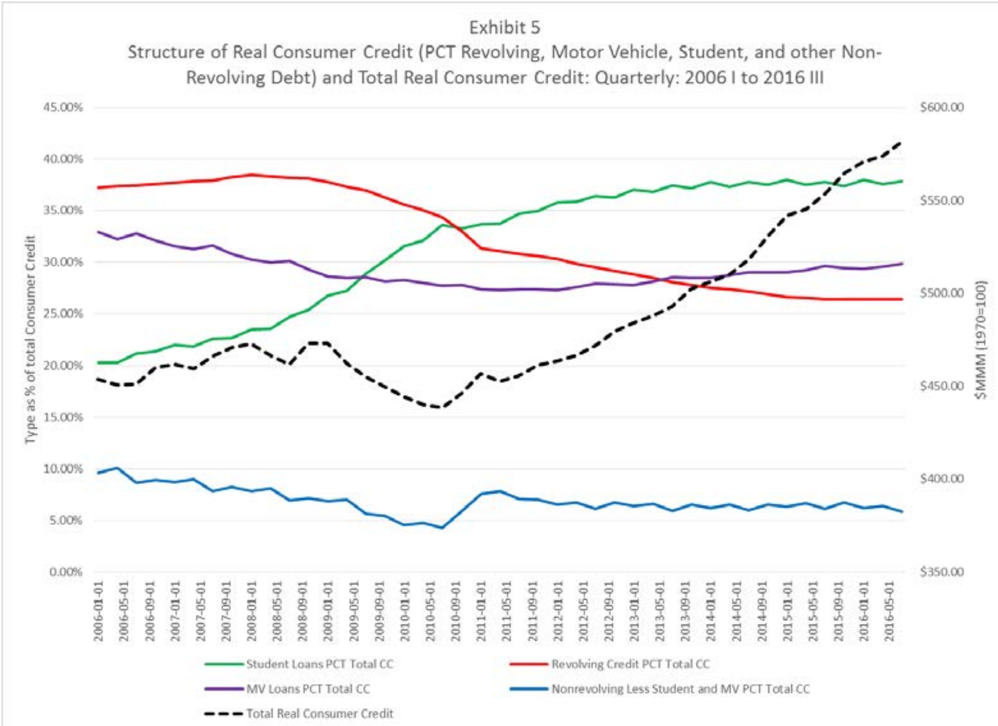
The use of consumer credit increased dramatically in the years following the Second World War, as the population relocated to the suburbs and borrowed money to purchase automobiles and other consumer durables. As can be seenin Exhibit 4, the five-year growth rate in real consumer credit averaged around 10% from the late 1950s through the late 1980s. While it dipped substantially in the early 1990s, it had returned to the 10% level by 1998. Over that same post-WW2 time period, the five-year rate of growth in real GDP tracked the five-year rate of growth in personal consumption almost exactly. It is important to note, however, that the growth rate in consumer expenditures was lower than the rate of growth in consumer credit, implying that more and more of our economic growth was consumer-credit-driven.[6]

The 2008 financial market meltdown, however, caused the consumer credit market to virtually collapse. As can also be seen in Exhibit 4, growth in consumer credit began to slow after 2000, and it was matched by a slowing in the five-year growth in both real consumer spending and real GDP. In 2008, however, the growth rate almost instantaneously fell to negative 24%, bottoming out at negative 28% in late 2010. As can be further seen in Exhibit 4, growth in real consumer spending and GDP recovered as consumer credit growth resumed.

4 ***Wall Street Journal,*** 28 December 2016

5 Steven C. Isberg, Ph.D; "Economic Realignment, Consumer Income, Debt, and Spending: Impacts on the Sustainability of Growth," ***Credit and Financial Management Review***, Second Quarter 2014

6 Data sources: Federal Reserve Bank of St. Louis, Economic Database



Since 2010, changes in the structure of consumer credit have limited its ability to spur real GDP growth through increases in consumer spending. As can be further seen in Exhibit 4, the five-year growth rate in consumer credit as of the third quarter 2016 (about 5.00%) has outpaced growth in real consumer spending and GDP, at 2.40% and 2.32% respectively. This can, at least in part, be explained by the fact that the consumer loan portfolio now consists of a greater percentage of student loan debt, and lower percentages of revolving credit, auto loans, and other forms of non-revolving credit.

As can be seen in Exhibit 5, student loan debt has risen from 20% to over 37% of total consumer credit since 2006. At the same time, revolving credit has fallen from its high of 38% to about 26.5% of consumer credit. The remaining 6.5% of the shift is explained by lower percentages made up of auto loans and other forms of non-revolving consumer credit.[7]

This structural change in the use of consumer credit is a sword that cuts in multiple directions. Replacement of credit driven consumption by credit driven investments in education will have the short term impact of reducing growth in consumer spending, and hence will slow growth in the general economy. As debt-financed students graduate and presumably get into the workforce at higher earnings levels, future consumption expenditure growth should follow. This may be slowed down, however, by the need for those graduates to service that accumulated student debt, reducing the amount of income allocated to spending, and also limiting access to other forms of consumer credit and even mortgage debt.

Studies and statistics show that those in possession of a college degree are earning more than those without college degrees. As of 2015, median earnings for holders of bachelor's degrees were over $70,000, while for those with no more than a high school education were just over $36,000. As of 2014, 63.5% of the labor force did not possess a college degree.[8]

A key factor to watch over the next few years will therefore be the impact on median earnings as more individuals having college degrees enter the labor force. The rate of job creation will need to at least keep pace with the rate at which these graduates enter the labor force in order for compensation levels to be maintained or even grow. Surpluses of college educated job candidates will put downward pressure on compensation if new jobs are not created by the economy.

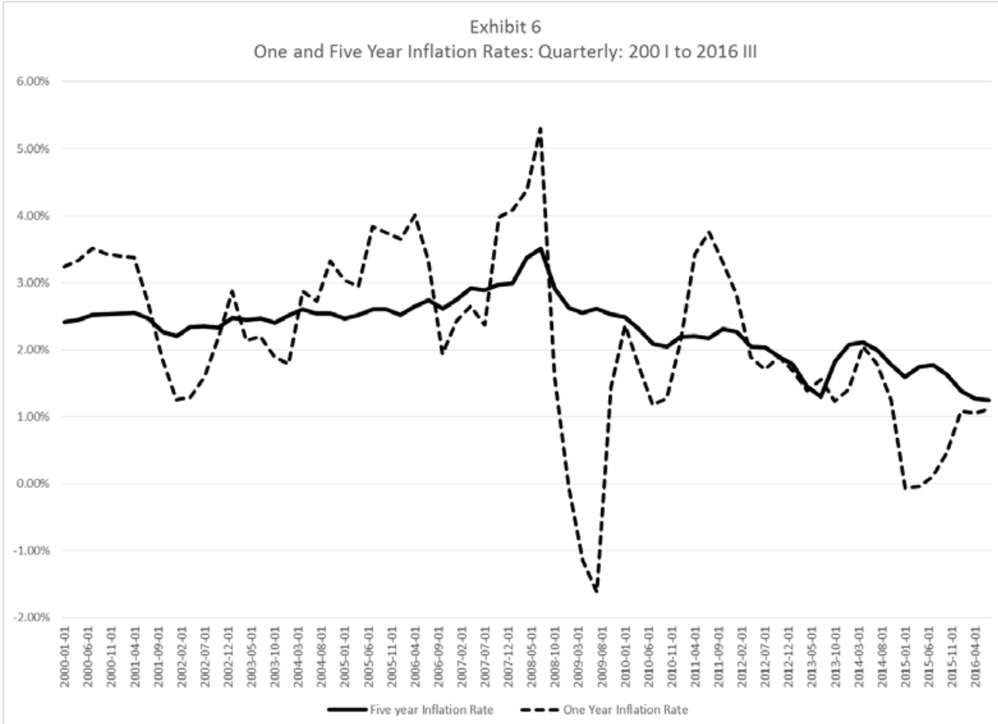
Here is where we can connect back to the issue of private domestic investment. Job growth will be correlated to private domestic investment growth. If the latter is squelched either by higher interest rates, a stronger dollar, or failed government policy, graduating students will be forced to deal with a weak job market and high levels of accumulated debt that will require immediate servicing. This would have a negative impact on consumer spending and could push the economy back into recession.

What to watch: inflation

One of the chief concerns about the impact of the quantitative easing in which the Federal Reserve engaged from 2008 to 2014 was inflation. In spite of the enormity of the expansion in the monetary base over that time period, high inflation did not materialize, and today, the rate lies well below the rate of 2.0% targeted by the Federal Reserve in maintaining its

7 Ibid.

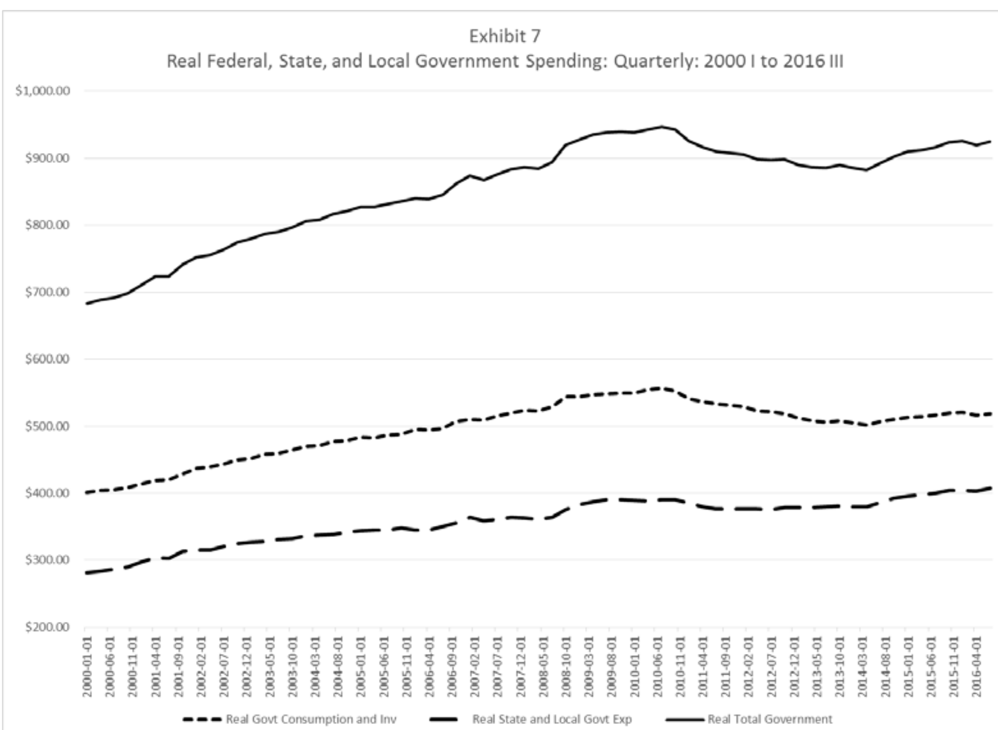
8 U.S. Department of Labor, Bureau of Labor Statistics

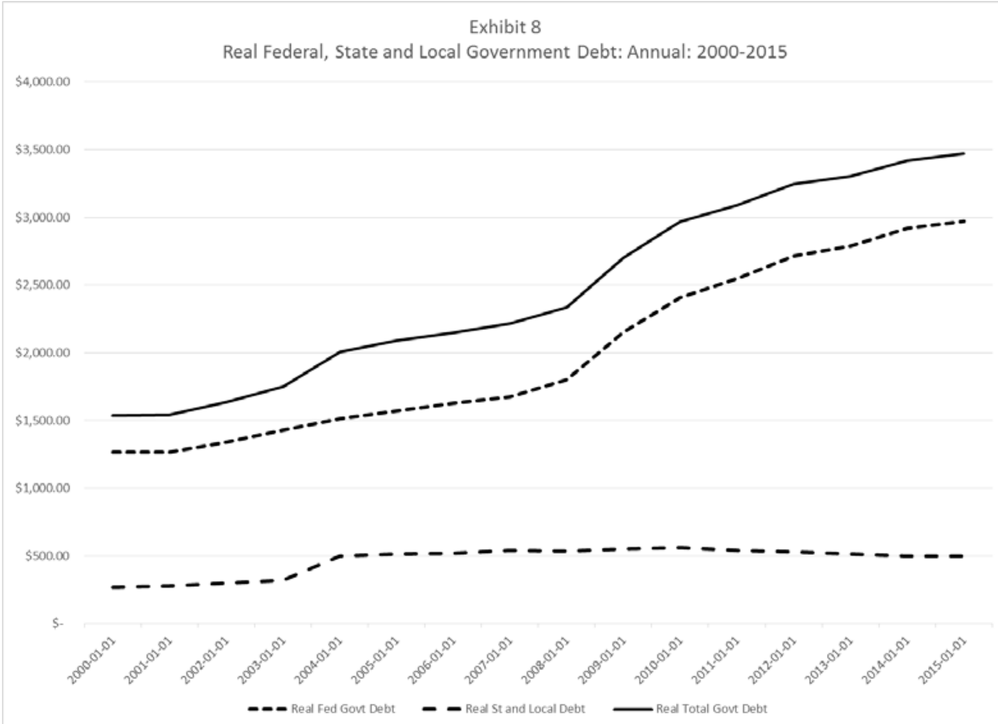


monetary policies. As can be seen in Exhibit 6, both the one-year and five-year rates of inflation, measured on a quarterly basis, generally fell during the period of heaviest monetary expansion, between 2011 and the end of 2013. As can be further seen, both rates grew to the 2.0% target level by the middle of 2014, at which time the Federal Reserve had begun to taper its quantitative easing program. By 2015, both rates had again fallen, and continued to do so through the initial interest rate increase at the end of 2015. Since then, the inflation rate has stabilized at just above 1.1%[9].

One of the main purposes of quantitative easing, not only in the US but in Europe and other economic zones, was the avoidance of a deflation that could have brought down the debt markets in those areas. As the Federal Reserve continues to "normalize" monetary policy, possibly continuing to gradually increase interest rates, deflation may again become a concern. The combination of monetary tightening, slow private investment growth and a sluggish job market would have a negative impact on aggregate demand, and therefore, put deflationary pressure on price levels. While deflation can be weathered in an economy with little debt, the impact of deflation on the western economies could cause a catastrophic meltdown in the debt markets,

9 Data sources: Federal Reserve Bank of St. Louis, Economic Database





led by the government and followed by the mortgage market segments. As a consequence, inflation will remain a factor to watch closely in the coming year.

What to watch: government spending and indebtedness

Government spending cannot be relied upon as a means for providing economic growth, and in fact, it may be useless as a tool for even stimulating the economy in the short run. Federal, state and local government spending appears to have reached their maximum levels in real terms given tax revenues and the ability of governments to continue existing on borrowed funds. As can be seen in Exhibit 7 (previous page), real government spending at the federal level peaked in the third quarter of 2010, whereupon it fell off and has only slightly risen in the past two years. The same pattern is evident in regard to real state and local government spending, which has been fairly level for the past seven years.

In spite of the leveling off in real federal government spending, the real federal debt level has continuously risen, accelerating after the collapse of the credit markets in 2008, and continuing to grow at a declining rate through the end of 2016. Real levels of state and local government debt have remained relatively steady over the same time period, most likely because most states are required to operate under balanced budgets. The nominal level of gross federal debt now tops $18 trillion, which when added to state and local government debt, results in total government indebtedness of well over $22 trillion. Continued growth in accumulated federal debt is unsustainable, yet has been projected to continue well into the next decade. While infrequently mentioned during the presidential campaign, it will be an issue that the new administration will need to confront in a meaningful way[10] as can be seen in Exhibit 8.[11]

10 Ibid.
11 Data sources: Federal Reserve Bank of St. Louis, Economic Database

At this point in time, it is too early to understand what the economic policies of the Trump administration will look like at the operational level. The president-elect has talked about infrastructure expansion, increases in military spending and tax breaks designed to keep manufacturing and other business within the domestic borders. How these policies will become operational in the short run without leading to an increase in the growth rate of federal indebtedness is problematic, and it will be very important to see how the transitional policies influence economic growth at the ground level.

If interest rate increases lead the economy back into recession and or create deflationary pressure in the economy, the administration may be forced to pursue a rapid intervention designed to mitigate the impact of those events or make the hard choice to allow the economy to adjust to lower price levels in a recessionary environment. While the latter may be better for the economy in the long run, it would be a painful experience in the short run. It could cause a deep recession and make it difficult for the presi dent-elect to pursue many of his other initiatives. In such a case, debt markets would need to be restructured and socio-political tension may rise due to worldwide recession.

Overall Outlook for 2017

At best, we should expect economic growth to continue at a slow rate. Higher overall economic growth would require additional growth in private domestic investment levels, including the housing sector, and such growth does not seem likely. The job market will continue to be unattractive for candidates who lack college degrees and/or sound technical skills. Even if the number of potential employees possessing college degrees were to increase, the labor market will need to expand in order to accommodate them. It is most likely that the gap that has developed between the economically successful and the unsuccessful, which has been expanding since the 1970s, will continue to widen in 2017. Rising government debt levels will continue to constrain that institution's ability to serve as any kind of economic growth engine, not that we should assume that it is appropriate in that role in the first place.

As the dollar strengthens, imported goods will become more affordable, and could lead to increases in our trade deficits. While this is not necessarily bad for consumers, it will not be good for domestic manufacturing. A stronger dollar may also increase incentives for companies to invest offshore, where their dollars will go further.

At worst, rising interest rates could lead to a further downshift in private domestic investment and push the economy back into recession. This could be exacerbated by deflationary pressure on prices. As mentioned above, this could lead to substantial default activity in both the governmental and consumer debt markets, including the mortgage market, and call for debt restructuring as a result. This would be a very difficult process to manage in an orderly fashion, and it could threaten the stability of the financial system as a whole.

The economic wild card seems to be the incoming administration and its new economic and foreign policies. Once again, it is too early to tell just how much of his plan President-elect Trump will be able to implement, whether a Republican congress will be cooperative, and how foreign governments and the global economy will respond. In any case, it should be an interesting year.

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