U.S. ECONOMICS 2016 YEAR AHEAD: The long and winding road

"With the U.S. economy hitting full employment, wage and price inflation should inch higher, supporting a super-slow Fed hiking cycle."

– Ethan Harris, Co-head of Global Economics Research

Our view

Rate hikes coming – but we don't see a rate shock: While the Federal Reserve appears finally to be ready to start increasing rates, the impact on the financial markets is not likely to be dramatic. The Federal Reserve has prepared the markets, with talk of rate hikes literally for years. The markets are pricing in a very high probability of a hike in December 2015, and are shifting closer to the three or four hikes we expect in 2016. Gradual and well-signaled rate increases should mean a modest response by U.S. risk assets, not the "taper tantrum" of 2013. Foreign assets, likewise, should remain calmer this time.

Four reasons for some GDP optimism looking ahead: As we see it, (1) The economy has already proved resilient in the face of shocks, weathering both the "taper tantrum" and rate hike worries; (2) Most of the big global shocks, such as to mining and manufacturing, already have been absorbed; (3) While mining and manufacturing have been hit, they are just 15 percent of the economy, and the other 85 percent – such as construction, services and government – actually has picked up a bit; (4) If growth is weak, the Fed – which has shown flexibility and a willingness to calibrate policy in the past – is likely to step in.

Steady as she goes: The strong dollar has been a headwind for the industrial and export sectors, but the consumer and services sectors are doing well. Moreover, we see few signs of late-cycle dangers: wage and price inflation remain muted; there is no malinvestment in housing, technology or elsewhere; and there are no noteworthy financial bubbles. The mix of a deep downturn and a gradual recovery over the past seven years means room for economic expansion probably remains. There will be a recession again at some point – the business cycle still has not been repealed – but it does not appear imminent to us.

Key calls

- **GDP growth to remain moderate but steady:** We project GDP growth staying flat at 2.5 percent in 2016, reflecting factors as diverse as demographically driven slow growth in the labor force and persistently weak productivity data.
- **Unemployment continues to edge down:** Moderate GDP growth will continue to drive the unemployment rate lower. We expect the official unemployment rate to hit 4.5 percent by the end of 2016, essentially reaching full employment.
- **Inflation edges up slightly:** With the economy essentially reaching full employment,

we project that both wage and price inflation will inch higher by about 0.5 percent and 0.2 percent, respectively, in the coming year. Core inflation will be up slightly, to 1.6 percent.

- **Up from zero:** A combination of slow but steady Federal Reserve rate hikes – we see three or four 0.25 percent increases annually in 2016 and 2017, with about a 100 basis-point rise during the coming year – and slightly higher inflation should lessen concerns about secular stagnation and being stuck at zero indefinitely.