U.S. ECONOMICS 2017 YEAR AHEAD: THINGS CAN GO SO RIGHT… AND SO WRONG

"The story of 2017 will be the change in leadership in Washington. After a slow start to the year, the economy should accelerate in the second half as tax cuts kick in. Obscured by all the thunder and lightning in Washington, the long-awaited uptrend in inflation likely has already arrived."

– Michelle Meyer, head of U.S. Economics

Our view

A quick look back to see how we got here

The wild ride this year began with a significant risk-off in the markets, in part triggered by concern of a U.S. recession. We did not see a recession but growth has slowed – current estimate of 1.6 percent – and the Federal Reserve has become more cautious, expecting a shallow hiking cycle with a lower equilibrium and terminal rate, revising the long-term Fed Funds rate to 2.875 percent.

Three themes for 2017

A trio of economic themes looks to shape the coming year:

1. A decade of Fed-led monetary easing could shift to fiscal stimulus.
2. Disinflation could shift to inflation, with fiscal stimulus, restricted immigration and restricted trade edging inflation nearly to the 2 percent target.
3. Uncertainty probably will remain, with opacity around risk factors such as shifts in government policy, both here and globally, and potential market volatility.

A seismic change in policy – but in which direction?

The main source of risk we see for the next few years comes from policy changes in Washington. With little clarity thus far, our 2016 baseline reflects the most likely outcomes: tax reform based on the House plan with a small amount of infrastructure and defense spending; China declared to be a currency manipulator; possible renegotiation of NAFTA; and small changes to immigration policy, but no new tariffs, no attempt to compromise the Fed's independence and no mass deportations.

Other policy outcomes are possible, including some with upsides for the economy (tax reform, greater infrastructure/defense spending, no significant changes to trade or immigration policy). We also could see outcomes with downside potential, including no infrastructure spending, tariff wars with China and Mexico, and faster deportation of immigrants. This creates policy uncertainty unlike any in decades.

Growth: Shifting forward to the second half
Assuming our baseline, the combination of tighter financial conditions and policy uncertainty will restrain growth in the first half of 2017. However, the second half should see a rebound in growth as tax cuts kick in and stimulate growth, offsetting the drag from a stronger dollar.

Inflation: Approaching target
Disinflation resulting from low commodity prices, global output gaps and depressed inflation expectations was the big concern a year ago. The reality was different: We saw inflation in stock valuations and home prices, but stubbornly slow wage and price inflation. We are now seeing acceleration in both wage growth and consumer prices. Core personal consumption expenditure (PCE) inflation increased 0.3 percentage points over this year, to 1.7 percent year over year. We expect another 0.2 percentage point gain in 2017 to 1.9 percent, and to hit the 2 percent target in 2018.

The Fed: Slower now, faster later
The Fed is likely to deliver a hike in December 2016, but likely will wait until September 2017 to move again. However, there is a risk the Fed could deliver two hikes next year – in June and December – if the forecasted first-half weakness fails to materialize. Looking ahead to 2018, the Fed could hike three times as GDP growth accelerates to a mid-2 percent pace, the unemployment rate falls further, and core inflation exceeds the 2 percent target.

Risks: Scenarios for 2018 and beyond
Given the uncertainty around policy changes, we believe the risks to the economic outlook are larger than normal. There are two major tail risks. In the upside scenario, substantial infrastructure spending could grow the economy by 3 percent in 2017 and 3.5 percent in 2018 while inflation accelerates – with a risk of more Fed hikes, slowing growth in 2019 and beyond. The downside scenario could occur if Washington dysfunction and a focus on trade restrictions and the deportation of immigrants undercut growth, possibly leading to a full-fledged recession by 2018.

Key calls

- We expect a slow start to the year but acceleration in the second half as tax cuts kick in.
- We are forecasting 2.3 percent growth in the second half of the year. On net, this leaves growth of 2.0 percent for the full year. The robust end to 2017 also kicks off 2018 on a strong footing; we are forecasting 2.5 percent growth for 2018.
- The long-awaited uptrend in inflation has already arrived. Core PCE inflation likely will come just shy of the 2.0 percent target by year-end.
- We expect only one rate hike in 2017, coming in the second half, as the Fed holds off because of heightened uncertainty at the beginning of the year combined with tighter financial conditions; a midyear hike could come if growth is higher than expected. We expect three hikes in 2018.