Interest Rates Move to the Center Stage

David Shulman
Senior Economist, UCLA Anderson Forecast
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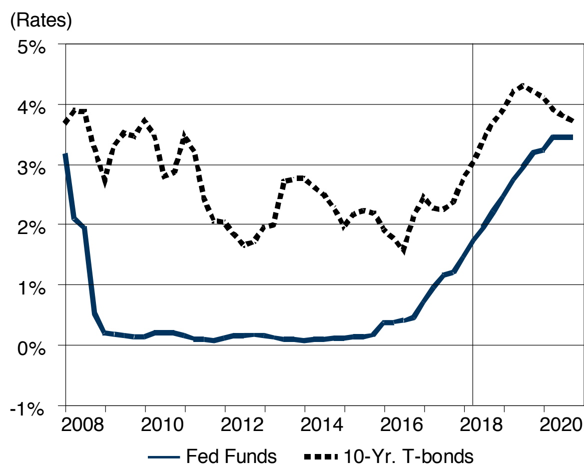
The era of ultra-low interest rates is behind us. With the yield on the 10-year U.S. Treasury Note surpassing 3% and with the Federal Reserve set to push up the Fed Funds rate above 2%, interest rates are well on their path to normalization. (See Figure 1) To be sure, we are not forecasting yields to reach their pre-crisis levels of 5%+ for both short-term and long-term rates, **but a Fed Funds rate north of 3% and a 10-Year Treasury yield north of 4% for late 2019 will seem awfully high compared to the past decade.**

Figure 1 Federal Funds vs. 10-Year U.S. Treasury Bonds, 2008Q1 -2020Q4F



Sources: Federal Reserve Board and UCLA Anderson Forecast

The rise in rates is being propelled by high inflation, higher wages, an exploding federal deficit and the quantitative tightening policy adopted by the Federal Reserve. An added wrinkle is the sale of fixed income securities by corporations utilizing their newly repatriated cash to buy back stock.

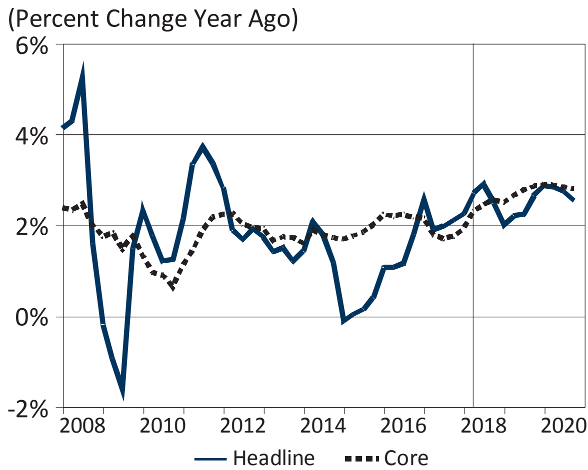
The Italian Job

Our interest rate forecast is largely based on domestic considerations. Now, all of a sudden, a political crisis involving the Euro in Italy along with monetary problems in Argentina and Turkey has triggered a flight to quality causing 10-Year treasury yields to plummet 30 basis points from 3.1% to 2.8% over a two-week period. **The flight to quality can best be seen in the Euro-area bond markets where over a four-week period ending May 29, Italian 10-Year yields spiked by 138 basis points from 1.8% to 3.18% while German yields were cut in half dropping from 58 basis points to 26 basis points. However, markets calmed down the next day.** At this point we do not know how this will work out and it will largely be dependent on the Italian electorate's position on the Euro. If the electorate decides to leave, we will face a currency/solvency crisis in the heart of Europe bringing with it even lower yields. While if the Italians decide to stay, yields will quickly snap back to where they were before. Because we do not view ourselves as experts on Italian politics we will stick to our U.S. interest rate forecast based on domestic considerations. Recall post-Brexit after dropping precipitously in the summer of 2016, markets quickly normalized.

The Domestic Backdrop for Higher U.S. Interest Rates

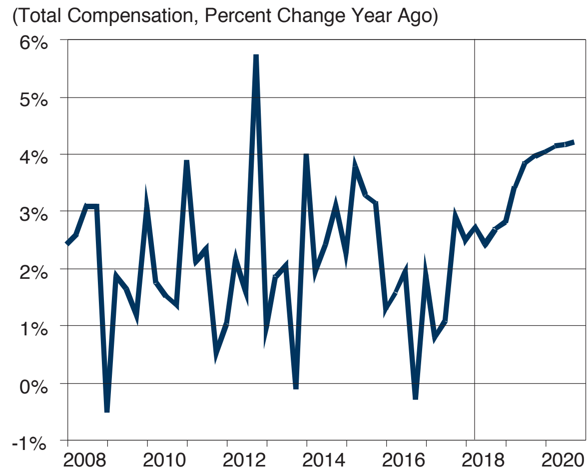
With year-over-year inflation as measured by the consumer price index already exceeding 2% and likely to be in the 2.5%-3% range over the forecast period, real bond yields, instead of being negative, will run in the 1%-2% range. (See Figure 2) Further, with the economy operating at full employment, wage increases will break out of the 2.5% recent growth rate to approach 4%. (See Figure 3)

Figure 2 Consumer Price index vs. Core CPI, 2008Q1 -2020Q4F



Sources: Bureau of Labor Statistics and UCLA Anderson Forecast

Figure 3 Employee Compensation, 2008Q1 – 2020Q4F



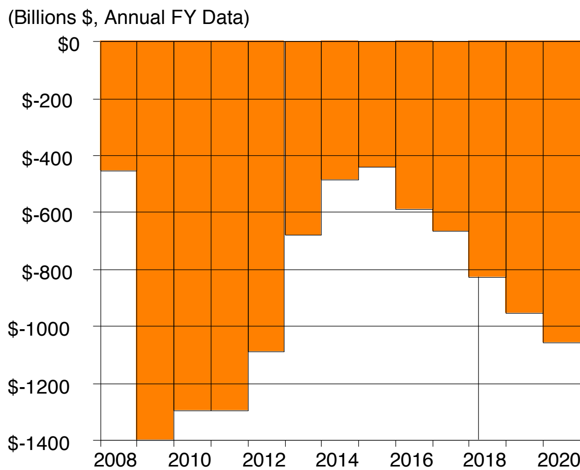
Sources: Bureau of Labor Statistics and UCLA Anderson Forecast

Further upward pressure on interest rates will come from the Fed's policy of quantitative tightening as it continues its course to reduce its balance sheet from approximately $4.4 trillion to about $2.8 trillion over the next few years. Thus, instead of buying bonds as it did during 2008 – 2015, the Fed has become a net seller. (See Figure 4) Adding to the supply is the Trump Administration's all-out fiscal policy of spending hikes and tax cuts layered on a fully employed economy. As a consequence, the federal deficit is forecast to increase from $666 billion in 2017 **to $1.06 trillion in 2020.** (See Figure 5)

Figure 4. Federal Reserve Assets, 2006 – 23May2018, In $Billions

Source: Federal Reserve Board

Figure 5 Federal Deficit, FY 2008 – FY 2020F

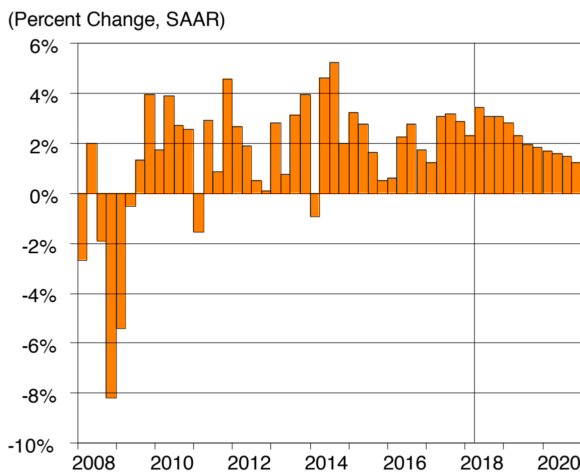


Sources: Office of Management and Budget and UCLA Anderson Forecast

The 3-2-1 Economy

Although we expect real GDP growth to pick up to 3%+ for the balance of the year, up from the first quarter's 2.3% pace, we expect growth to fade in 2019 and 2020 as higher interest rates take their toll. In round numbers on a fourth quarter-to-fourth quarter basis, think of the economy growing at 3% in 2018, 2% in 2019 and 1% in 2020. (See Figure 6) Another way of looking at it is that a fully employed economy has difficulty growing without substantial increases in productivity.

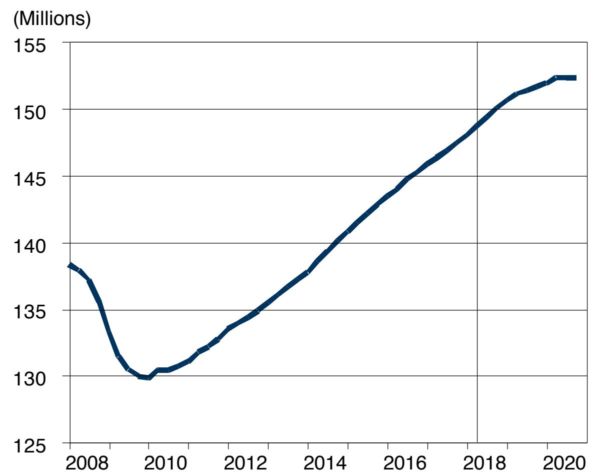
Figure 6. Real GDP Growth, 2008Q1 -2020Q4F



Sources: Department of Commerce and UCLA Anderson Forecast

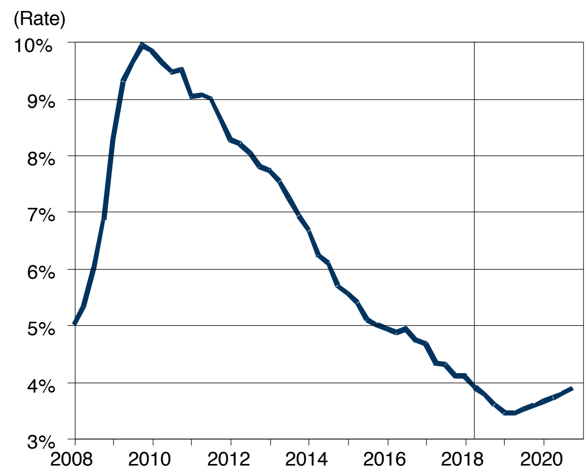
As the economy bumps against its full employment ceiling, job growth will noticeably decelerate over the forecast horizon. For example, employment growth averaged 200,000 jobs/month in 2017; it will average 133,000/month for the remainder of this year and then decline to 85,000/ month and 60,000/month in 2019 and 2020, respectively. (See Figure 7) Concomitantly, the unemployment rate will decline from its current 3.9% to 3.4% in mid-2019 and then gradually return to 3.9% by the end of 2020. (See Figure 8)

Figure 7 Payroll Employment, 2008Q1 – 20120Q4, In Millions, SA



Sources: Bureau of Labor Statistics and UCLA Anderson Forecast

Figure 8 Unemployment Rate, 2008Q -2020Q4F, SAAR

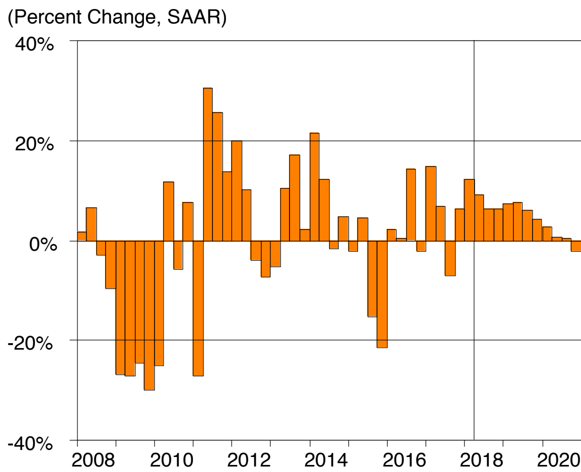


Sources: Bureau of Labor Statistics and UCLA Anderson Forecast

Business Investment Drives the Bus

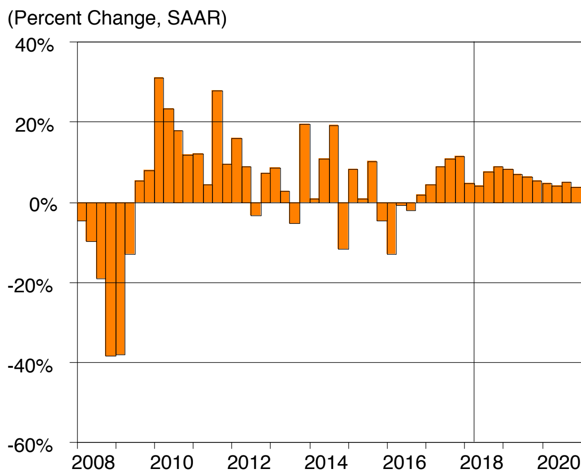
Spurred by a major reduction in corporate tax rates, 100% expensing for equipment purchases and deregulatory policies coming out of Washington, D.C., we forecast business investment to continue to be the driving force in the economy. For both 2018 and 2019, we forecast real investment in both business equipment and structures to increase at an approximate 7% clip. (See Figures 9 and 10) However, growth will slow in 2020 as the effects of 100% expensing wane.

Figure 9 Real Equipment Spending, 2008Q1 – 2020Q4F



Sources: U.S. Department of Commerce and UCLA Anderson Forecast

Figure 10 Real Investment in Business Structures, 2008Q1 -2020Q4

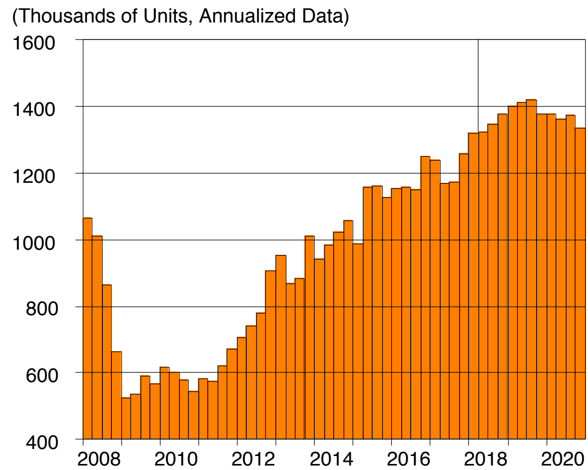


Sources: U.S. Department of Commerce and UCLA Anderson Forecast

Housing Activity Growing, but Less than Robust

Housing activity has been the great disappointment of the economic recovery and expansion that began in 2009. To be sure, housing starts have more than doubled off their moribund lows of 2009-2011, but still remain well below their long-term average and a far cry from the earlier boom periods.[1] Specifically, we are forecasting housing starts to increase from 1.21 million units in 2017 to 1.34 million units and 1.40 million units in 2018 and 2019, respectively. (See Figure 11) However, we see housing starts declining in 2020 to 1.36 million units as the lagged effects of higher interest rates and a slowing economy inhibit new construction.

Figure 11 Housing Starts, 2008Q1 -2020Q4F



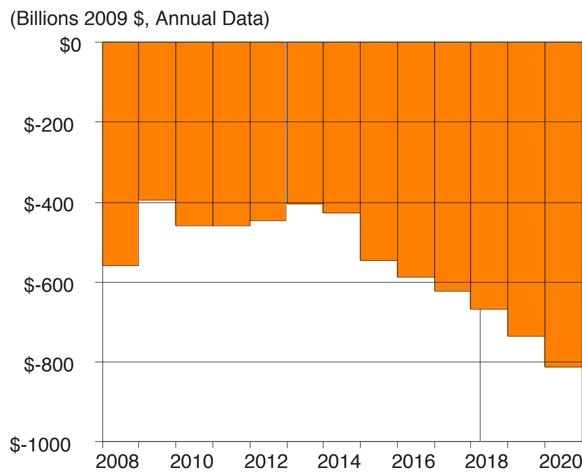
Sources: Bureau of the Census and UCLA Anderson Forecast

Trade Remains the Biggest Downside Risk

Despite all of the bluster, some of which is legitimate, coming out of the Trump Administration decrying the U.S. trade deficit, the trade deficit, in terms of real net exports, is forecast to increase from $622 billion in 2017 to $814 billion in 2020. (See Figure 12) Why? The trade deficit is the result of the U.S. consuming more than it produces which is the result of a very low national savings rate. Thus, in order to reduce the deficit, the U.S. has to save more and/or produce more domestically. Over the near-term it is hard to produce more, but the high deficit fiscal policy of the Trump Administration reduces national savings requiring

1. See Shulman, David, "The Best of Times and the Worst of Times for Housing," UCLA Anderson Forecast, June 2018

Figure 12 Real Net Exports, 2008Q1 -2020Q4F

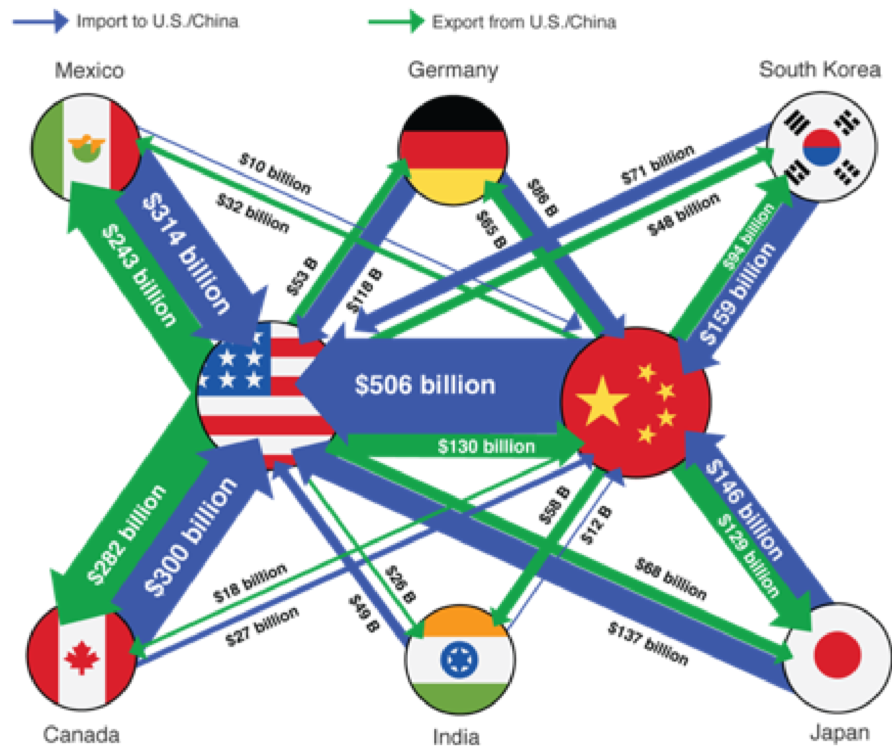


Source: U.S. Department of Commerce and UCLA Anderson Forecast

us to import more. All the Trump Administration can do is move around the trade deficit among our import partners.

The risk to the forecast is that with all of the talk about a trade war with China and repealing NAFTA, we can sleepwalk into a serious economic accident. For example, in 2017 the U.S. imported a total of over $1.3 trillion dollars of goods from China, Mexico, Canada, Japan and Germany. (See Figure 13) A trade war implies higher tariffs and non-tariff barriers that work as a tax on the American people that would raise prices and restrict output. That is hardly the recipe for economic growth. And because it is hard for import using industries to shift sources in the short-run, there exists the threat of very real economic dislocations. **Put bluntly, the administration is playing with fire** and the recent nervousness in the stock market is beginning to reflect the risks associated with a trade war.

Figure 13



Source: Barrons

Conclusion

The U.S. economy is leaving behind a very long period of ultra-low interest rates. Interest rates are in the process of normalizing with 10-year U.S Treasury yields reaching 4% and the Fed Funds rate surpassing 3% as economic growth accelerates and inflation exceeds the Fed's magic 2% level. High fiscal deficits and the Fed's quantitative tightening policy will put upward pressure on interest rates. Meantime, the economy, spurred by strong business investment, should grow 3% this year. However, growth will slow as the economy bumps against its full employment ceiling and high interest rates work to slow housing in late 2019 and 2020. Our simplified view is that we are in a 3-2-1 economy with growth on a fourth quarter-to-fourth quarter basis will be roughly 3% in 2018, 2% in 2019 and 1% in 2020. **The two major downside risks to the forecast is the potential for a trade war to break out with one or more of our major trading partners and for the uncertainty around Italian politics to broaden into a full-blown Euro-area crisis.**