

Regime Change

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The sudden 10% decline in stock prices (see Table) and the rise in long-term interest rates in early February signaled what economists call a “regime change.” (See Figures 1 and 2) The economic environment is changing from one of sluggish growth and low inflation to one of accelerating growth and moderate inflation. Moreover, monetary policy is transitioning from one of accommodation to one of normalization and fiscal policy is moving from a moderate

deficit to a high deficit regime with trillion dollar deficits in the on deck circle. (See Figure 3) The \$300 billion budget compromise (2 years) combined with the recently enacted \$1.5 trillion dollar tax cuts (10 years) highlighted the demise of the so called deficit hawks. Included in the budget compromise was a substantial increase in defense spending which ratified our long held belief that the era of contraction in that sector is over. (See Figure 4)

Figure 1 S&P 500 Index , 24Feb17 - 23Feb18



Sources: Standard and Poor's via BigCharts.com

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Figure 2 10-Year U.S. Treasury Bond Yields, 24Feb17 - 23Feb18



Sources: BigCharts.com

Will the 2018 Stock Market Be a Rerun of 1987?

The quick run-up in stock prices in January took place under a backdrop very reminiscent of the boom and crash in stock prices that took place in 1987. Recall that the S&P 500 advanced 33% from January-August 1987, only to decline by 39% by October. Further, like 1987 there was a Fed transition from Volcker to Greenspan in August of that year while Powell replaced Yellen in January of this year. However, unlike 1987, stocks dropped 10% in January, while in 1987 a similar drop took place in April. The Table below highlights the similarities and a few differences between 2018 and 1987.

SIMILARITIES

Indicator	January 1987	January 2018
S&P 500	+13.2%	+7.5%*
Extended Bull Market	Started 8/82	Started 3/09
Computer Trading	Portfolio Insurance	Algo Trading
Economy	Strengthening	Strengthening
Profit Growth	Accelerating	Accelerating
Dollar	Weakening	Weakening
Oil Prices	Up from lows	Up from lows
Inflation Rate	Increasing	Increasing
Fed	Tightening	Tightening
10-Year Treasury Yields	Bottoming, about to rise	Rising
Pro-Growth Tax Reform	1986 Tax Act	2017 Tax Act
Trade Tensions	Japan/Germany	China/NAFTA
White House Scandal	Iran/Contra	Russian Interference

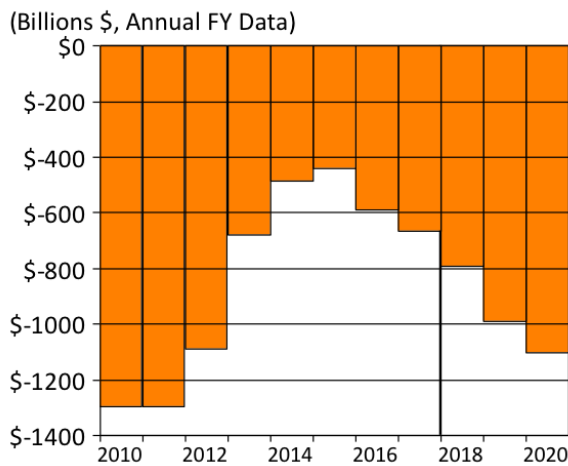
DIFFERENCES

Europe	Uniting	Dividing
Big Power Rivalry	Declining	Increasing
Shiller CAPE	14X	35X

*-As of January 26.

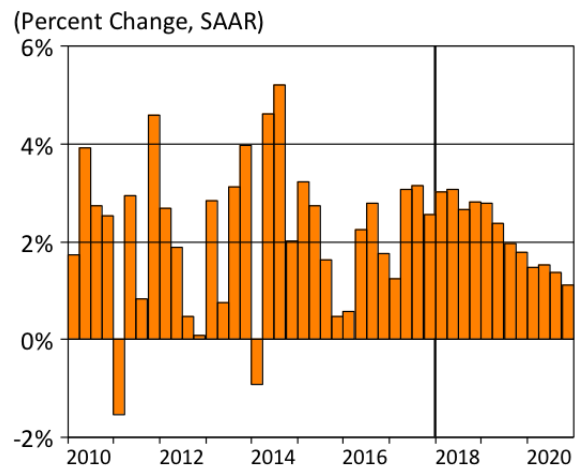
Source: <https://shulmaven.blogspot.com/2018/01/eerie-parallels-january-2018-january.html>

Figure 3 Federal Deficit, FY 2010 -FY2020



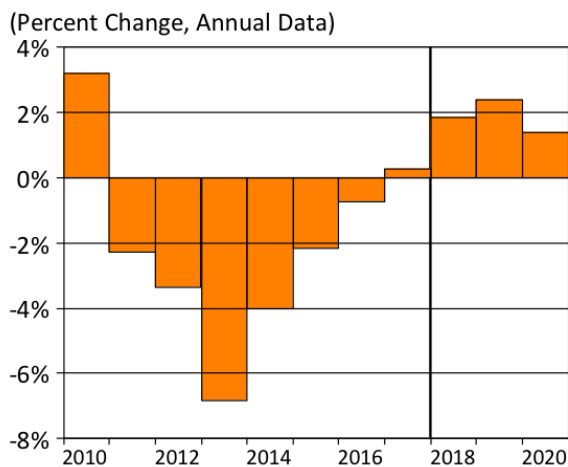
Sources: Office of Management and Budget and UCLA Anderson Forecast

Figure 5 Real GDP Growth, 2010Q1 - 20120Q4F



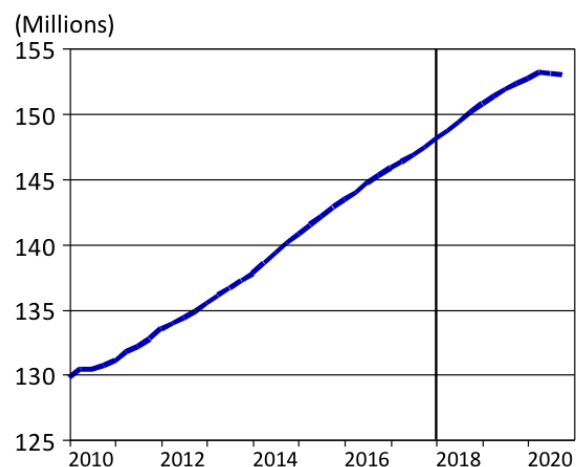
Sources: U.S. Department of Commerce and UCLA Anderson Forecast

Figure 4 Real Defense Purchases, 2010 - 2020



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

Figure 6 Payroll Employment, 2010Q1 -2020Q4F



Sources: U.S. Bureau of Labor Statistics and UCLA Anderson Forecast

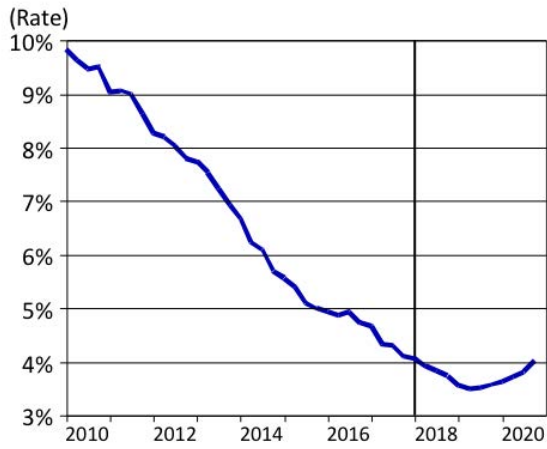
Growth Driven by Business Investment

Spurred by rising business fixed investment, real GDP growth is on track to continue its 3% pace established in the second quarter of 2017. (See Figure 5) For all of 2018 we forecast a growth rate of 2.9%, but that will slow to 2.6% in 2019 and a sluggish 1.6% in 2020. Why the slowdown? Simply put, the economy is already operating at full employment and it is bound by slow labor force growth and sluggish productivity. Nevertheless, job growth will continue, albeit at a slower clip than in recent years and the unemployment rate will hit 3.5% in early 2019. (See Figures 6 and 7)

As we mentioned above, the key driver of the economy will be business fixed investment. All three categories of business fixed investment (equipment, intellectual property and structures) will be expanding robustly in 2018 with real equipment spending leading the way with a gain of 8.4%. (See Figures 8, 9, and 10) Business investment is responding to pent-up demand, the near moratorium on new regulations by the Trump Administration as well as the reduction in business taxation and the new 100% expensing rules for the depreciation of capital equipment. Nevertheless, growth here will slow as the economy begins to operate at its full potential.

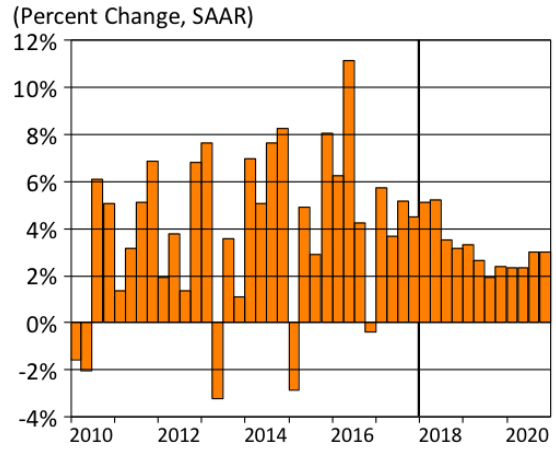
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Figure 7 Unemployment Rate, 2010Q1 - 2020Q4



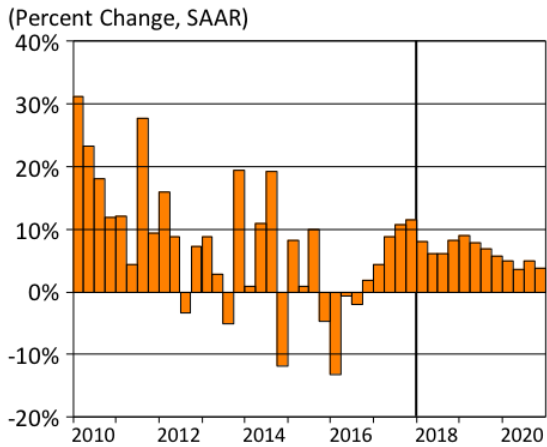
Sources: U.S. Bureau of Labor Statistics and UCLA Anderson Forecast

Figure 9 Real Intellectual Property Spending, 2010Q1 - 2020Q4F



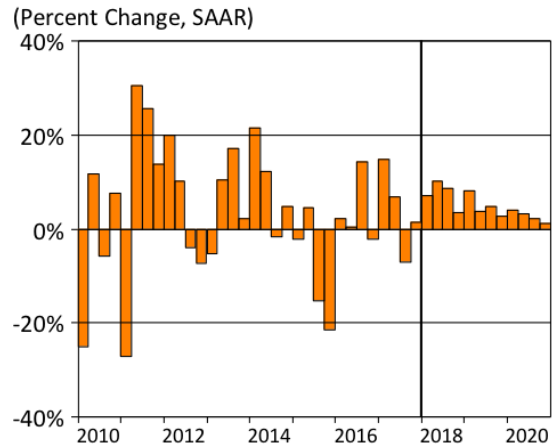
Sources: U.S. Department of Commerce and UCLA Anderson Forecast

Figure 8 Real Equipment Spending, 2010Q1 - 2020Q4F



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

Figure 10 Real Business Investment in Structures, 2010Q1 - 2020Q4F

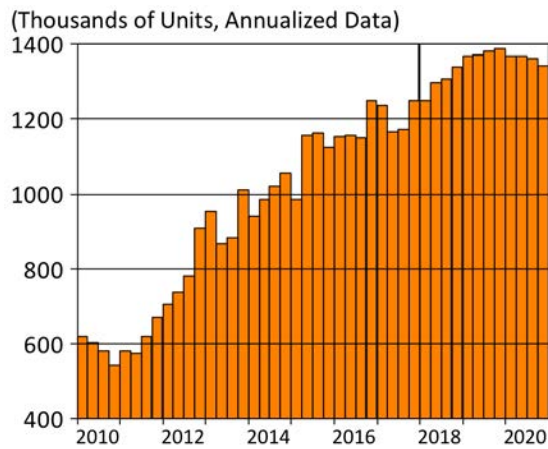


Sources: U.S. Department of Commerce and UCLA Anderson Forecast

No Boom for Housing

Although housing activity will continue to expand through 2019, it will be far from a boom. Higher interest rates (discussed below) and higher home prices will take their toll on housing starts. (See Figure 11) Simply put, if we didn't have a housing boom with mortgage rates below 4%, how will we have one when mortgage rates exceed 5%? Thus, after recording 1.2 million housing starts in 2017, we are forecasting 1.3 million units in 2018 and 1.38 million and 1.36 million units in 2019 and 2020, respectively.

Figure 11 Housing Starts, 2010Q1 - 2020Q4

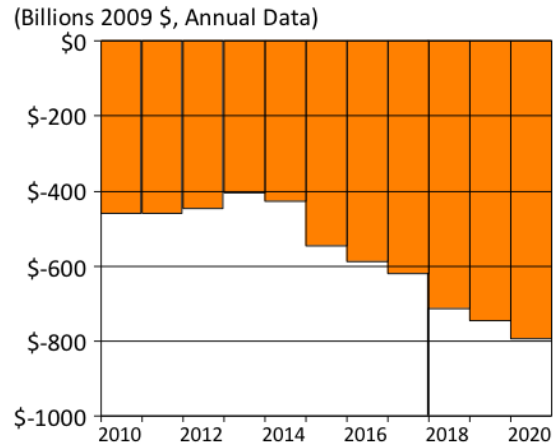


Sources: U.S. Bureau of the Census and UCLA Anderson Forecast

A Blow Out in the Trade Deficit

Although President Trump has railed against the trade deficit, the stepped up pace of economic activity along with increase in the federal deficit will cause **the trade deficit, as measured by real net exports, to increase from \$620 billion in 2017 to nearly \$800 billion in 2020.** (See Figure 12) Because the United States is consuming more than it is producing it has to make up the difference through imports. As a result, the Trump fiscal policy will be playing a major role in increasing the trade deficit. Moreover, instead of improving the situation, the Trump Administration proposals to increase tariffs on steel and aluminum will actually make things worse as domestic costs rise and foreign producers retaliate.

Figure 12 Real Net Exports, 2010 -2020

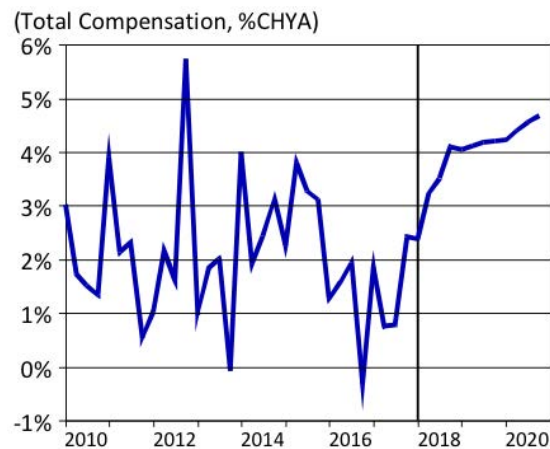


Sources: U.S. Department of Commerce and UCLA Anderson Forecast

Higher Wages, Inflation and Interest Rates Ahead

One of the triggers of the stock market sell-off in early February was a reported increase in average hourly earnings of 0.3% in January over December. Instead of using hourly earnings we prefer to use the employee compensation index as a better measure of the strength of the labor market largely because that index includes bonuses and benefits. In 2017 that index increased at a very modest rate of 1.4% over 2016, but the quarterly run rate for 2018 will likely be above 4% and approach 4.5% by 2020. (See Figure 13) This is how a fully employed economy is supposed to behave.

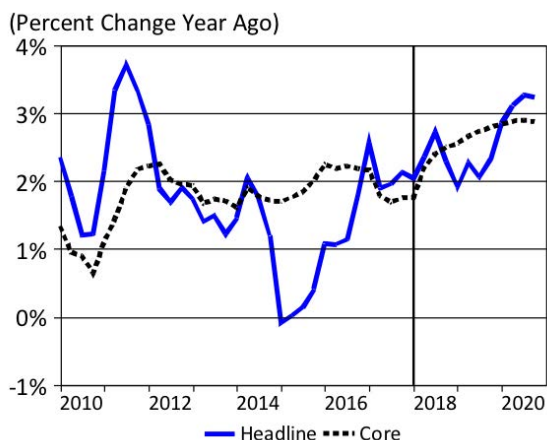
Figure 13 Employee Compensation per Hour, 2010Q1 - 2020Q4F



Sources: Bureau of Labor Statistics and UCLA Anderson Forecast

Inflation is not as quiescent as it was earlier in the decade. The fears of deflation have abated and for the first time since 2012, the consumer price index increased by over 2%. **Going forward, with the end of the oil price rout and rising wages coming from an increasingly tight labor market, inflation as measured by both the headline and core consumer price indices will exceed 2% over the forecast horizon and likely reach 3% in 2020.** (See Figure 14) Indeed, the month-over-month increases reported for January in the headline and core consumer price indices of 0.5% and 0.3%, respectively, is supportive of our view. Moreover, the price cuts for cellular services will anniversary this spring and that will trigger a near automatic increase in year-over-year inflation.

Figure 14 Headline vs. Core Consumer Price Index, 2010Q1 -2020Q



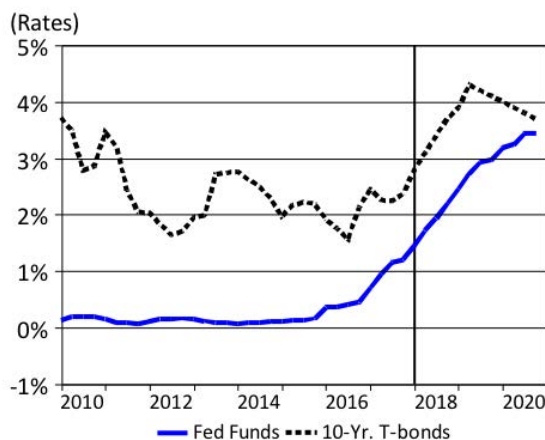
Sources: U.S. Bureau of Labor Statistics and UCLA Anderson Forecast

In a fully employed economy, with rising inflation and an exploding federal deficit, what is a central bank supposed to do? The answer is obvious. **The Fed will become more aggressive in raising interest rates.** We are forecasting four quarter point hikes in the federal funds rate this year and continued increases throughout the forecast horizon to a target of 3.25% - 3.5% in 2020. (See Figure 15) We are aware that this looks very aggressive, but we would surmise that former Fed Chair Janet Yellen would be on board with this. Why? She, as an adherent of the Phillips Curve, would be troubled by our and other forecasts of a 3.5% unemployment rate which would signal oncoming inflation and as a neo-Keynesian economist she would be horrified at trillion dollar federal deficits being overlaid on a fully employed

economy. We would expect no less from Jay Powell, the new Fed chair.

Given the prospect of rising inflation and a substantial increase in Treasury issuance arising from the deficit, long-term interest rates will likely surprise on the upside. Further, with the Fed shrinking its balance sheet, which in effect works as a net issuance of government securities, the long shortage of “safe assets” is about to come to an end with a vengeance. Further, with both Europe and Japan now firmly in recovery modes, their periods of unusually low interest rates are also about to come to an end. **Thus, we would not be surprised to see the 10-Year Treasury yields exceeding 3.5% this year and cross 4% in 2019.**

Figure 15 Federal Funds vs. 10-Year U.S. Treasury Yields, 2010Q1 -2020Q4



Sources: Federal Reserve Board and UCLA Anderson Forecast

Conclusion

The title for the report is “Regime Change.” We mean it. The Trump Administration has put in place an all-out stimulus policy on top of a fully employed economy. As with an automobile, when an economy runs hot, sometimes a few gaskets break. Near-term, spurred by strong business fixed investment, the outlook is for continued 3% growth, but as we enter 2019 the economy could very well begin to sputter under the strains of higher inflation and interest rates and by 2020 it could very well stall out.

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