REAL GDP SLOWS TO 0.7% IN Q1 2017, HURTING FULL YEAR FORECAST

Real GDP slowed to 0.7% in Q1 2017, less growth than Obama’s final quarter of 2.1% growth in Q4 2016. What’s going on? Growth is slower, is it President Obama’s economic policies? What happened to the animal spirits (let’s not forget Dow Jones industrials rose 7.9% Q4 2016 and 4.6% Q1 2017) unleashed after the unexpected Trump victory last year? Well growth in 2017 is starting out the year in a 0.7% hole perhaps, and we had to give up on our official MUFG 2017 real GDP forecast of 2.5% this year. Growth of 2.5% is mathematically impossible for the full year 2017 without some big 3% plus quarters coming up. It sounded high the 2.5% in 2017 forecast after 1.6% economic growth in 2016, but don’t forget 2016 was slower than 2015’s 2.6% largely due to the crash in crude oil prices. Consumer expenditures had been fairly consistent, and strong, looking back to 2014. Our forecast in 2017 of 2.5 percent really just represented a rebound back to 2015’s 2.6% growth as the inventory drag is

Below line: Percentage point contributions to 2016 1.6% real GDP
gone, business investment is perking up, as well are exports as the world economy is “doing better.” Getting to 2.5% was no big deal. After getting Friday’s GDP report, 2.5% growth for 2017 would be a big deal, unless you want to pencil in a rebound in inventories—but we don’t normally like to think of inventory accumulation being “growth.” We marked the GDP growth forecast in 2017 down to 2.2% basically due to the soft patch for spending by consumers in the first quarter.

Meanwhile, the Make It Great Again growth of 3.0% in 2018 is not impossible, yet. The 2018 story is a little more on the heroic side and requires government spending at all levels to kick in 0.4 percentage points of growth. Tax cuts for business and consumers are not really assumed to take place on a massive scale, and in any event we don’t see “taxes” fueling more consumption (strong enough already) or more business investment in structures, equipment or software. There is a business/economic cycle, and companies may have bought all the investment they need for this expansion for now. The economy isn’t not great right now. The nation is at full employment: 4.5% unemployment. There is no one out of work. The 1.6% real GDP growth last year was fast enough to lower the unemployment rate from 5.3% in 2015 to 4.8% in 2016 on an annual average basis.

Business investment was stronger in Q1 2017 even as the consumer was AWOL last quarter. Fed officials often decry the lack of investment as if it is something that keeps them from putting rates up to even 3% any time soon (not till December 2019 latest forecast). Companies shipped more
equipment in Q1 2017 which matches with the durable goods orders here, but we are not sure it will last. There is still talk in Washington of changes in taxes possibly allowing for the immediate expensing of equipment purchases. Until this uncertainty over potential tax policy changes lifts, spending on equipment could actually get postponed.

<table>
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<tr>
<th>$BLN Nominal GDP expenditures</th>
<th>3Q 15 YOY%</th>
<th>Q1 16</th>
<th>Q2 16</th>
<th>Q3 16</th>
<th>Q4 16 YOY%</th>
<th>Q1 17 Annual rate</th>
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</table>
| Equipment & Intellectual Property | 1823.5 | 4.4 | 1806.4 | 1817.4 | 1813.2 | 1822.9 | 0.0 | 1854.3 | 6.9%
| EQUIPMENT | 1092.6 | 4.2 | 1066.3 | 1058.7 | 1049.3 | 1053.5 | -3.6 | 1079.2 | 9.8%
| Information processing equipment | 322.1 | 4.6 | 319.9 | 316.8 | 322.8 | 324.4 | 0.7 | 334.3 | 12.2%
| Computers | 75.4 | -7.1 | 76.0 | 78.2 | 77.0 | 74.4 | -1.3 | 76.8 | 12.9%
| Other processing equipment | 246.6 | 6.7 | 243.9 | 238.6 | 245.8 | 250.0 | 1.4 | 257.5 | 12.0%
| Industrial equipment | 224.7 | 3.8 | 222.2 | 227.3 | 226.1 | 228.7 | 1.8 | 236.5 | 13.6%
| Transportation equipment | 310.7 | 10.3 | 301.3 | 297.6 | 286.7 | 286.6 | -7.8 | 292.6 | 8.4%
| Other equipment | 235.1 | -3.2 | 222.9 | 217.0 | 213.7 | 213.8 | -9.1 | 215.8 | 3.7%
| INTELLECTUAL PROPERTY | 730.9 | 4.9 | 740.1 | 758.7 | 763.9 | 769.4 | 5.3 | 775.1 | 3.0%
| Software | 330.1 | 3.8 | 336.0 | 339.4 | 342.6 | 343.7 | 4.1 | 346.2 | 2.9%
| Research & Development (R&D) | 320.3 | 5.7 | 323.0 | 337.9 | 338.8 | 342.3 | 6.9 | 345.5 | 3.7%
| Entertainment, literary, artistic | 80.6 | 6.2 | 81.1 | 81.4 | 82.5 | 83.4 | 3.5 | 83.4 | 0.0%

1 Communication, medical, photocopy, office and accounting equipment; nonmedical instruments
2 Furniture; agriculture, construction, mining/oilfield, and service industry machinery; electrical equipment

MARKETS OUTLOOK

Bonds yields closed 3 bps higher at 2.28% this week. The first look at first quarter GDP (0.7%) did not provide much excitement either. 10-yr Treasury yields were 2.31% at GDP release time, and actually rose to 2.33% on the news from a second report, the Employment Cost Index (wages), which rose 0.8% in Q1 2017, the biggest quarterly jump looking back to 2009 when the recession ended. Treasury yields then drifted down to the 2.28% close of the week in quiet trading conditions.
FEDERAL RESERVE POLICY

The Fed meets May 2-3 to consider its monetary policy. This is a non-regularly scheduled press conference meeting so no action is expected. The median Fed forecast made at the March meeting looks for three rate hikes this year. They've done one 25 bps rate hike to 1.0%, and now have two more left to go, presumably at one of the three remaining meetings with press conferences in June, September, and December.

If we can forget next week’s Fed meeting, the odds of a June meeting rate hike to 1.25% are surprisingly high. July Fed funds futures closed Friday at odds of 64% versus last Friday, April 21 when the odds were much lower at just 44%. The only problem with the Fed funds market-based odds was unchanged at 64% as perhaps New Yorkers and Wall Street still control much of world markets expectations, and they seemed to take the warm spring weather day off.

March 15, 2017 Press Statement Paragraph 1

“Information received since the Federal Open Market Committee met in February indicates that the labor market has continued to strengthen and that economic activity has continued to expand at a moderate pace. Job gains remained solid and the unemployment rate was little changed in recent months. Household spending has continued to rise moderately while business fixed investment appears to have firmed somewhat. Inflation has increased in recent quarters, moving close to the Committee’s 2 percent longer-run objective; excluding energy and food prices, inflation was little changed and continued to run somewhat below 2 percent. Market-based measures of inflation compensation remain low; survey-based measures of longer-term inflation expectations are little changed, on balance.”

In Wednesday’s statement on May 3, the jobs market tells two stories with the 98K weakling payroll jobs report for March, yet two-tenths drop of unemployment to 4.5% [4.4% was the best during the Greenspan Housing Bubble Years]. “Household spending” is no “longer expanding at a moderate pace” obviously and is the soft patch behind Friday’s tepid 0.7% GDP report for the first quarter. And core PCE inflation probably slipped back a notch from reaching the 2.0% Holy Grail. Core PCE inflation was 1.8% in February and no higher than 1.7% in March according to our estimate. But who knows how they will describe current economic conditions in this paragraph, and whether the 64% odds of a rate hike in June shades their characterization of how well the economy is doing right now.
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