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US economic fundamentals are solid, for now.

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Summary

- US economy is fundamentally solid with above-trend growth expected this year and into 2019, helped by a deficit-financed fiscal stimulus.

- Monetary policy is gradually tightening. Fed expects to raise policy rates above neutral to a modestly restrictive setting.

- Risks are growing for a recession in 2020

  - Fiscal stimulus runs out in 2020
  - Fed policy risks: economic ‘soft landing’ difficult to achieve
  - Possible yield curve inversion
  - Trade war adds risks to outlook

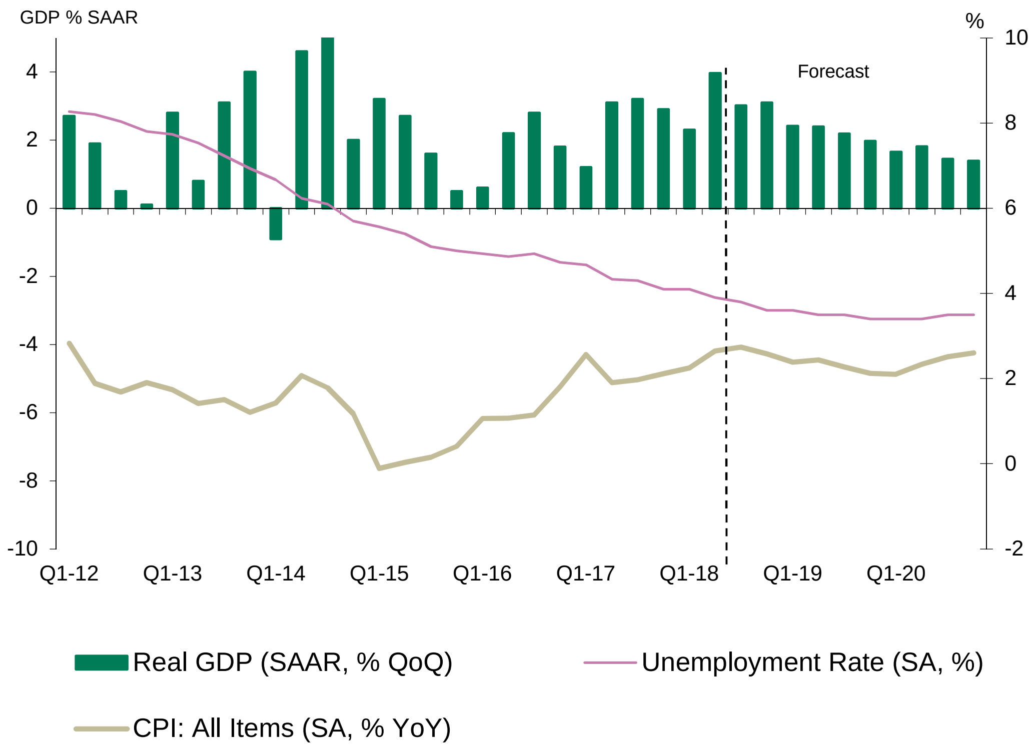
US growth: strong cyclical expansion continues in 2018

Real GDP growth expected near 3.0% in 2018

Highlights

- A solid job market supports consumer confidence and spending.
- Continued gains in business investment.
- Deficit-financed fiscal stimulus (tax cuts + spending increases) to provide significant short-term boost to 2018-19 growth.
- Core PCE inflation above 2% this year.

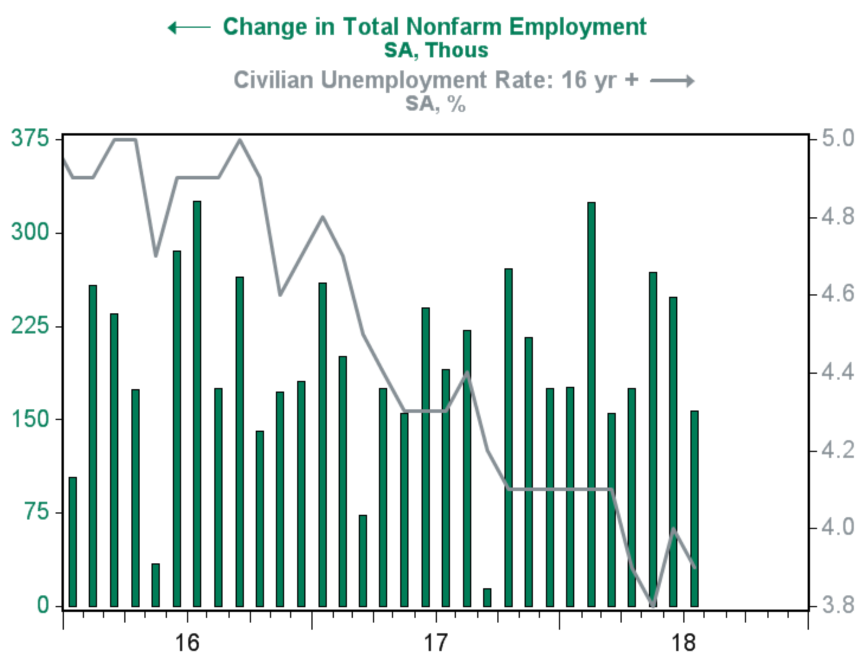
US macro forecast at a glance



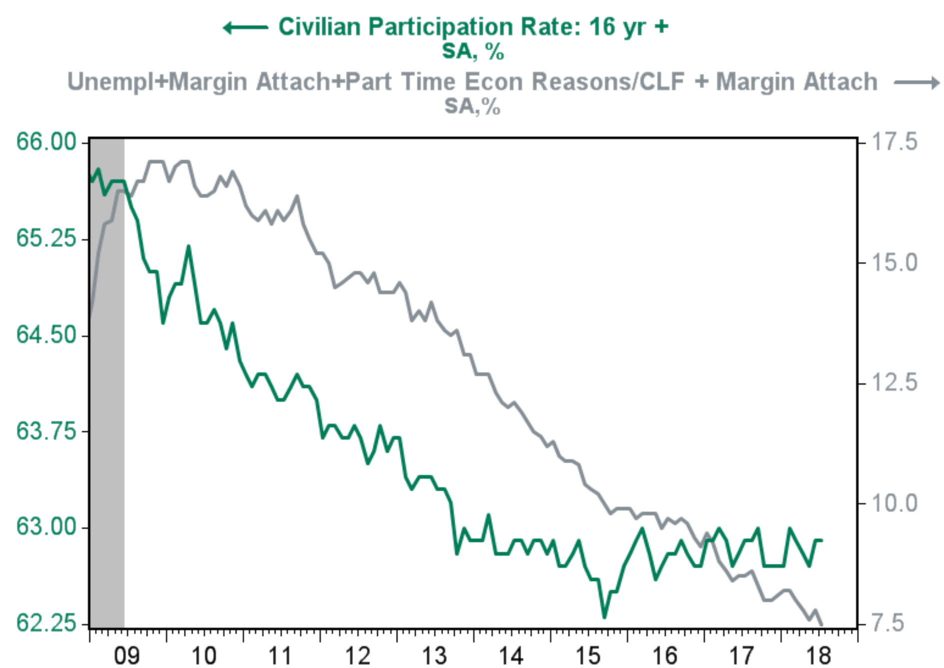
Source: BEA, BLS, Crédit Aricole CIB

Robust job market conditions

- The July unemployment rate was 3.9% compared with the Fed’s full employment estimate of 4.5%.
- Payroll gains year to date have averaged 215K per month.
- The number of job openings currently exceeds the number of unemployed.
- However, average hourly earnings growth has been sluggish (+2.7% YoY).



Source: Bureau of Labor Statistics/Haver Analytics

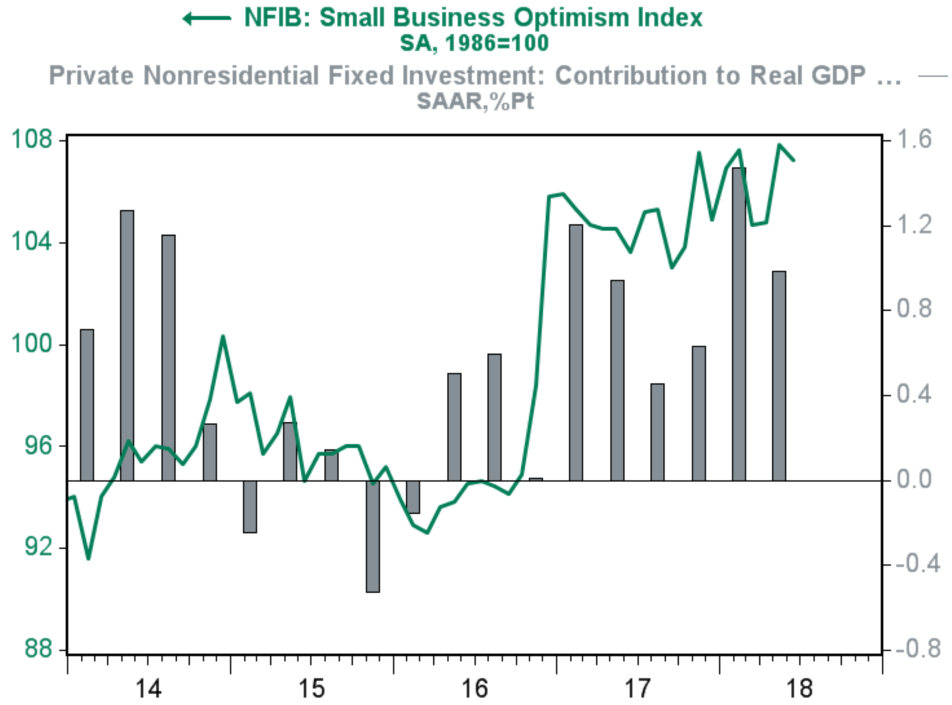


Source: Bureau of Labor Statistics/Haver Analytics

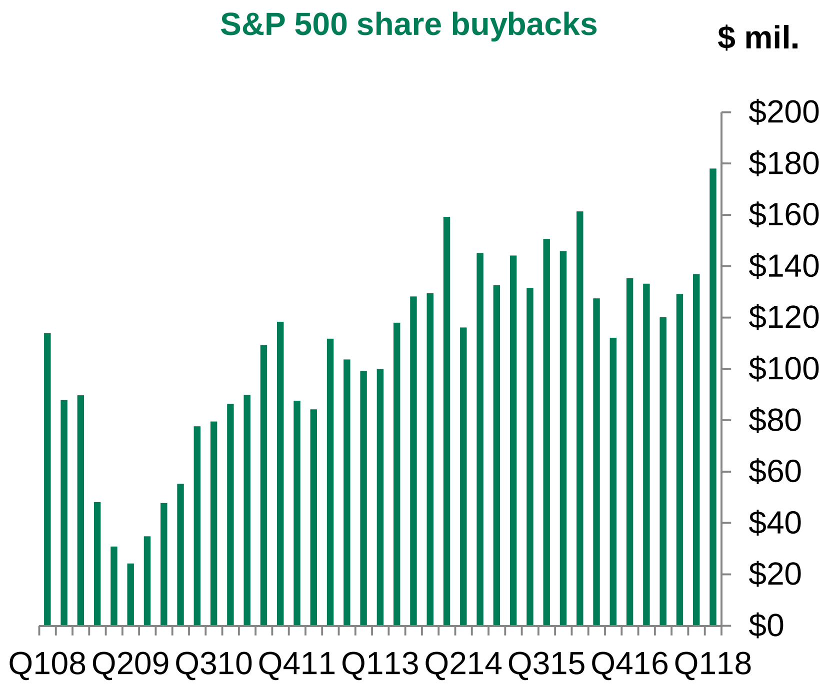
Business capex recovery continues

- Business investment trends have firmed following the collapse in oil & gas sector activity in 2016. Firms see a solid pace of domestic growth, higher after-tax profits less business regulation and capex investment incentives

- Flush with cash after tax cuts, firms did a record amount of share-buybacks in Q1 ($178 billion).

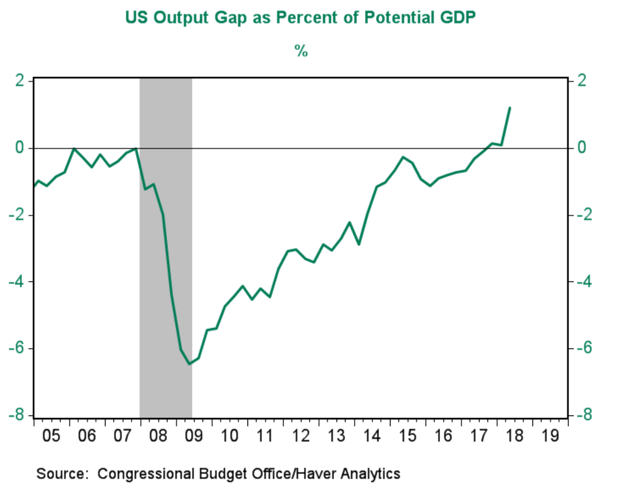


Sources: NFIB, BEA/Haver

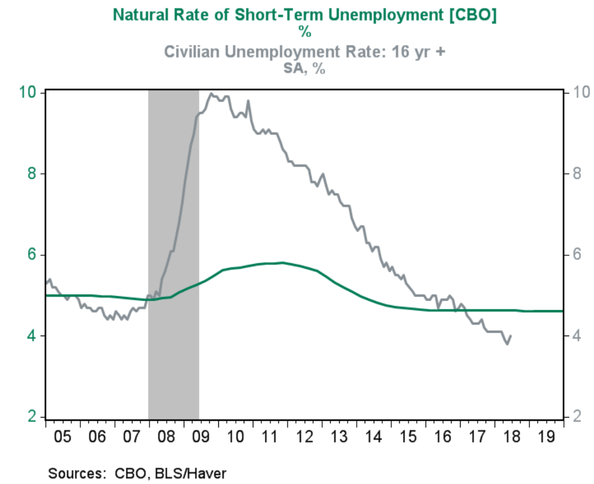


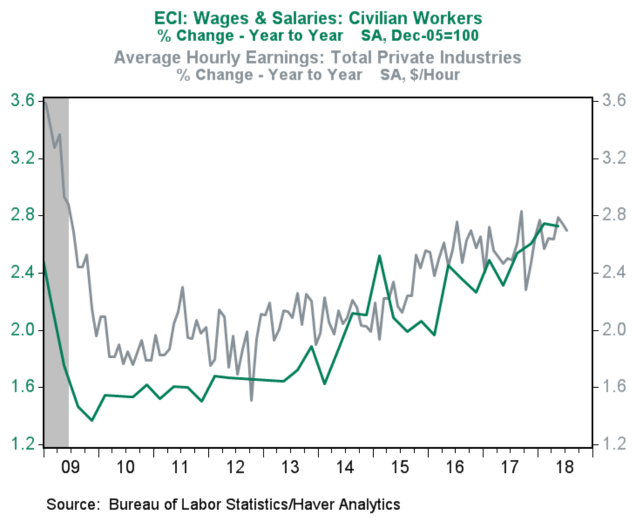
Source: S&P, Crédit Agricole CIB

Economic fundamentals suggest inflation pressures will rise



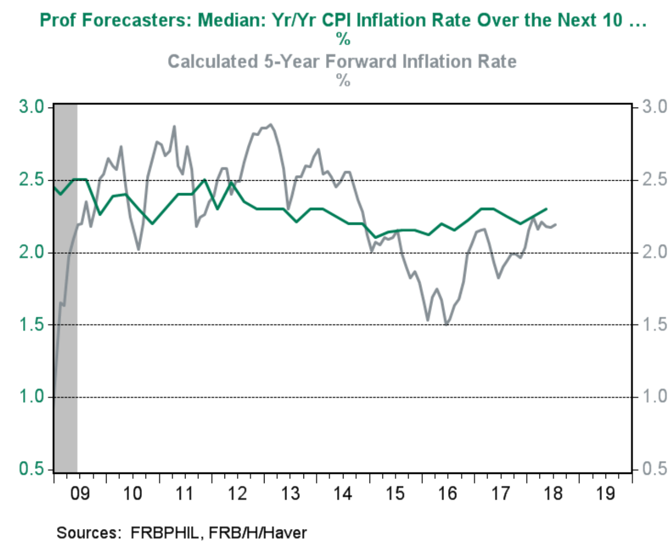
Above potential growth has eliminated slack and pushed unemployment below natural rate.





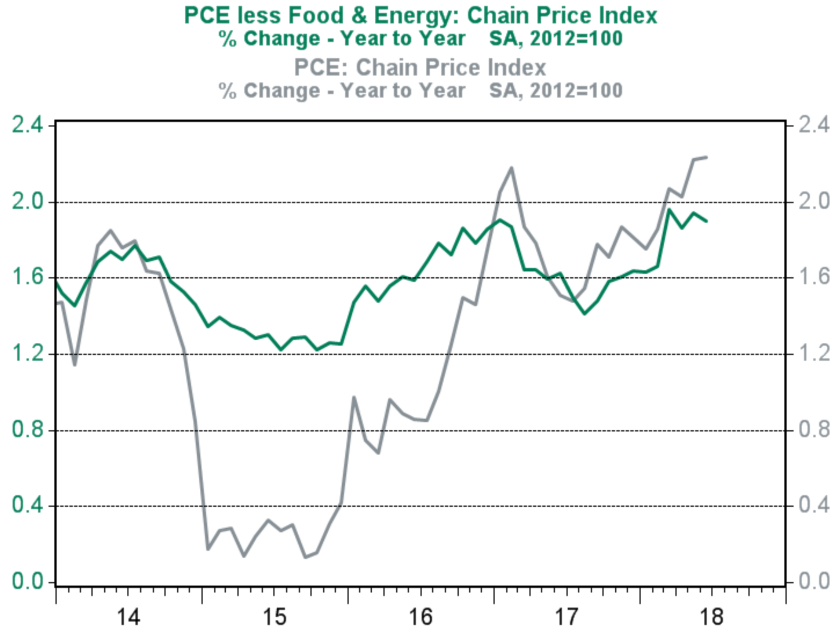
Further tightening of job markets should increase wage costs.

Upward drift in measures of inflation expectations

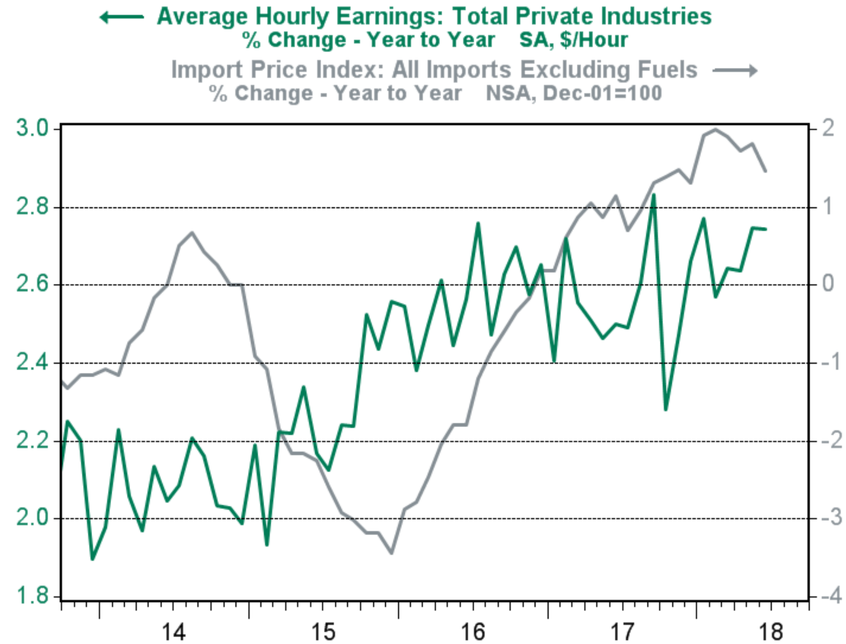


Inflation moves above 2% target this year

- PCE core inflation (1.9% YoY in June) has essentially met the Fed's 2% objective. Fed officials have noted that there was some leeway around the 2% inflation objective and a limited overshoot would not be worrisome.
- Increased tariffs and duties, raising US import prices, remain a wild card.



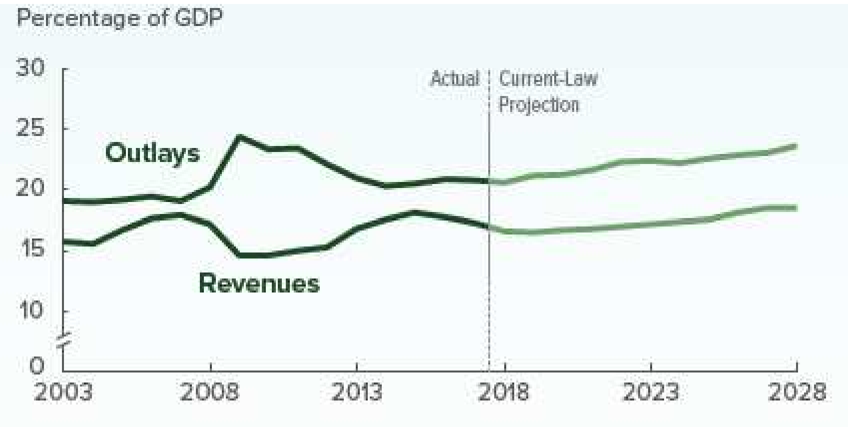
Source: Bureau of Economic Analysis/Haver Analytics

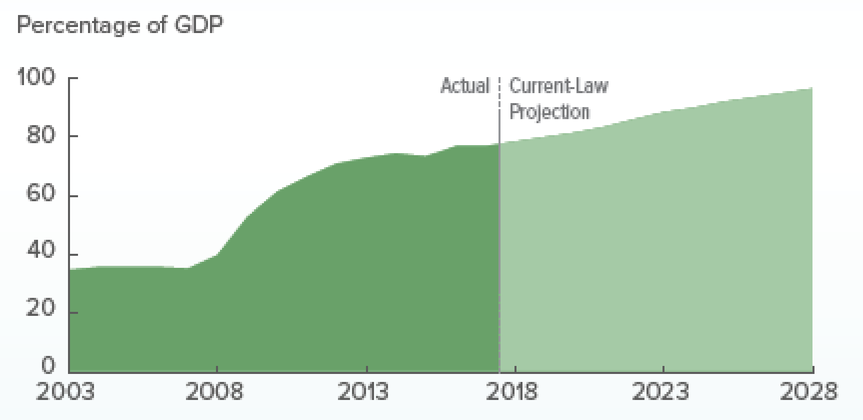


Source: Bureau of Labor Statistics/Haver Analytics

2018 fiscal follies: cut taxes and spend more

US Outlays, Revenues and Debt



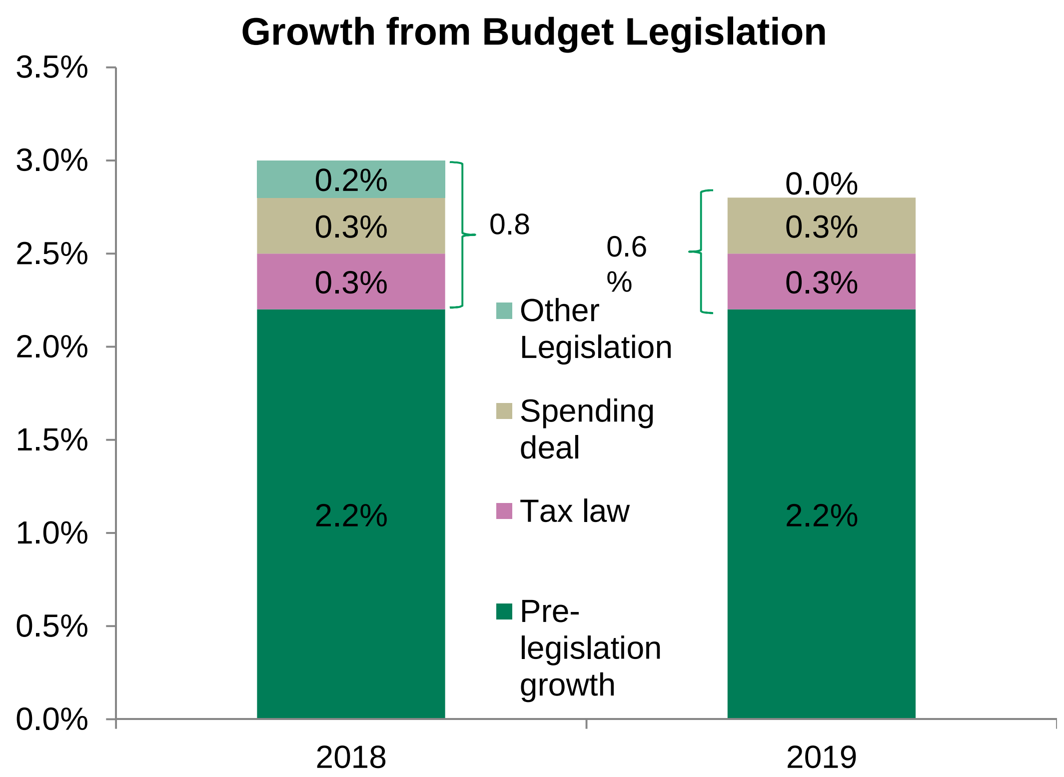


Source: CBO, The Budget and Economic Outlook 2018-2028

- Republican fiscal policies point to budget deficits over $1 trillion in 2019 & 2020.
  - There is no supply-side miracle with tax cuts that "pay for themselves"
- Fiscal stimulus will likely lift near-term growth well above potential.
  - Increased after-tax income and a lower user-cost of capital suggest greater demand growth.
- Financing deficits may require higher rates (risk premium) to attract investors.
  - Crowding out corporate investment, potentially dampening productivity
- Limits counter-cyclical fiscal policy at next downturn?

Tax cuts and higher spending temporarily boost growth

- Tax cuts and other provisions in the TCJA are expected to boost growth 0.5 to 0.3 percentage pts. this year and next.
  - Higher after-tax profits and incomes → higher spending and investment
- The Bipartisan Budget Act of 2018 raised government spending caps by about $300 billion. This could boost GDP growth by 0.3 percent-age pts. in 2018 and 2019
- Over the entire 10 year budget horizon, the dynamic impact might boost the level of GDP by 0.7%, according to CBO estimates. The positive impact is front loaded, raising risks for 2020.



Source: CFRB, CBO, Crédit Agricole CIB

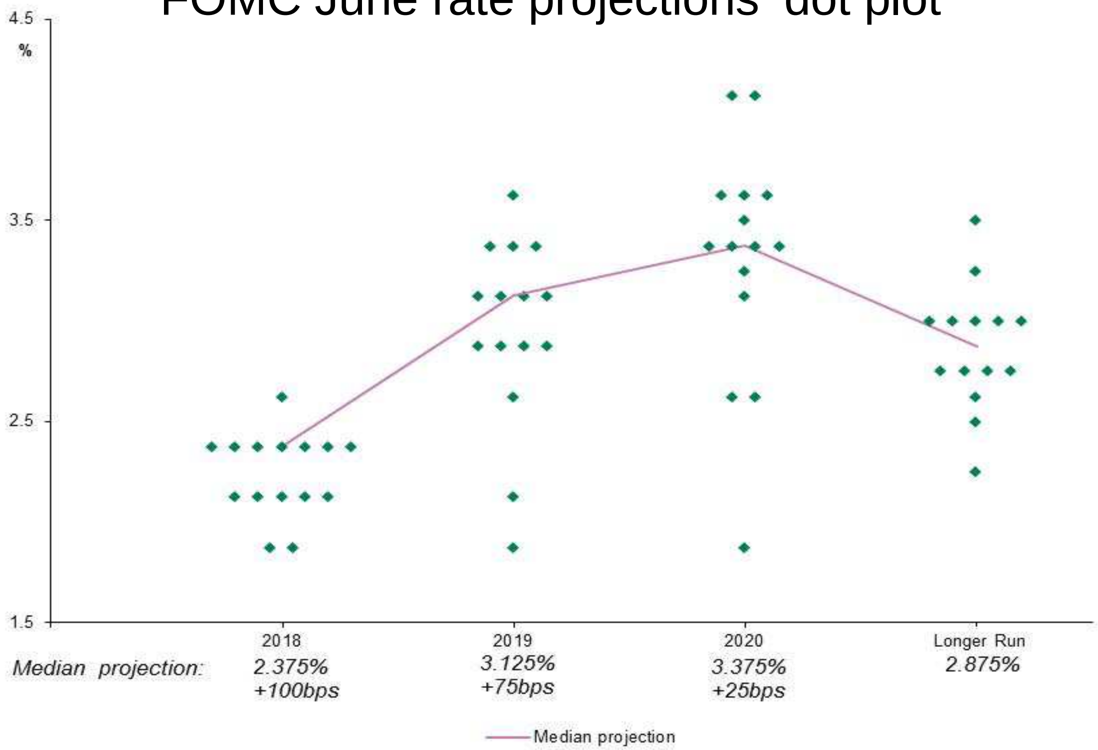
Federal Reserve: Tighter policy ahead

Source: June Fed press Conference.

Monetary policy: from accommodative to restrictive in 2019

- **The Fed is expected to pursue “further gradual increases in the target range for the federal funds rate”**
- The latest FOMC projection is for two additional hikes this year (likely in September and December) and 3 additional hikes in 2019.

FOMC June rate projections ‘dot plot’



Source: Federal Reserve Board, Bloomberg, Crédit Agricole CIB

Why the Fed should hike interest rates

FOMC June Economic Projections and Crédit Agricole forecasts

	2018	2019	2020	Longer run
Change in real GDP (%)				
June '18 Projection	2.8	2.4	2.0	1.8
March '18 Projection	2.7	2.4	2.0	1.8
CA-CIB (August)	**3.1**	**2.3**	**1.6**	**1.9**
Unemployment rate (%)				
June '18 Projection	3.6	3.5	3.5	4.5
March '18 Projection	3.8	3.6	3.6	4.5
CA-CIB (August)	**3.6**	**3.4**	**3.5**	**4.5**
PCE inflation (%)				
June '18 Projection	2.1	2.1	2.1	2.0
March '18 Projection	1.9	2.0	2.1	2.0
CA-CIB (August)	**2.2**	**2.0**	**2.3**	
Core PCE inflation (%)				
June '18 Projection	2.0	2.1	2.1	
March '18 Projection	1.9	2.1	2.1	
CA-CIB (August)	**2.1**	**2.2**	**2.2**	
Fed funds rate (%): range midpoint				
June '18 Projection	2.4	3.1	3.4	2.9
March '18 Projection	2.1	2.9	3.4	2.9
CA-CIB (August)	**2.375**	**3.125**	**3.375**	**2.8**

*Source: Federal Reserve Board, Crédit Agricole CIB. N.B. Projections of change in real GDP and PCE deflators are from the fourth quarter of the previous year to the fourth quarter of the year indicated. Projections for the unemployment rate are for the average civilian unemployment rate in the fourth quarter of the year indicated. Each participant's projections are based on his or her assessment of appropriate monetary policy. Longer-run projections represent each participant's assessment of the rate to which each variable would be expected to converge under appropriate monetary policy and in the absence of further shocks to the economy. The projections for the federal funds rate are the value of the midpoint of the projected appropriate target range for the federal funds rate or the projected appropriate target level for the federal funds rate at the end of the specified calendar year or over the longer run.

- Above-potential growth coupled with a stimulative fiscal policy in the context of full employment increases the odds of rising inflation.
- Given signs of accelerating wage gains and higher energy prices, some intensification of inflation pressures is likely.
- Fed officials believe "the range of possible outcomes for economic activity and inflation to be particularly wide."
  (1) Trade policy impact
  (2) Fiscal policy
  (3) Natural rate of unemployment
  (4) Inflation expectations below 2%

Policy Risks: ‘soft landing’ very difficult to achieve

- History suggests that, at the current unemployment rate, recoveries last only a few more years.
- Monetary policy is still accommodative, fiscal stimulus has increased sharply, inflation fundamentals are firming and the economy has very little available slack.
- The FOMC faces the significant challenge of steering the economy to a “soft landing” through the gradual removal of monetary accommodation—something the Central Bank has never achieved.
  - “The economy historically has always ended up in a full-blown recession whenever joblessness has risen by more than 0.3-0.4 percentage point…not only do we have an economy that is growing at an above-trend pace—at a time when the labor market is already quite tight—but the economy will be getting an extra boost in 2018 and 2019 from the recently enacted tax and spending legislation.” *FRBNY President Dudley*

- Possible scenarios:
  - Premature tightening that unnecessarily chokes off the expansion
  - Tightening that comes too late to prevent a boom-bust cycle

Potential Risks: Fed policy and an inverted yield curve

- Fed officials will consider the impact of their policy rate hikes on the shape of the Treasury yield curve. Several Fed officials might hesitate to deliberately invert the yield curve through raising rates at the short end, given the “historical regularity that an inverted yield curve has indicated an increased risk of recession.”

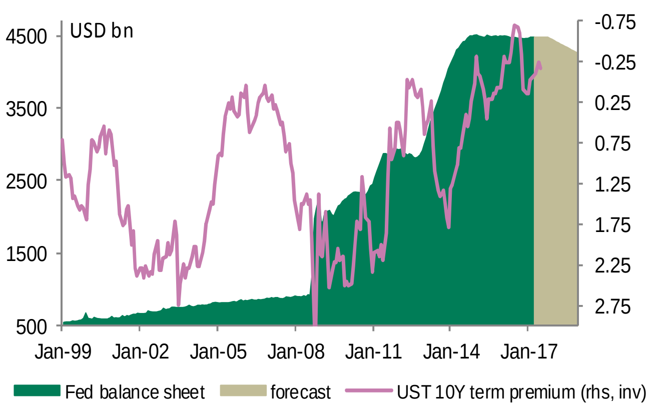
- The elements contributing to the flatter yield include: (1) a rising Fed funds rate, (2) downward pressure on term premiums from the Fed’s large balance sheet, (3) asset purchase programs by other central banks (4) increased Treasury issuance in short-dated securities and (5) a reduction in investors’ estimates of the longer-run equilibrium real interest rate R*.

- These factors have prompted a few Fed officials to suggest a flatter curve might be a less reliable indicator than in the past. The matter will continue to be discussed.

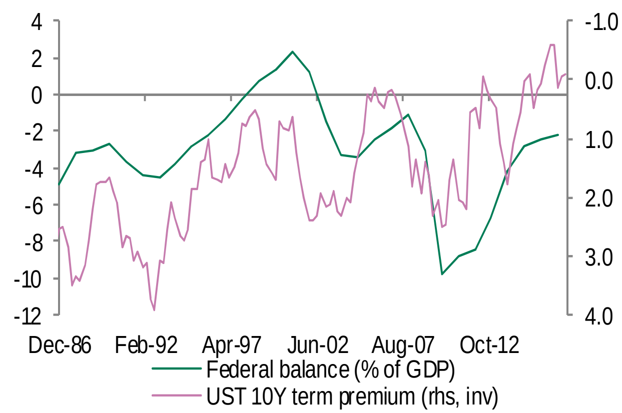
Treasury yields move higher

- We remain modestly bearish on rates over the medium term. Even though we think the 10Y rate has room to go higher, there is limited upside due to possible flight-to-quality trades from risk assets, developments in Europe & emerging markets and international trade issues.
- We expect the yield curve to continue to flatten. With rate hikes more front-loaded now (in 2018 and 2019). If the flattening continues at its recent pace, we believe we could see a completely flat yield curve by the end of the year.

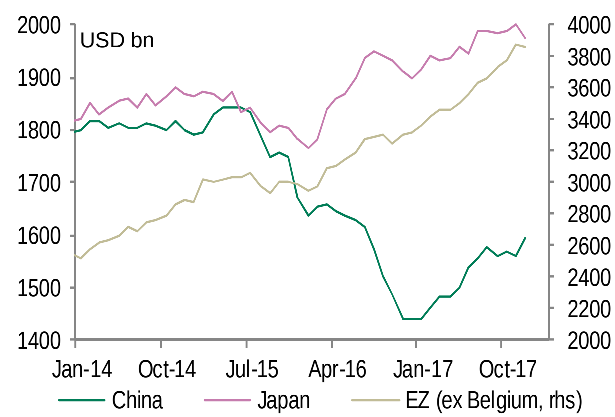
Demand slows: reduction in Fed's balance sheet



Supply could pick up: wider US fiscal deficit expected



Will foreign investors continue to buy US FI?



Source all charts: Crédit Agricole CIB, Bloomberg, NY Fed

Trade disputes increase uncertainty and curtail current business investment

- Consider a US business, faced with growing sales, trying to decide whether to build a big new manufacturing facility in Ohio to meet the growing demand for its products.
  - The firm makes sophisticated industrial equipment that is exported around the world — a sector where the United States has competitive advantages and where the jobs tend to pay well.
  - The US firm recently got a tax cut and fiscal incentives for capital investments. Meanwhile its stock price has been rising, lowering its cost of capital.
- These facts suggest that the project should be undertaken.
  - But at the same time, the manufacturer has no visibility on the cost of the steel and aluminum used in production.
  - More importantly, the firm has no idea if it will find itself in the middle of a trade war with the countries that are likely to be interested in buying its products.
  - One might hope that the Trump Administration's trade brinkmanship will lead to better access for US products abroad. But in the meantime, an investment decision may be postponed.

US/China trade war?

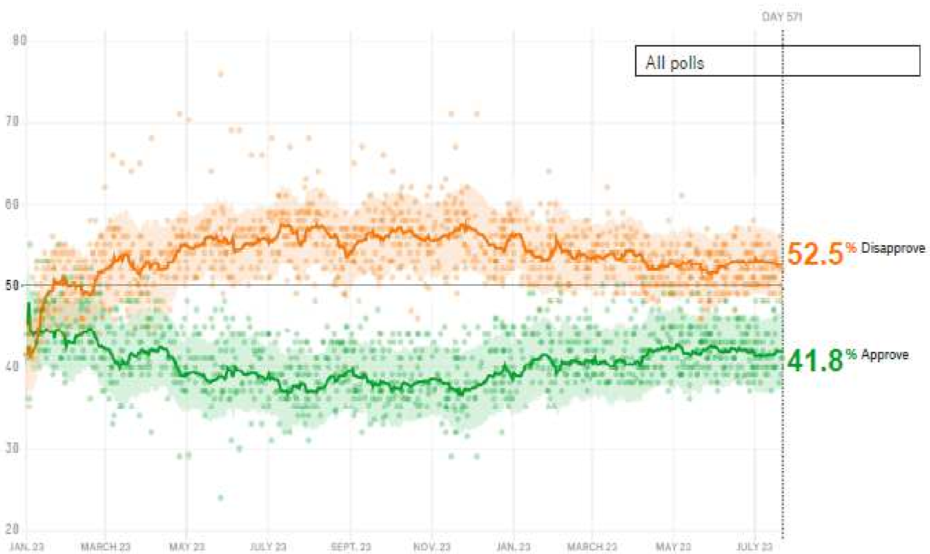
We suspect that trade tensions will heat up this summer with the mid-term elections in view. China bashing plays to trumps political base.

- Trade – US demands market openness and a numerical reduction in China's surplus. China wants an agreement in principle only—no targeted reduction.
- IP protection – the US wants an end to forced transfer, espionage and subsidies to key technologies, while China wants to revise its patent law.
- Investment access – the US is asking for the removal of most restrictions, while China wants the same for its companies
- The Trump Administration announced $50bn of Chinese imports (25% rate). China responded proportionately, increasing tariffs. Trump threatens an additional $200 bn of tariffs (25% rate?) and an additional $200 bn if China retaliates further. $450 bn.
- China imports only $130 bn from US but could counter additional tariff increases with measures hurting US companies already doing business in China. Delayed imports at ports, safety inspections, boycotts etc.
- The impact of $50 bn tariffs is modest. It might trim 0.1 point from growth.
- In a severe global trade war scenario, US GDP growth could be 0.3% to 0.4% less in 2019 and 2020 relative to our base case with the unemployment rate 0.3 points higher.

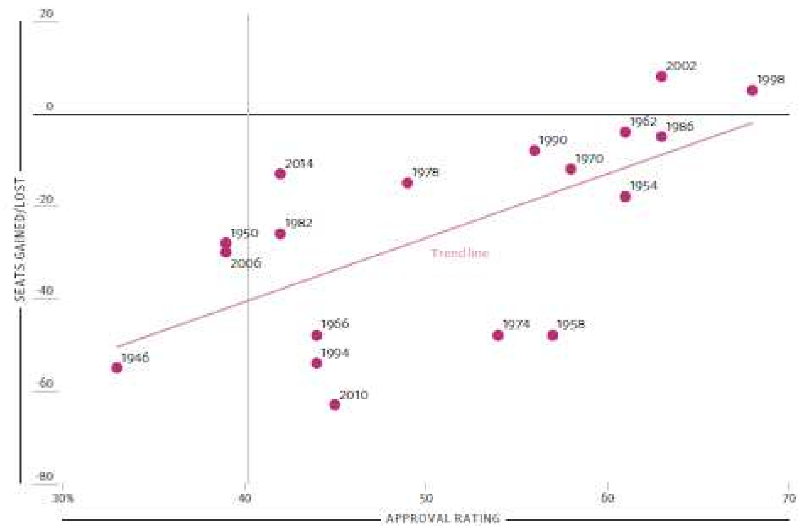
Midterm elections on 6 November 2018

- There is a better than 50/50 chance that the mid-term elections will result in a Democratic House majority.
- It would be harder for the Democrats to win a majority in the Senate as there are fewer vulnerable Republican seats at risk in this election.

President Trump approval ratings



President's job approval vs House seats gained/lost by his party in midterms



Source: WSJ, fivethrityeight.com, Crédit Agricole CIB

US Macro: Key Takeaways

- US economy is fundamentally solid with above-trend growth expected this year and into 2019, helped by a deficit-financed fiscal stimulus.

- Monetary policy is gradually tightening. Fed expects to raise policy rates above neutral to a modestly restrictive setting.

- Risks growing for a recession in 2020

  - Fiscal stimulus runs out in 2020
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  - Possible yield curve inversion
  - Trade war adds risks to outlook

Enjoy it while it lasts!

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