

# Tim Duy's **Fed Watch**

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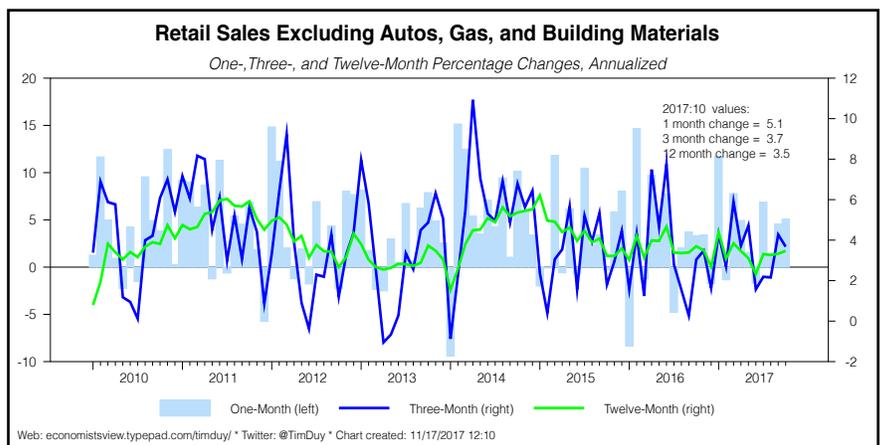
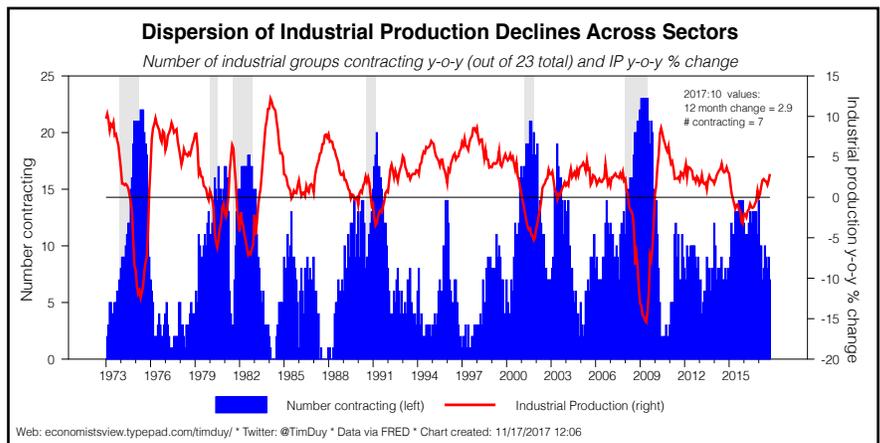
## All Systems Go For A December Rate Hike

Incoming data indicate the US economy retains momentum as 2017 draws to a close, clearing the way for the Fed to hike rates in December. **Inflation, however, remains on the soft side and continues to make some FOMC members nervous.** That said, the consensus looks set to downplay those concerns amid an environment of solid economic growth and declining unemployment rates. **I think it will be a challenge for FOMC members to shift gears to steady policy until growth moderates sufficiently to stabilize unemployment rates.**

Looking back at the past week's data reveals an economy that continues to march upward. Industrial production grew 0.9% in October, bolstered by a 1.3% gain in manufacturing. The nation's industrial activity stands 2.9% higher than year ago levels and the dispersion of weakness across sectors continues to fall. The 2015 weakness that drove recession fears is rapidly fading into a distant memory.

With the holiday season approaching, all eyes will be on the consumer. October retail sales rose 0.2% while September was revised up from 1.6% to 1.9%. Hurricane-related effects continue to be evident in the data. Solid gains in autos likely reflect replacement purchases, while building supplies and gas sales both retreated. The underlying pace of sales, however, has remained fairly stable since mid-2015. With job growth gradually slowing, an acceleration in spending might not be in the cards, but we shouldn't expect a broad-based deceleration in activity either.

Housing starts gained in October, but the message is



bit more mixed. The gains were driven by a rebound in multi-family housing starts. The overall trend in that market, however, I think remains negative (we are probably past peak apartment building for this cycle); note that multifamily starts are still below year ago levels despite the gain. Consequently, I wouldn't read too much into the gain expect that it may help bolster the residential component of GDP in the final quarter of this year. Importantly though, the slow, upward gains of single family starts continues and should support homebuilders.

Core-CPI inflation accelerated in October, which will warm the hearts of central bankers. That said, the shelter component supported the move, specifically a gain in lodging away from home component. This may be an artifact of the hurricanes and as such would fade in subsequent reports. Though inflation remains weak, most FOMC members will take comfort in the partial rebound since the dismal numbers of early-2017. **They will see this as evidence supporting their contention that transitory factors drove this year's inflation weakness.**

Not all central bankers, however, stand ready to give the "all's clear" on inflation. Chicago Federal Reserve President Charles Evans reiterated earlier warnings on the topic:

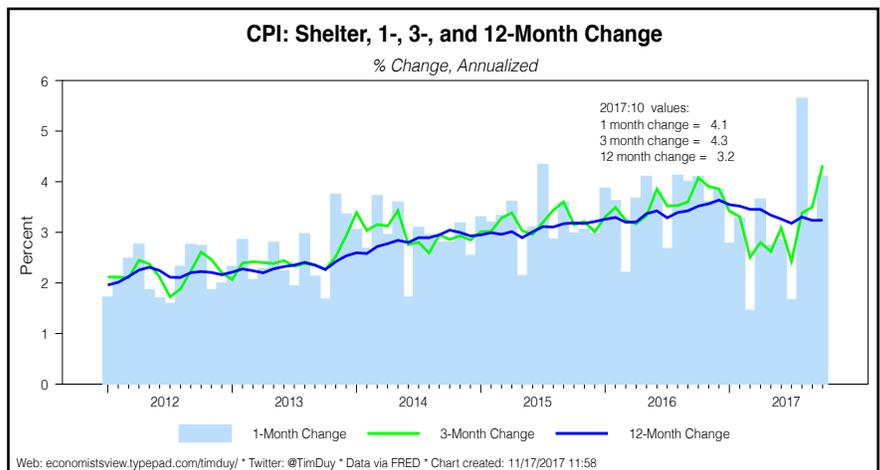
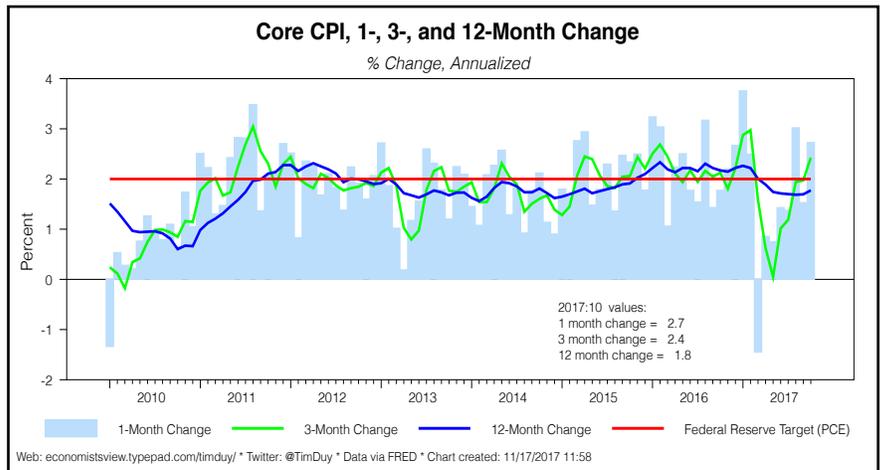
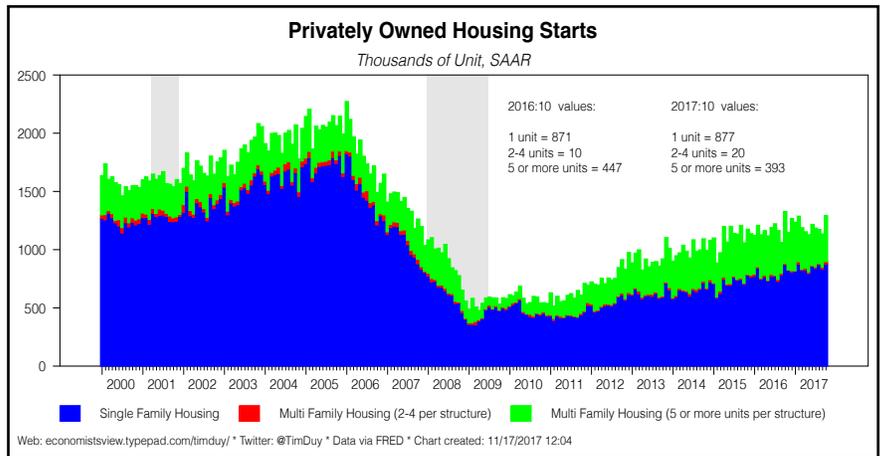
*I am concerned that persistent factors are holding down inflation, rather than idiosyncratic transitory ones. Namely, the public's inflation expectations appear to me to have drifted down below the Federal Open Market Committee's (FOMC) 2 percent symmetric inflation target.*

Evans would like to see more explicit communication on the part of the Fed supportive of a symmetric inflation target that allows for inflation as high as 2.5%. This was an intriguing addition to his argument:

*I also worry that giving too much prominence to financial stability considerations in discussions of monetary policy could erode the public's confidence in our commitment to our 2 percent inflation objective. Financial stability is obviously very important. But there are better tools than monetary policy for promoting it. In contrast, when it comes to meeting our inflation objective, monetary policy is the only game in town.*

**In general, central bankers believe that low interest rates can contribute to excessive risk-taking that leads to financial instability.** These worries will likely become more prominent if the Fed does not see evidence that financial conditions tighten as they raise short-rates. This in turn could prompt the Fed to tighten policy beyond what would be indicated by their dual mandate. **Evans is warning that even discussion along this line of thinking would lead the public to believe that the Fed does not prioritize its inflation target.**

Note that Evans is only a voting member for one more



meeting; this is his last chance to dissent if he wants to end on a dovish note. As for participants rotating into voting spots next year, two took hawkish positions. San Francisco Federal Reserve President John Williams sticks with the current script, [via Reuters](#):

*"My view is that a perfectly reasonable path for policy would be one more increase this year, and three next year," Williams told reporters on the sidelines of a conference on Asian economic policies...*

Reuters also reports that Cleveland Federal Reserve Pres-

ident Gretchen Mester supports additional rate hikes, adding that:

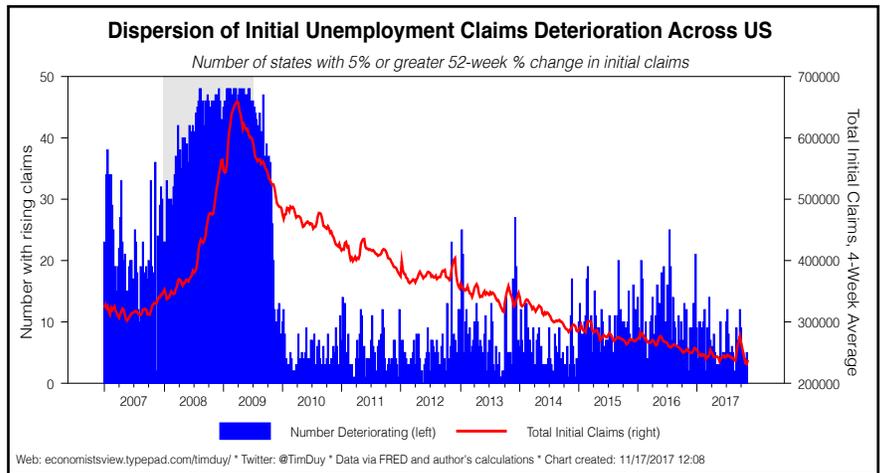
***"I am not as troubled by where inflation is today. There is good reason to believe it is going to come back up," Mester said at a monetary policy conference at the Cato Institute.***

Williams and Mester look ready to climb aboard the Fed's rate hike express train. Nonvoter St. Louis Federal Reserve President James Bullard **will not be joining them:**

***"The main concern I would have is that we raise rates in December and inflation expectations fall... which would in my view be a vote of no confidence from markets," Bullard told reporters.***

St. Louis doesn't rotate back onto the FOMC until 2019. The world will be completely different then.

The Thanksgiving Holiday makes for a slow week. Most



of the action will come on Wednesday with the durable goods and consumer sentiment reports. Plus, we also get the minutes of the last Fed meeting that day as well. Something to talk about around the turkey.

**Bottom Line: Despite some nagging concerns about inflation, the Fed looks poised to continue hiking rates on the back of a generally solid economy.**

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Professor Duy received his B.A. in Economics in 1991 from the University of Puget Sound, and his M.S. and Ph.D. in Economics in 1998 from the University of Oregon. Following graduate school, Tim worked in Washington, D.C. for the United States Department of Treasury as an economist in the International Affairs division and later with the G7 Group, a political and economic consultancy for clients in the financial industry. In the latter position, he was responsible for monitoring the activities of the Federal Reserve and currency markets. Tim returned to the University of Oregon in 2002. He is the Senior Director of the Oregon Economic Forum and the author of the University of Oregon Statewide Economic Indicators, Regional Economic Indicators, and the Central Oregon Business Index.

Tim has published in the *Journal of Economics and Business* and is currently a member of the Oregon Governor's Council of Economic Advisors and the State Debt Policy Advisory Commission. Tim is a prominent commentator on the Federal Reserve. MarketWatch describes his blog as "influential." The Huffington Post identified him as one of the top 26 economists to follow on Twitter, and he is listed on StreetEye as one of the top 100 people to follow to discover finance news on Twitter. Major national and international news outlets frequently quote him, including the *New York Times*, the *Washington Post*, the *Financial Times*, the *Wall Street Journal*, and *Bloomberg*. He also writes a regular column for *Bloomberg Prophets*.

*Notice: This newsletter is commentary, not investment advice.*

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