First Trust
Monday Morning OUTLOOK
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New Policies, New Path

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Back in the 1970s, supporters of the status quo said there was nothing to be done about stagflation (high inflation and slow growth). It was a "fact of life" that Americans had to accept after experiencing faster growth and lower inflation during the decades immediately following World War II.

Then, along came the supply-side and monetarist economists with new ideas about how the "policy mix" mattered, that marginal tax rates affected the incentive to work and invest and that the supply of money helped determine inflation. Simple ideas, in retrospect, but decried as radical notions at the time by supporters of the stagflation status quo. Supply-side economics was dismissed as "voodoo economics."

Similar arguments have come back into vogue in the past decade, with apologists for slow growth arguing the US simply can't grow as fast as it used to. "Secular stagnation" means growth will be permanently slow. Rapid growth, they claim, is a thing of the past.

In the 1980s, when supply-side policies were tried, they worked. Growth picked up, inflation fell. Now, the U.S. is going through another major shift in the "policy mix," with the federal government focusing on deregulation and tax cuts. In a nutshell, we've gone from a political philosophy that said "you didn't build that" to one that says "please build that."

As a result, expectations about the economy are changing rapidly. The Atlanta Fed is now projecting real GDP growth at a 5.4% annual rate in the first quarter, which would be the fastest growth for any quarter since 2003. We think that's on the optimistic side and expect growth at more like a 4.0% annual rate, but, either way, the economy is showing signs of an overdue acceleration and we are now projecting growth of 3.5% for 2018 (the fastest "annual" growth since 2003).

Friday's jobs report brought news that wages are now accelerating as well. Average hourly earnings grew 0.3% in January and are up 2.9% from a year ago. Some analysts said wages were probably lifted in January due to unusually bad weather, which was also the culprit behind the drop in the number of hours worked for the month.

It is true that the number of workers missing work due to weather was the second highest for any January in the past 20 years. But we've had other months with nasty weather since 2009, and this is the first time since then that wages were up 2.9% over a twelve-month period. Meanwhile, jobs increased 200,000 for the month, so we doubt bad weather was the key trigger.

Surprisingly, even uber-dove Minneapolis Fed President Neel Kashkari, who has dissented against rate hikes in recent Fed meetings, waxed enthusiastic on Friday about the faster pace of wage growth, saying it "could have an effect on the path of interest rates." Kashkari and the rest of the policymakers at the Fed will have more than six more weeks to mull over the incoming data and decide whether they warrant a new path for short-term interest rates. We think a steeper path is not only warranted, but likely.

At the last meeting in 2017, which was the last time the Fed issued it's "dot plot" for the expected path of interest rates over the next few years, the median forecast was three rate hikes this year, with the odds of two rate hikes or less outweighing the odds of four rate hikes or more. At the press conference following that meeting, Fed Chief Janet Yellen said some, but not all, of the policymakers had incorporated the tax cut into their forecasts.

But now that the tax cut is a fact and the economy is accelerating, we think the new forecast to be released on March 21 will show close to an even split between advocates of three or four rate hikes. We'd put our money on four, and we don't see a slowdown in economic growth during 2018, like we might have seen in some recent years, giving the Fed an excuse to pause its rate hikes during the year.

No wonder the yield on the 10-year Treasury has gone from 1.86% on Election Day 2016 to 2.84% on Friday. The "animal spirits" are restless, monetary policy is gaining traction, and the "secular stagnation" of the past several years is looking less secular by the day.

In this environment, as markets reassess what's possible, we may have more days like Friday in the equity market. But more economic growth will ultimately be a tailwind for equities, not a headwind. Stock market investors who can't take a one-day 2.1% drop in equities, or even a 10% correction, shouldn't be in the stock market to begin with. Those who can remain calm and stay invested will be rewarded.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
2-5 / 9:00 am	ISM Non Mfg Index – Jan	56.7	**56.9**	59.9	56.0
2-6 / 7:30 am	Int'l Trade Balance – Dec	-$52.1 Bil	**-$51.4 Bil**		-$50.5 Bil
2-7 / 2:00 pm	Consumer Credit– Dec	$20.0 Bil	**$17.9 Bil**		$28.0 Bil
2-8 / 7:30 am	Initial Claims – Feb 3	232K	**234K**		230K