Current Economic Conditions

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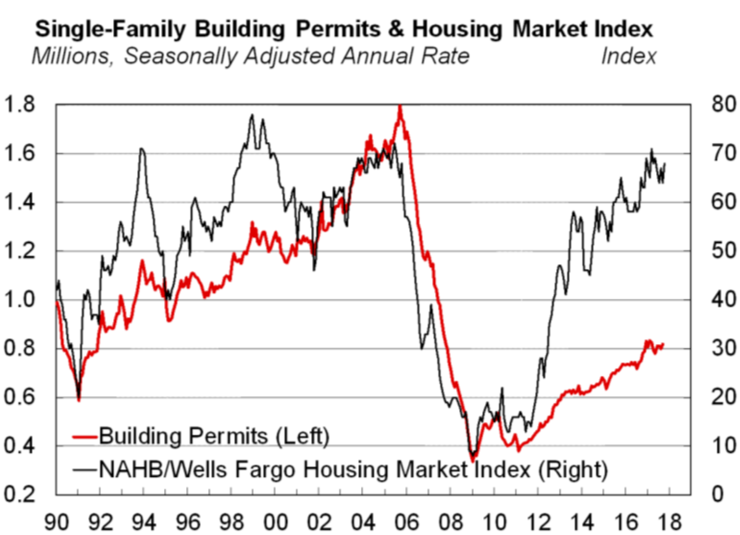
GLOBAL ECONOMIC EXPANSION ACCLERATES; U.S. POISED TO JOIN IN

The global economy is posting its strongest growth since 2011, when the initial recovery from the 2008-2009 global recession faded. Global industrial production, as measured by the CPB Netherlands Bureau for Economic Policy Analysis, was up 3.7% year-over-year in July. Industrial production in European Union manufacturing rose to a new cyclical high in August and was up 4.3% year-over-year. Production has reached all-time highs in Germany and in much of Central Europe. Industrial production in Japanese manufacturing was up 5.4% year-over-year in August and is close to breaking out of the range it has fluctuated within since 2010. Machine tool sales in Japan were up 46% year-over-year in September. Exporters in Germany and Japan are benefitting from the acceleration in Chinese growth that began in early 2016 when China reversed its transition to consumer-led growth and renewed its dependence on export- and investment-led growth. Globally, semiconductor shipments have been especially strong; they were up 23.9% year-over-year in August. The International Monetary Fund recently boosted its global GDP forecasts for 2017 and 2018. This is consistent with a recent acceleration in the Organization for Economic Cooperation and Development's broadest leading indicator.

Data on industrial production show the U.S. lagging behind the rest of the world. Industrial production in manufacturing rose just 0.1% in September after declines of 0.4% in July and 0.2% in August. Production was held down by hurricanes Harvey (in August and September) and Irma (in September). But except for petroleum and coal products (mostly oil refining) and chemicals, where production was constrained by Harvey-related plant shutdowns that extended into the month, most industries showed solid growth in September. Growth was especially strong in wood products (includes lumber), nonmetallic mineral products (includes most other building materials), and electrical equipment (includes appliances), which geared up for the recovery from the hurricanes.

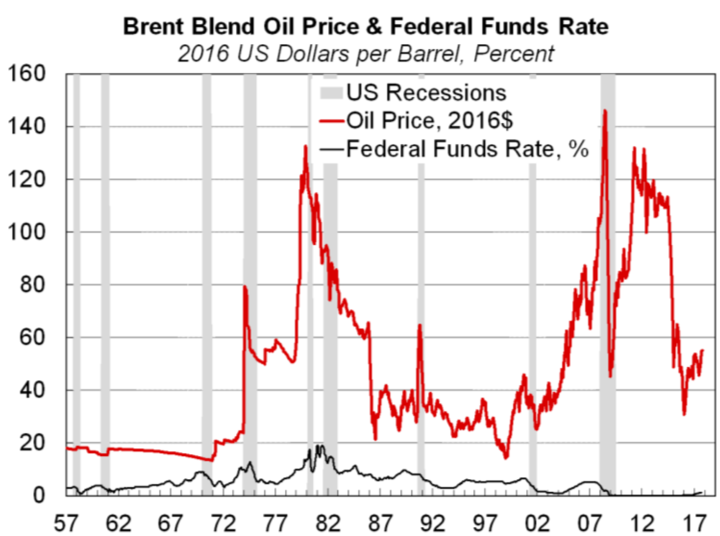
A rebound in the new orders component of the Institute for Supply Management's Manufacturing PMI, to its second-highest reading since 2009, suggests that growth in industrial production could be especially strong in coming months. Bigger-than-expected increases in the Empire State Manufacturing Index and the Federal Reserve Bank of Philadelphia's Manufacturing Business Outlook Index in October have confirmed that signal. Production of refineries and chemical plants will rebound in October simply because they are not shut down for part of the month. Auto production must increase to replace the vehicles destroyed by the hurricanes. Growth in production of building materials (and furniture and appliances) could remain strong even after the recovery from the hurricanes if the housing market picks up after its recent lull. Housing starts fell in September, but single-family building permits rose, and the NAHB/Wells Fargo Housing Market Index rebounded in October to its highest level since May.



Other leading indicators are consistent with faster growth in the manufacturing sector and overall economy. Stock prices continue to hit record highs. Baa corporate bond yields remain close to last year's 60-year lows. The University of Michigan's Consumer Sentiment Index rose in early October to a 14-year high. My leading index for industrial production in U.S. manufacturing is pointing to 3% annualized growth over the next six months. The Atlanta Fed's GDPNow estimate is calling for 2.7% annualized growth in U.S. real GDP in the third quarter. I think that's too high because it doesn't assume a hurricane-driven liquidation of inventories in September (a negative for GDP growth), but I think the U.S. economy could grow at a 3% rate in 2018 and perhaps beyond, especially if tax reform is enacted.

Ironically, tax reform might hold down growth in the fourth quarter. If Congress can't pass tax reform before the end of the quarter and make it retroactive (or at least effective immediately), companies will delay investments in plant and equipment until 2018. If faced with a choice between making an investment in 2017 (and depreciating it over many years) and delaying that investment until 2018 (and expensing it immediately), it probably pays to wait. If Congress passes a tax reform bill that includes an incentive for repatriation of foreign-source income, immediate expensing of investment, and a lower corporate tax rate, investment will surge, boosting growth in the short term and, because of its impact on productivity and real wages, in the medium term. Cuts in individual tax rates, a larger standard deduction, and an increase in child tax credits will do little for growth and will increase the federal budget deficit, threatening growth in the very long term, but cutting corporate taxes without cutting individual taxes won't fly politically.

Several factors help explain the acceleration in global growth. Carmen Reinhart and Kenneth Rogoff have argued that economic recoveries after recessions associated with financial crises are weaker than recoveries from other recessions and have found that it takes about 10 years for an economy to get back to normal after a financial crisis. We're now into the tenth year after the financial crisis, and its impact could be starting to fade. Major central banks have injected tremendous amounts of liquidity into the global economy via "quantitative easing." That did little for economic growth in the short run and might cause inflation and asset bubbles in the long run, but it seems to be boosting global growth now. However, financial crises and quantitative easing get far more blame and credit than they deserve. I think most of the acceleration in global growth is due to the decline in oil prices that began in the middle of 2014. This explanation is consistent with the fact that growth has accelerated more in Europe and Japan, which produce little oil, than in the United States, where oil production has risen and oil imports have plummeted. Industrial production in European Union manufacturing declined from April 2014 to August 2014, but has risen 10.4% (3.4% annual rate) since then. China's return to debt-financed and investment-led growth, focused on state-owned enterprises, has also boosted global growth, but presents risks in coming years.



What could bring this expansion to an end? Most expansions (and associated bull markets in stocks) are ended by some combination of high oil prices and rising interest rates. Oil price shocks are usually caused by geopolitical events and are difficult to predict. Interest rates usually rise to expansion-threatening levels in response to increases in inflation that are bigger than desired and faster than expected. Inflation remains stubbornly low, especially at the consumer level, but recent increases in the prices of oil, copper, lumber, and other commodities suggest that some pressures might be starting to build at the producer level. If central bank policies don't trigger an undesirable increase in inflation, repeal of the North American Free Trade Agreement might. The Fed's favorite inflation measure has been below 2.5% since NAFTA was enacted in January 1994; before NAFTA, inflation had been above 2.5% for 27 years.