March 27, 2017

The 2017 Economic Outlook

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Change in Economic Growth Leadership in Early 2017

Our outlook for 2017 has not changed significantly since the beginning of the year, but we are seeing the underlying sectoral trends come into clearer focus. After a 2 year slump the goods producing areas of the economy are experiencing renewed vitality. The goods producing areas of manufacturing, mining and construction created 75,000 net new jobs in February – the most since March 2000. Exports grew 7.4% year-over-year in January, signaling the end of the downturn in the international economy. Stagnant world economic growth in the last 2 years had been a primarily source of weakness in world goods and commodity markets. Manufacturing indicators have also shown a pick-up in activity since late 2016. New orders for capital goods have shown nascent signs of recovery. Business inventory-to-sales ratios have continued to recede from peaks experienced during mid-2016.

In conjunction with the goods recovery and in some regards a result of it, inflation has accelerated in early 2017. This trend is expected to continue throughout 2017 as the rising price of goods, except for autos, joins persistent trends in services inflation to bring total annual inflation to a 2.7% annualized growth rate, upwardly revised from 2.4% in the previous publication. Higher inflation will likely translate into higher interest rates for 2017. The 10-year Treasury yield is forecasted to reach 3.0% by year-end. In response to rising inflationary pressures, the Federal Reserve is forecasted to raise the Fed Funds rate target 3 times in 2017 instead of twice as forecasted at the beginning of the year. The net stimulatory impact of potential fiscal policy changes by the new Administration and Congress is still unknown. Hence, forecast uncertainties remain high, but potential is probably tilted to the upside as the year progresses.

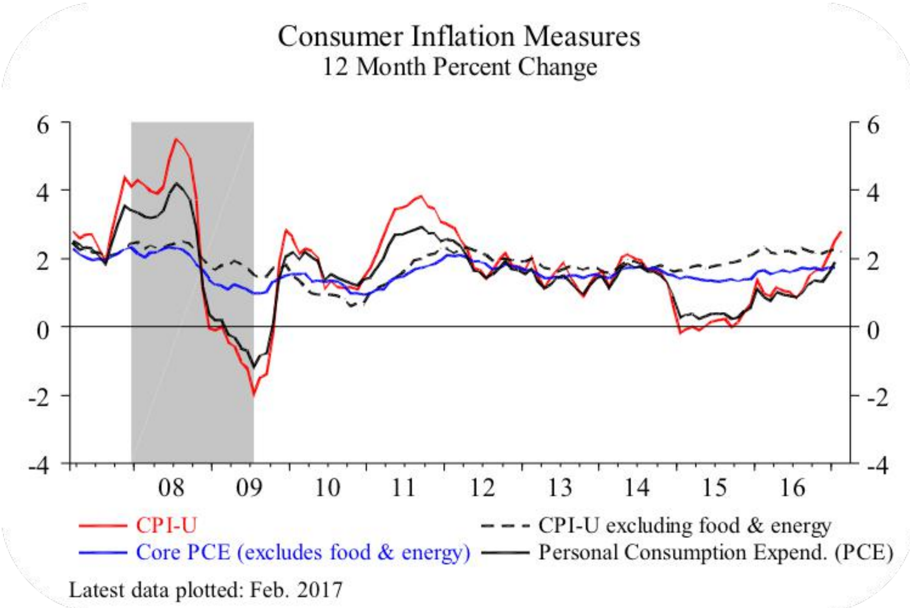
In contrast to the recovery in the goods-producing areas of the economy, consumer spending started the year on a soft note. After a strong fourth quarter, consumers reigned in spending in January on goods and especially on services. The outlook for consumer spending this year is mixed. On one hand, a strong job market, improved consumer finances and rising consumer confidence should support continued overall growth in consumer spending in 2017. On the other hand, rising inflation and interest rates will likely temper consumer spending growth to a slower pace than experienced during most of the economic recovery. The early disappointments in consumer spending this year confirm our view that pent-up demand is no longer a major source of continued consumer spending.

Although little has changed in the overall outlook for 2.1% real GDP growth in 2017, only slightly lower than the 2.2% initial forecast, the year started with surprises to both the upside and to the downside. We expect an interesting year in the economy in 2017 overall in which the goods side of the economy experiences above average growth while the consumer-led areas of the economy slow somewhat relative to past years of the economic recovery. It may be a prelude to a reversal in economic growth leadership from consumer spending to the goods-producing business sectors of the economy. (Please see the table on page 12 for the Huntington Wealth and Investment Management forecasts.)

Inflation Accelerates

Virtually all aggregate measures of inflation surged in January. The Consumer Price Index (CPI-U) rose 0.6% in January for its largest one month advance since August 2012. Inflation was more modest in February, but the annual growth rates are clearly rising. (Please see the chart.) Energy led the early year increase, but measures of inflation excluding energy and foods have been holding firm. The CPI-U excluding food and energy was up 0.3% in January followed by 0.2% in February. More price increases for consumers are probably in the pipeline. The Producer Price Index for Final Demand rose 0.6% in January for its largest increase since February 2013. Producer prices continued to rise 0.3% in February for a 2 month increase of 0.9% in total. The Personal Consumption Expenditures price index from the GDP accounts (referred to as PCE inflation) rose 0.4% for its largest one month increase since February 2011. The so-called core PCE, which excludes food and energy, rose 0.30% in January for its largest one month percentage gain since January 2007. Core PCE inflation is the measure favored for policy decisions by the Federal Reserve. In its March 15th FOMC statement, the Federal Reserve explicitly targeted 2.0% in Core PCE as its intermediate and long-term inflation objective. After the January surge this measure was at 1.74% -- on the doorstep of the Federal Reserve's target.

Inflation Starts the Year in Brisk Fashion



The robust gains across a wide spectrum of inflation measures brought annual inflation rates into line with what they were prior to the deflationary commodity declines of the last 2 years.

While recent price increases are still within the bounds of normal inflation rates during the overall economic recovery, the pace of growth could quickly accelerate to new highs for the expansion, should trends continue. We are revising our annual inflation forecast for 2017 from 2.4% to 2.7% due to the unusually strong start to the year.

The acceleration in inflation will likely also have an impact on monetary policy. We are raising our projections for the Fed Funds rate target at year-end to the 1.25% to 1.50% range. This represents 2 more 0.25% increases in the Fed Funds rate target this year in addition to the quarter percent increase in the Fed Funds rate target implemented in March that brought the Fed Funds rate target into its current 0.75% to 1.0% range. The projections correspond exactly to the median of the Federal Reserve policy maker individual forecasts released March 15th.

Labor Markets Expanding But Still Have Room to Grow

The economy continued to produce solid job growth in January. Labor markets surprised positively with net payroll gains of 235,000 workers in February following upwardly revised 238,000 gains in January. However, a shift from services sector employment towards goods producing sectors mirrors a general change in economic leadership in 2017. Broad-based gains in manufacturing, mining and construction created 75,000 net new jobs in February – the most since March 2000. Construction employment gains of 58.000 may have benefitted from mild weather in February, but strength was also apparent in mining and manufacturing. Non-durable Goods Manufacturing employment rose by 18,000 in February for the largest monthly employment gain since April 1992. Durable goods employment was also solid at 10,000 net new jobs, although Motor Vehicles and Parts lost 3,500 as the auto industry probably began to restructures its product mix. (Please see the section on Consumer spending.) The Mining sector added the most jobs since January 2012 with resurgence in the energy and materials sectors.

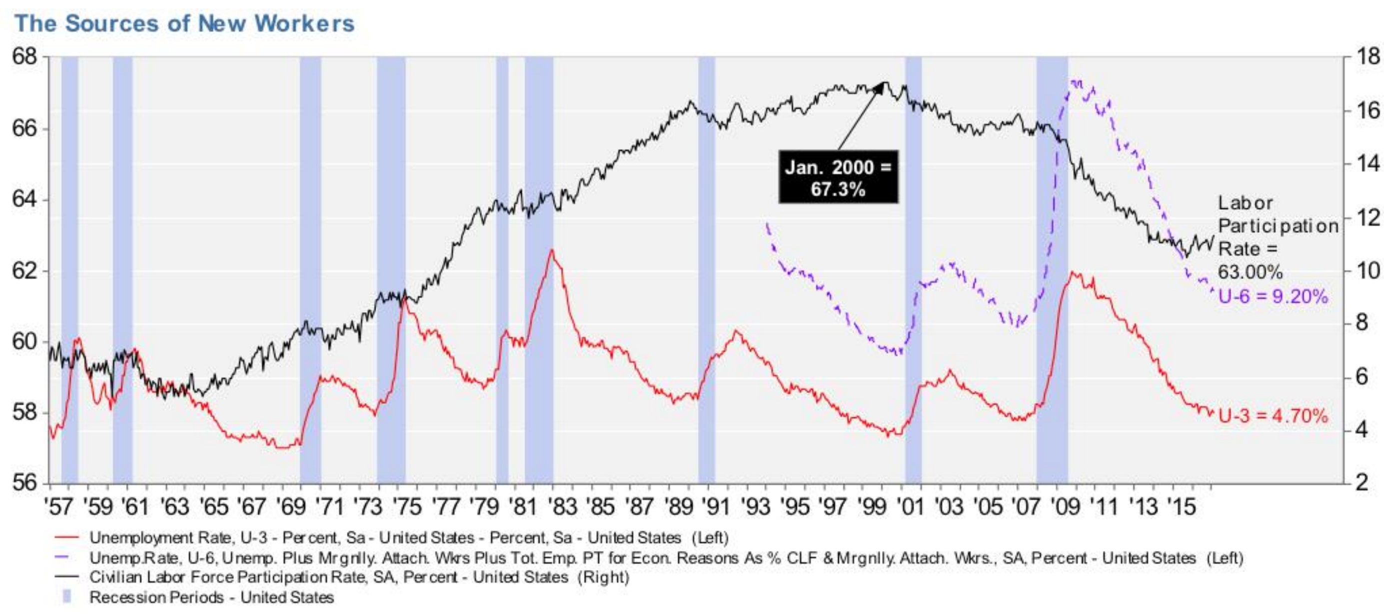
In contrast to the goods producing sectors, job growth slowed in the private services sector from 165,000 average net employment growth in 2016, and 167,000 in January, to 132,000 in February. Retail Trade employment dropped -26,000 in February after adding 39,900 jobs in January. Employment in Education & Health Services (+62,000), Professional & Business Services (+37,000) and Leisure & Hospitality (+26,000) were the areas of greatest service sector employment growth in February.

Workers are responding to improving labor markets by coming back into the workforce. The labor force participation rate rose from 62.7% in December to 63.0% in February. The labor force participation rate in February was the highest since March 2014, and more will likely reenter the workforce in the coming years as long as the economic expansion continues.

Where will new workers come from?

Labor Force Participation has been well below the norm during the period extending from the 1990s to just before the recession as evidenced in the following chart. Retiring baby boomers will keep the exit rate high for the demographic group above 55 years in age. Hence the question, so what will be the source of the new workers, especially if demand is raised by stimulative fiscal policies?

Labor Force Participation and the U-6 Underemployment Rate May Have Substantial Room to Improve After Precipitous Deterioration during this Economic Expansion



Labor Markets continued…

One promising answer is further increases in the labor force participation rate. Participation has dropped 4.3% from its peak in January 2000, but even a 1% net increase in participation by the overall non-institutional population could increase the civilian labor force by 2 ½ million. So labor markets may not be as tight as the official 4.7% unemployment rate suggests.

One source of new workers is potential prime working age workers between the ages of 25 and 54. Labor force participation for this group has dropped significantly from 84.5% in August 1997 to 81.7% in February 2017. For every 1% increase in the participation rate in this prime working age group, approximately 1.25 million new workers would enter the workforce. Although various policy changes could help to expedite labor force reentry, rising wages and job opportunities with an improving economy would likely entice many to find jobs.

Rising participation in the 20 to 24 age group is also a potential area of strong labor force gains. The participation in this group has dropped precipitously from 78.2% in March 2000 to 71.7% in February 2017. While a 1% increase in the labor force participation rate of this group adds a much more modest 215,000 workers, the upward potential in raising the overall participation of this group is probably substantial. Success in raising participation in this prime labor force entry age demographic group could have positive multiplier impacts on raising long-term economic growth. At this critical age the establishment of new households and lifelong working career paths would have immeasurable positive long-term benefits for new workers and their communities.

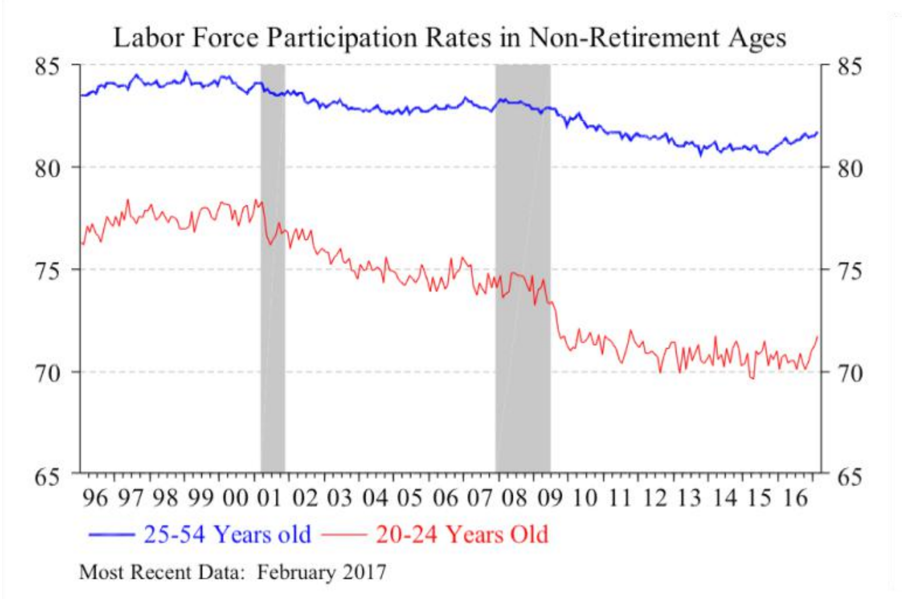
Potential Labor Force Segments for Increased Participation – those outside the workforce who are 20-24 years old and 25-54 years old

In addition to the reentry of many workers into the workforce, the still elevated official U-6 under employment rate is a potential source of new workers. The U-6 rate essentially adds Part-time workers who desire Full-time work to the official unemployment rate. It also adds other marginally attached workers to the workforce that would likely take jobs if opportunities arose. The U-6 underemployment rate has dropped substantially from a 17.1% post-recession high to 9.2% in February.

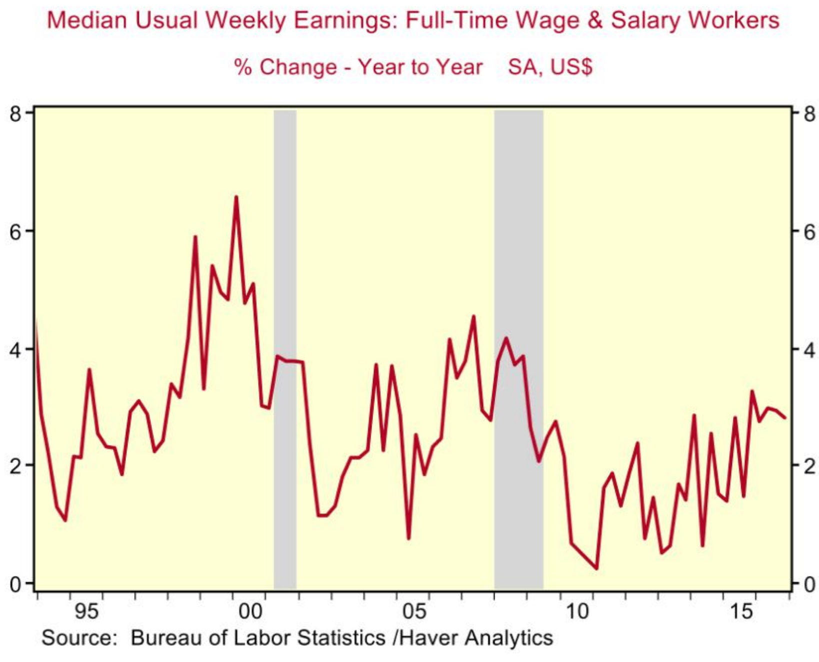
However, it still could provide significant willing worker hours if the rate dropped to its most recent low of 7.9% in December 2006. In summary, it is too soon to conclude that there are not enough workers to grow the economy.

Another sign that labor markets still have some spare capacity has been relatively tepid overall wage growth during the economic recovery. Wages have been climbing at a faster pace in the last year, rising 2.8% per hour for private industries in the last year after slow hourly wage growth near 2% for most of the economic recovery.

However, Median Weekly Earnings have remained below usual compensation growth in the last two economic recoveries as evident in the following chart. Part of labor compensation may be in forms not reflected in this statistic, but generally low wages indicate labor markets are not strong in all regards. The historically low wages may also be a contributing factor to the unusually low participation rate, as well. If demand in the economy continues to rise, firms will need to continue to raise wages, which in turn should increase voluntary labor supply.



Median Wage and Salary Growth during Recovery has been below the last 2 cycles

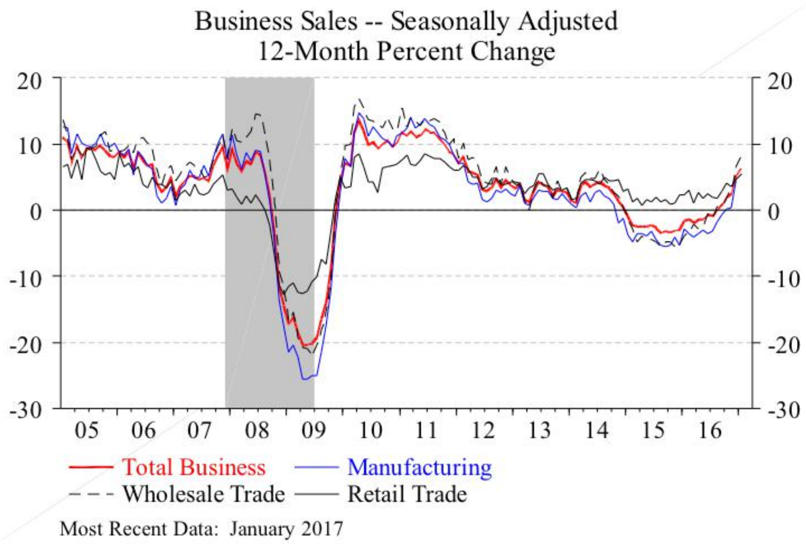


Thanks to Chief Investment Officer, John Augustine, for insightful views contributing to the labor market analysis.

Business Activity Rising as Goods Producing Sectors Recover

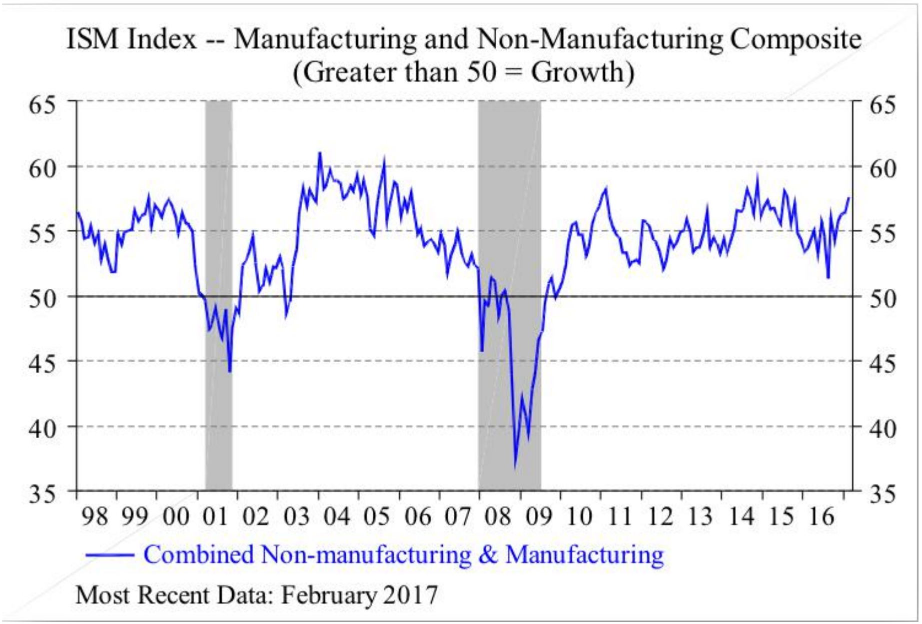
Business Sales were down for much of the last two years but no longer. Sales in all three major sectors of business began to pick up in the second half of 2016, and most were well above sales of January 2016. (Please see the following chart.) The broad-based pick up in goods-producing areas of the economy signals an end to the downturn in these sectors of the economy, which were the sources of much of the anemic overall economic growth during 2016. In general, manufacturing, mining and construction should return to solid growth in 2017, providing a renewed source of economic growth for the nation and regional economies that have a high concentration of goods production – like the Midwest and surrounding states.

Manufacturing is one of the main beneficiaries of the general improvements in goods markets this year. As evidenced in the chart below, new orders for manufacturing spiked to their highest growth rate since December 2013. **All 16 industries contributing to the ISM survey showed increases in new orders in February – a rare event.** Demand for manufacturing has been broad-based and accelerating overall.

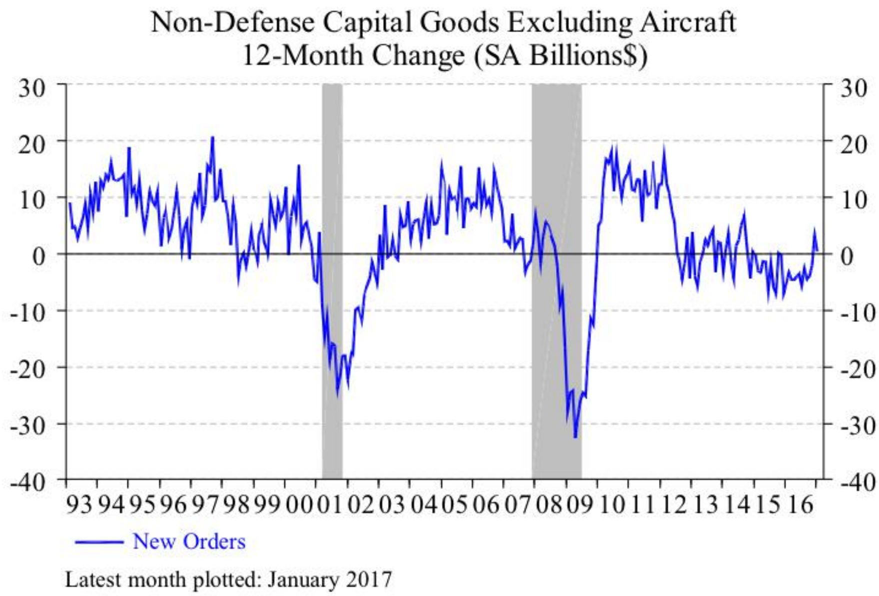


The manufacturing sector is picking up significantly, but the services sector is also growing faster according to the most recent ISM report on non-manufacturing business. The Combined ISM Composite for the whole economy clearly reflects an economy heating up from its tepid growth in 2016. (Please see the following chart.)

What's behind the recovery in business activity? The recovery began during the third quarter 2016 as economy-wide profits began to grow quarter-on-quarter. The correction in inventories was well under way, and the world economy began to strengthen. (See the next section.) Finally, business confidence rose after the election adding another source of business activity recovery. Ultimately, better profits, cash flows and confidence should lead to pick-up in capital spending. The following chart on growth in new orders for non-defense capital goods may indicate the beginnings of a 2017 acceleration in business equipment investment.



Demand for Capital Goods Showing Nascent Signs of Recovery



The International Economy and Exports showing Signs of Recovery

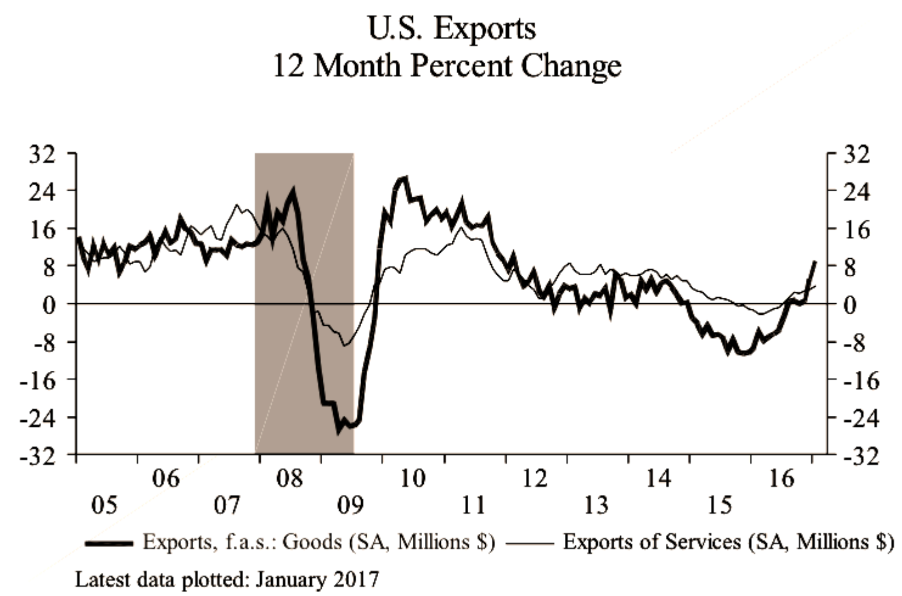
Total Exports of Goods and Services grew 7.4% in the 12 months ending January as the world economy finally lifted out of its 2 year slump. The recovery was especially strong in goods exports, which rose 9.0% since January 2016. Exports provided impetus to U.S. economic recovery in its first 3 years as evident in the chart, but export growth had stalled in 2012, and dropped in 2015 as well as the first half of 2016.

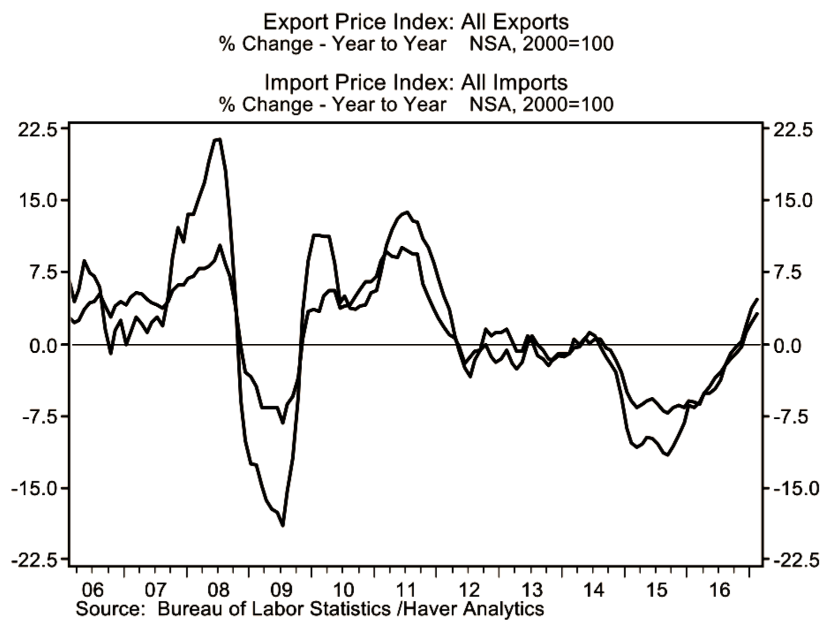
Rising commodity prices worldwide in the last year have been boosting emerging market economies, which in turn have demanded more goods and services from the U.S. and other developed economies. A gradual improvement in China beginning in late 2016 coupled with sustained growth in Europe has also helped to reenergize world trade. Even the actions by OPEC and other energy producers to slow production have aided countries strongly reliant on energy exports by improving their relative trade balances.

Exports Growing Again as International Economy Improves

Total spending growth on Exports and Imports have been broad-based across capital goods, consumer goods, materials and foods. Weather conditions probably provided some boost in January, but the annual increases have been accelerating in recent months, indicative of an improvement in fundamental economic conditions. Much of this improvement is reflected in volumes, but export prices have also been rising, especially for industrial supplies and materials. Petroleum prices have been the biggest contributor to rising U.S. import prices.

Both Exports and Import Prices Have Been Rising



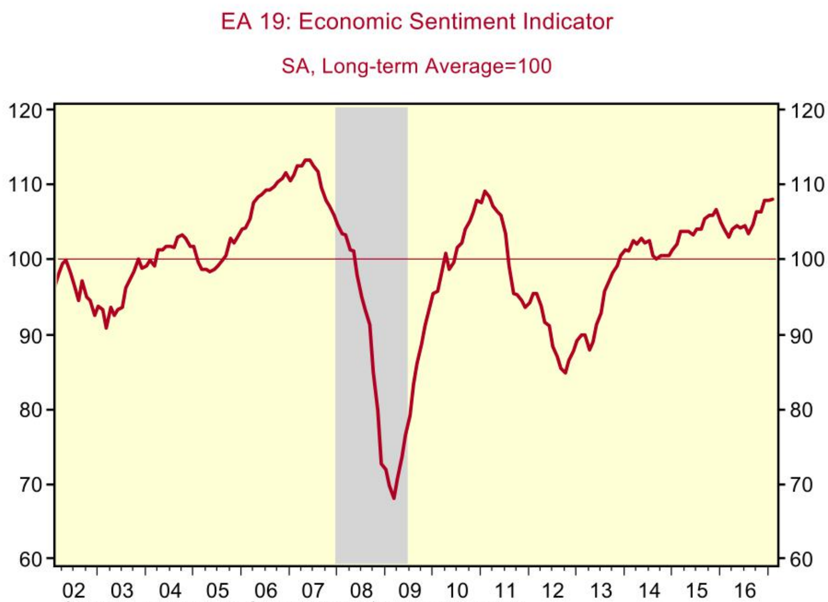


European Economic Sentiment Rising

Europe has been surprising to the upside. The continent's economy certainly will have its challenges in 2017 from Brexit and a weak banking system relative to other developed economies. However, its overall economy continues to grow at a solid pace for the post-2009 period. Additionally, employment continues to grow, the unemployment rate continues to fall and inflation continues to rise.

The newly depreciated euro will likely provide a further boost to exports from the Eurozone and wider EU economies. Import prices have been rising, but since 2010 export prices have retained their growth advantage over import prices.

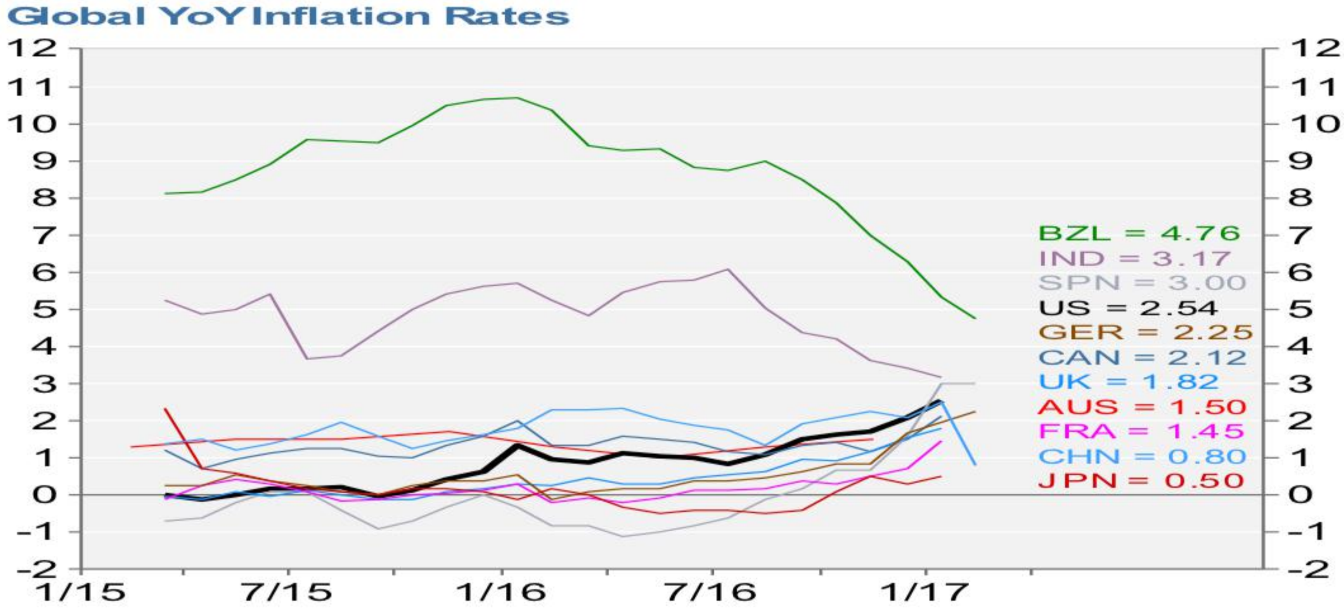
As evident in the chart, the broad Eurozone Economic Sentiment Indicator continues to rise above its 10-year average, boding positively for economic growth in 2017. Our overall view is that the world economy is improving in 2017, and generally with stronger economic growth comes inflation. The chart below shows generally rising inflationary pressures in the world economy. The only exceptions in the chart that stand out are Brazil (BZL) and Indonesia (IND) – countries that have changed their own monetary policies to combat domestically generated inflation.



Source: European Commission /Haver Analytics

Even countries with significantly lower interest rates than in the U.S., such as Germany (GER), are experiencing accelerating inflation year over year (YoY). As a result the direction of long-term interest rates abroad will likely move upwards as the year progresses. Hence, the price of many foreign bonds may not be as stable in 2017 as they have been in recent years.

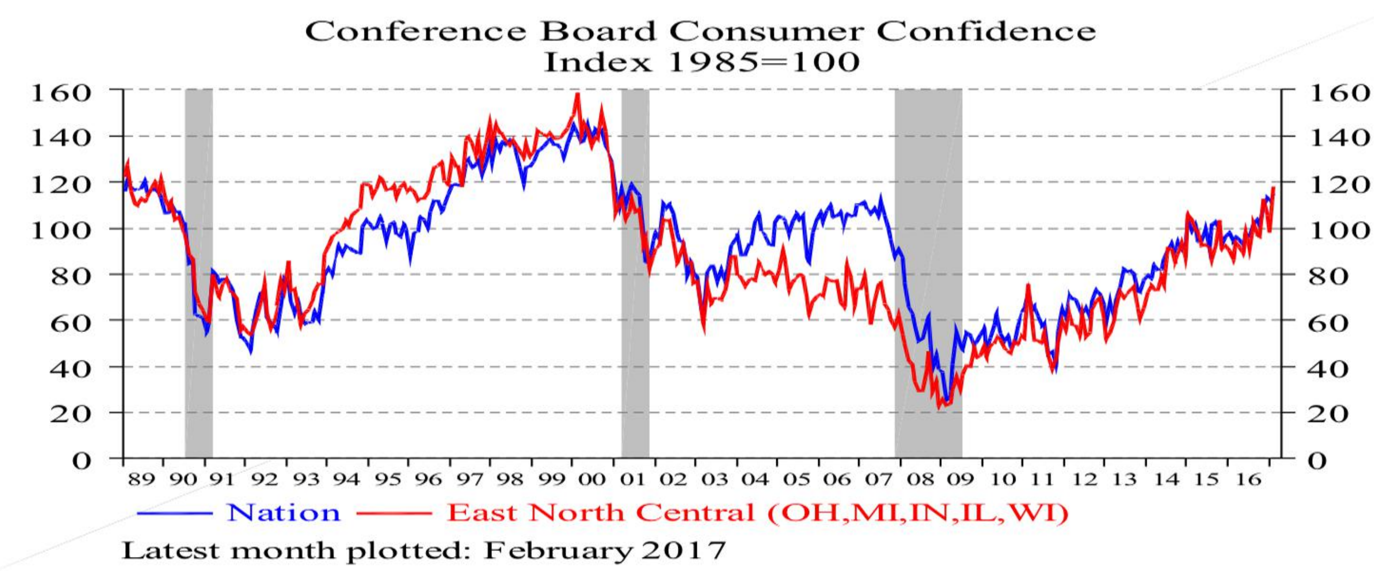
Inflation Accelerating Worldwide



Consumers Surprise to the Downside in January

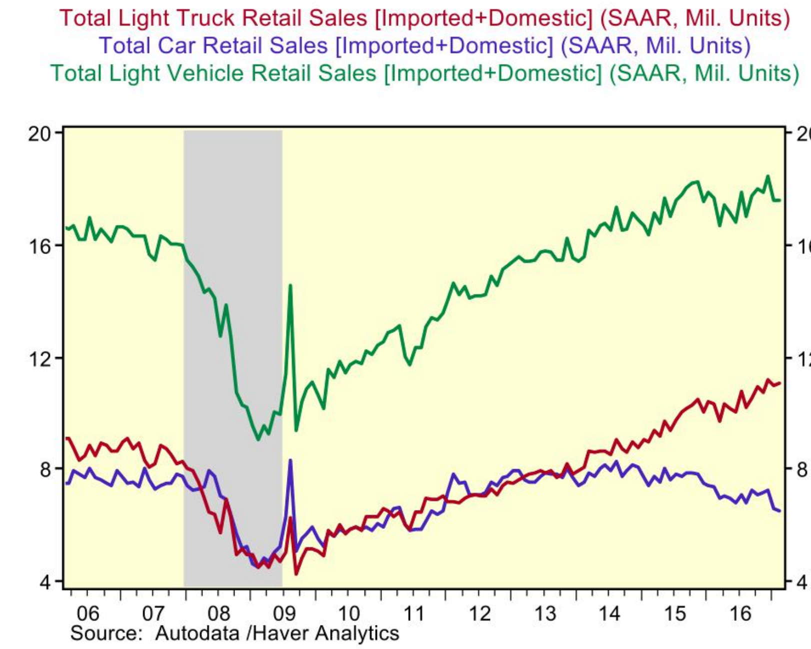
U.S. Consumer Confidence has been rising, but consumer spending actually disappointed in January after robust 3% annualized real growth in the fourth quarter. A pause that refreshes may be in store as consumers pay off holiday bills. However, rising inflation in early 2017 has eroded gains in real incomes, and contributed to a decline in real consumer spending in January. Weak performance by the U.S. consumer will not continue in our opinion based on our forecast that the overall economy should continue to expand, and nominal wages and salaries continue to rise. However, the slow consumption growth confirms our view that the consumer may slow somewhat in 2017 versus recent years. Pent-up demand has been largely satisfied by many consumers in the long expansion. Rising inflation and interest rates will likely pose new headwinds to consumer spending this year. Hence, while business and export areas of real GDP will likely be getting a boost in 2017, consumer spending is expected to keep overall GDP growth at least somewhat in check.

Consumer Confidence Rising Nationally and Regionally



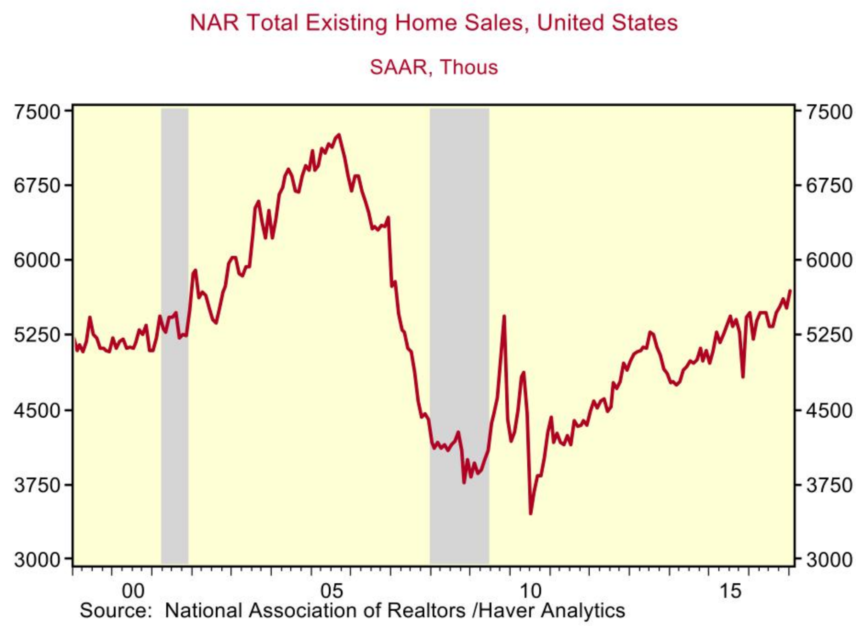
Vehicle Sales at High Levels, But Mix Shifting Away from Cars

Vehicle sales have been remarkably stable on average in the last 2 years. Annualized vehicle sales were 17.6 million for 2 consecutive months starting 2017, virtually equal to 17.55 million in 2016 and 17.42 million in 2015. However, consumer tastes have been changing for the types of vehicle they demand. The chart below reflects this shift in sales from conventional cars towards larger vehicles. This shift does not reflect any fundamental weakness in the economy, but it will likely challenge vehicle producers to meet this change in consumer preferences should it become permanent.



Existing Homes Sales Steadily Rise but remain below the Housing Boom

Permits for new single family homes picked up somewhat in early 2017, but pending home sales for January predicted a relatively soft first quarter for existing housing sales overall for the country. The pause in aggregate activity coincides with other consumer spending indicators in January pointing to a relatively slow start to the year for the consumer. The important upcoming spring home-buying season will be a new test for the overall strength of the housing market, but slow and steady is the most likely direction of housing for 2017 overall. Existing home sales have continued on a gradual recovery with the South and Midwest generally showing stronger cyclical recovery than the West and Northeast. Homes in the Midwest and South generally have better affordability than in the West and Northeast, and will likely retain this affordability advantage for the foreseeable future.



Key Economic Indicators Table

	2015	2016	2017
Real GDP Annual Growth Rates 2009 Chained Prices			
Consumption	3.20%	2.70%	2.30%
Private Fixed Investment	4.00%	0.70%	3.60%
Exports	0.20%	0.40%	3.50%
Imports	4.60%	1.10%	5.10%
Government	1.80%	0.80%	1.00%
Net Inventory Change	$84.0B	$21.1B	$34.9B
Total Real GDP	2.60%	1.60%	2.10%
Nominal GDP (concurrent dollars)	3.70%	2.90%	4.30%
Consumer Price Index Annual growth for Urban Consumers	0.10%	1.30%	2.70%
Federal Funds Rate Target Year-end range	0.25% to 0.50%	0.50% to 0.75%	1.25% to 1.50%
10-year Treasury Note Year-end interest rate yield	2.17%	2.51%	3.00%
Corporate Profits Average annual growth rate	-3.00%	0.00%	7.70%
Average Monthly Non-farm Payrolls Thousands	226K	187K	156K
Unemployment rate Annual average	5.30%	4.90%	4.60%

Historical Data Source: Haver Analytics, FACTSET, other sources in text

Recessions shown in grey in charts

Forecasts: Shown in green. Huntington Wealth and Investment Management, a division of The Huntington National Bank.