

## **Post-Liftoff, Peering into 2016**

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### **Key points:**

- Atlanta Fed President and CEO Dennis Lockhart, in a January 11, 2016, speech to the Rotary Club of Atlanta, discusses his current reading of the national economy and his outlook for 2016.
- Lockhart says the economy is growing at a respectable pace, with solid domestic demand amid a weaker external sector. He foresees moderate growth in 2016 at a pace between 2 and 2.5 percent, along with signs of a tightening labor market and accelerating wage growth.
- The global economic environment is a downside risk to his outlook, but growing domestic investment could provide a potential upside.
- Lockhart expects the economy to enjoy enough self-reinforcing momentum to sustain gradually rising interest rates. Monetary policy decisions are not on a preset path and will be data-dependent, he states.
- A key focus for 2016 will be the behavior of inflation. Lockhart expects inflation to begin converging to the FOMC's 2 percent target, but he will look for more hard evidence in the data.

### **Introduction**

This is the ninth time I've addressed this Rotary Club. It's the tradition of this club to have the Atlanta Fed president talk about the year ahead. That requires mustering the courage to make real predictions. That's a heavy responsibility, but I take comfort in the expectation that by this time tomorrow, you will be a little vague about what I said.

You are probably well aware that something has changed as regards Federal Reserve interest-rate policy. On December 16, after a two-day meeting of the Federal Open Market Committee (FOMC), we announced an increase in the target range for the benchmark policy rate—the federal funds rate (fed funds).

The action taken at the December meeting ended an era of a policy rate set at essentially zero. The fed funds rate had been at essentially zero for seven years, and last month's action marked the first rise in the Fed's policy rate in almost a decade.

The decision we took was not a surprise. It was very well signaled. As a result, the financial markets—both domestic and global—absorbed the news without unusual volatility.

If you followed the run-up to the FOMC's decision, you know that the financial press and the financial community in general fell into the habit of calling the expected rate rise "liftoff." Instead of Cape Canaveral, we have Cape Yellen, I guess. I'm hoping members Hugh Carter and Stan Anderson are here today. Hugh, Stan, we have liftoff. It's done.

Liftoff has gone well operationally. The FOMC willed that short-term rates go up, and they did. There was some uncertainty associated with the mechanics of the first rate rise because the Federal Reserve's balance sheet had been greatly expanded by quantitative easing. There is, potentially, a large overhang of tradeable bank reserves in the market for fed funds, and the demand for fed funds by banks is small. This situation has not turned out to be a problem, and fed funds have been trading comfortably in the stipulated range of 25 to 50 basis points.

The FOMC's December decision is a small, first step ushering in what I expect to be a new era of normalization.

Today I want to look ahead. I will give you my current reading of the national economy and the outlook for 2016. I'll comment on the risks around the outlook. I'll give you my sense of the outlook for further interest-rate moves, based on what I know today. And I'll discuss the key factors that will influence my thinking about subsequent rate moves as the year unfolds.

Some of you—those amazing perfect-attendance members, at least—have heard my disclaimer eight times before. My remarks today are my personal views. I'm not speaking for the Federal Reserve or the FOMC.

## Recent data/current condition of the economy

Before I look into the future, let me summarize the current state of the economy. The economy is growing at a moderate pace—not a spectacular rate of growth, but respectable, just a little shy of the longer-term trend rate of growth per my team’s estimation.

Greater strength is coming from domestic demand than from the external (or export) sector, which is weaker. Domestic momentum has been fueled by growth of consumer activity. In the third quarter of 2015, the annualized rate of growth of consumer activity was 3 percent. That’s a solid number. We don’t yet have a good reading on the full fourth quarter, but we believe it may show a slowdown. We also don’t yet have official holiday spending numbers, but early reports suggest some year-over-year growth. All in all, the fourth quarter could look rather weak.

There is some good news within the trend of household and personal consumption. Auto sales have been extraordinarily strong. In fact, auto sales have never been better, it’s fair to say. The annual pace of unit sales of cars, SUVs, and light trucks hit 18.1 million in November and 17.2 million in December. However, according to my auto dealer contacts, they have resorted to discounting and aggressive incentives to sustain the high level of sales. This may have pulled forward future demand.

Those same auto dealer contacts have cited low gasoline prices as a spur to recent sales. As last year got started, there was much anticipation of the gas price “dividend,” so to speak. Lower gas prices were expected to translate to a pickup in broad consumer activity. There were signs of this happening in the second half, but some of the dividend appears to have gone to savings. The savings rate rose about a half a percent in the second half of last year.

As I said, the external sector of the economy is currently weaker than the purely domestic side. Weakness in the manufacturing component of industrial activity reflects softer exports due to the higher dollar exchange rate.

Two other factors are weighing on the current rate of growth. There is a fall-off of investment in the energy sector—the oil and gas sector—in response to falling oil and gas prices. And there has been a slowdown in inventory investment following an accumulation of inventories in the first half of last year.

Overall, I would say that recent economic data have been mixed, the fourth quarter may be disappointing, but in the same breath I would say mixed data do not undermine my basic forecast.

One reason is the strength of employment growth and what that says about overall economic momentum. We got the final 2015 employment report just last Friday. It showed December (nonfarm) payroll growth of 292,000 jobs. This capped a year in which the monthly average net gain in jobs was a strong 221,000. Close to 2.7 million new jobs were created in 2015, following an even better year in 2014.

## **Outlook for 2016**

I'll now get to those predictions. Let me now lay out my outlook for 2016. I have a mildly optimistic outlook for 2016. Mildly, not wildly. I expect the broad economy to continue to expand at a moderate pace. To venture an estimate—between 2 and 2.5 percent, possibly a little higher.

This rate of growth should be sufficient to maintain positive momentum in employment conditions. Growing employment—in both jobs and hours—adds to aggregate household incomes that, in turn, keep consumer activity growing.

The hiring trend in our economy has been quite encouraging. The official unemployment rate is 5.0 percent. This statistic doesn't tell the whole story, but we're making impressive progress. That said, there is still a gap to be closed to reach full employment. Over the next year or so, I believe we'll see measures of unemployment and underemployment fall within the range most economists equate with full employment. As you may know, full (or maximum) employment is one of the two congressionally mandated objectives of monetary policy.

As we move through 2016, I expect to see growing signs of a tightening labor market. Wage growth, for example, should accelerate as labor markets tighten. In fact, our business contacts have told us in recent months that it is increasingly difficult to find and retain staff. There is not yet convincing evidence of faster broad-based wage growth, but there were some hints of a pickup in wage growth in the second half of 2015. I expect to see clearer signs of accelerating wages in 2016.

## **Risks to outlook**

There are risks on both sides of the trajectory I've described. In my view, the downside risks relate mostly to the influence of the rest of the world on our economy.

Last week we saw a global selloff in stock markets apparently triggered by data from China that fell short of expectations. The bearish environment was compounded by tensions between Iran and Saudi Arabia, the bomb test claimed by North Korea, and lower oil prices. When such volatility develops, I think it's helpful to look at the real economy of the United

States (as opposed to the financial economy) and ask if something is fundamentally wrong. Are there serious imbalances that make the broad economy vulnerable to foreign shocks? I don't see that kind of connection in current circumstances.

Since the American consumer is central to domestic demand, it's prudent to watch for a shock or development that could cause the consuming public to get very cautious. An obvious question is the effect of higher interest rates. I don't expect higher interest rates to snuff out consumer demand. The relatively modest rate increases forecast by FOMC participants over the year are premised on continuing economic momentum. I expect that the economy will enjoy enough self-reinforcing momentum to handle gradually higher rates.

There are also plausible upside risks. The global economic environment could improve. There are tentative signs of quickening recovery in Europe, for example. The positive consumption effects of low oil and gasoline prices have not run their course, in my opinion. Corporations have a lot of cash on the sidelines available for investment. Even modest improvements in the outlook could bring this cash off the sidelines. The economy could snap back faster from a soft fourth quarter if the three factors holding back the economy—global conditions, oil sector investment, and inventory adjustment—dissipate more quickly than expected.

### **Policy outlook**

I expect further rate increases will be justified by economic performance in 2016. In my opinion, expectations for the path of the Fed's interest-rate policy should be grounded in these basic points:

There is no predetermined schedule of increases, no preset path of policy. No map. Monetary policy is not on autopilot.

Decisions will be data-dependent. That is to say, the evolution of economic conditions will dictate the timing and, to a lesser extent, the magnitude of further rate increases. Based on the current consensus outlook of FOMC participants, rate increases will likely come in gradual steps—something less frequent than every meeting.

I'd like to be more definitive in predicting future rates, but the degree of uncertainty—particularly as regards global influences on our economy—affirms the wisdom, in my opinion, of letting the economic data do the talking. This means there is necessarily some tension between clarity of direction and policy optionality. It's not possible to max out both. I think the Committee has struck a reasonable balance under the current circumstances.

## **Key factor—inflation**

I will be watching a broad spectrum of data this year, but the behavior of inflation will be a key focus.

The FOMC has set a target for inflation at 2 percent over the longer run. We have a specific way of measuring inflation—a particular version of a particular index—but I'll speak in more general terms here.

Inflation has been running well below target for some years, in fact, and just above zero by our preferred measure for the past year or so. Much of the undershoot of the inflation target reflects the likely passing influence of the fall in energy prices as well as the dollar's downward pressure on import prices.

Price data are a lens that helps us evaluate the performance of the overall economy. Inflation numbers tell us something about overall demand conditions and whether the economy is reaching a notional steady state. Factoring out the transitory influences of oil prices and the dollar exchange rate on the inflation rate, the data suggest there is still a modest shortfall from target.

A phenomenon as complex as price trends across the complete spectrum of goods and services in our economy is best evaluated using a dashboard approach. Dashboards commonly involve up arrows, down arrows, and sideways arrows to depict the trend of the data. In the case of inflation, think of an up arrow as indicating rising inflation—that is, prices rising faster. A down arrow indicates disinflation (the slowing of the rate at which prices are rising) and could also be a warning of deflation (falling prices, broadly). A sideways arrow represents a stable reading of inflation, even if below target.

The 30 or so inflation data series we track at the Atlanta Fed, taken together, suggest a sideways arrow. Inflation is below where we want it, below what we consider to be most healthy, but the picture is not really worsening.

That said, recent measures of inflation expectations hint at some slippage. We care about inflation expectations data because what the public believes about inflation can be self-fulfilling. It's important that expectations be anchored at the right level. It's more difficult to achieve an inflation objective of 2 percent over the long haul if people are fixated on the wrong number.

I think the various measures of inflation expectations should be monitored closely this year. I will be watching for any signs of a more definite downshift. As of now, I'm not overly

alarmed by recent readings. I believe inflation expectations remain reasonably well anchored in the neighborhood of our target.

I'm forecasting inflation readings to start to converge to our 2 percent target in 2016. I supported the FOMC's decision in December to lift off. The Committee had laid out a criterion of having "reasonable confidence" that the inflation rate would move to target in the medium term. From my perspective, our satisfaction of the criterion of "reasonable confidence" was based on projections of the most likely outcome. I will be looking for more hard evidence in the inflation data as the year proceeds.

So, to sum up, I am optimistic about the economy's prospects in the new year, but I will be watching the data trends closely. Let me emphasize that the Fed's monetary policy is still quite accommodative even with the first rate increase last month and the assumption of subsequent increases in 2016. That will help the economy continue to build momentum.