With gross domestic product (GDP) growth at 3.3% annualized in the third quarter, the Federal Reserve (Fed) is likely to raise rates in December for the fourth time in the past 13 months. The Fed raised the federal funds rate by 25 basis points (0.25%) last December and again in March and June of 2017 to a new range of 1.00% – 1.25%.

The Fed has been more inclined to raise rates recently amidst signs of a strengthening economy. U.S. employers have added new jobs for more than 80 consecutive months as the unemployment rate dropped to just 4.1% in October. Third quarter GDP growth was revised up from an annualized rate of 3.0% to 3.3% November 29, according to the U.S. Department of Commerce. Retail sales are up 4.6% year-over-year, consumer spending has been increasing steadily, and corporate earnings are up more than 10% over the past 12 months. (See: Fed Hikes Rates for Second Time this Year)

The Fed rate hike is part of a two-pronged normalization process to boost interest rates from historic lows and reduce the Fed’s debt security holdings. In addition to a gradual rate increase, the Fed began a long-term effort to trim its $4.5 trillion balance sheet in October. It plans to accomplish that by ending its policy of purchasing Treasury issues and mortgage-backed securities. As the older securities reach maturity, the Fed will not replace them with new debt holdings, essentially allowing its inventory of debt securities to decline over time.

Headwinds

Fed policy mistakes and tax reform failure are the biggest concerns for the U.S. economy. Here are some of the key challenges the economy and the markets face in the months ahead:

Fed balance sheet reduction. Under new Federal Reserve chair nominee Jerome Powell, the Fed’s balance sheet reduction plan is expected to continue on track. The policy is considered necessary to systematically reduce the central bank’s direct influence on the capital markets, but it could lead to some problems in the short term. With liquidity marginally diminishing, interest rates could rise and stock and bond prices could dip. Consumer spending and business development could also be affected, as could the residential and commercial real estate markets. However, we believe that these issues can be mitigated if the Fed is predictably methodical in its balance sheet reduction strategy. Also, some of the potentially negative impacts from this policy change could be significantly offset by prospective changes in tax policy and the ongoing reduction in regulatory burdens. (See: How Fed Monetary Tightening Could Affect the Economy)

Low yields and government debt abroad. Yields on government bonds and notes remain at low levels, both here and abroad. As governments in Europe and Japan – where some fixed income investments still carry negative rates – begin to normalize their monetary policy, that could have a cooling effect on their economy and markets. China could also face some prolonged economic challenges as a result of its mounting debt.
Slow wage growth. Although employment growth has been strong the past few years, wages are still relatively low and moving up slowly – only 2.4% year-over-year.

Stock valuations. Stocks continue to climb, pushing the S&P 500® index to new highs and a 12-month forward price earnings (P/E) level of about 18.3. That’s the highest level since 2004 (and more than three points higher than the historic average). (The forward P/E measures the stock price-to-earnings ratio of the S&P 500 index based on corporate earnings forecasts for the upcoming 12-month period.)

Tailwinds

We have seen several signs of a strengthening economy in recent months, including GDP growth of 3.3% annualized in the third quarter. Additional signs include:

- Although retail sales growth has been fitful this year, sales grew 1.9% in September (aided by the hurricane recovery efforts in Florida and Texas) and another 0.2% in October. Year over year, retail sales are up 4.6%. With the holiday shopping season upon us, it will be interesting to see if consumers will open their pocketbooks and keep sales growing. While rising gasoline prices may push up gross retail sales numbers, a key to the economy will be sales of new vehicles and homes.

- Personal consumption expenditures have increased for 32 consecutive months beginning February 2015.

- Oil prices continue to rise as the surplus in the global oil supply recedes. With OPEC expected to continue its limited production policy, supplies could continue to drop, driving prices higher. The rising prices have already spurred a rebound in U.S. drilling and production operations, which could continue to ramp up as supply dwindles and prices improve. A rebound in the U.S. oil industry could lead to improving profits and an increase in well-paying jobs.

- The unemployment rate has dipped to just 4.1%, although some areas of weakness remain, such as wage growth.

- Corporate earnings were up about 8.5% through the first 11 months of 2017 – an improvement over previous years – and manufacturing and capital spending activity appear to be on the upswing.

- The dollar has declined versus most major currencies throughout 2017, aiding the earnings of U.S. multinationals and exporters, as well as making U.S. companies more competitive abroad.

- In Europe, the economic recovery continues despite historically low interest rates and slow wage growth.

Expectations

As noted, we have recently seen signs of a strengthening economy, but the Fed’s long-term policy of reducing the balance sheet and raising the federal funds rate could have a dampening effect on the economy and the markets. But we expect the impact to be minimal if the Fed is flexible in implementing its plan. However, meaningful changes in tax and regulatory policy could bolster capital spending and longer term growth.

We believe employment will remain strong, with the possibility of accelerating wage growth as the job market tightens.

The consensus view for inflation has been 2.2% for 2017 and 2.3% for 2018. This would be a continuation of a subdued trend that has been in place for a number of years. If the domestic and global economy continues to show solid growth, inflation could be a modest upside surprise.
Another Fed rate hike in December – with more expected in the months ahead – could put upward pressure on interest rates.

Outside the U.S., over the next 12 months, we expect European growth to continue its gradual improvement. We believe that China will continue to have GDP growth of around 7%, but still faces some persistent fundamental risks due to past excessive credit growth. We also expect the emerging market economies to continue to improve.

In the U.S., the economic recovery should continue and a recession should be avoided if consumer spending continues to improve, wages and corporate earnings continue to rise, the oil industry remains stable, and consumer interest rates continue to move up.

2 Factset, refers to companies of the S&P 500.
3 The S&P 500® Index is a market-cap weighted index that represents the average performance of a group of 500 large-capitalization stocks.
4 Factset, November 30, 2017.
5 Factset.
8 Factset.

Media contact: Samantha Mehrotra, 612-844-4197, samantha.mehrotra@thrivent.com

All information and representations herein are as of December 1, 2017, unless otherwise noted.

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