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US ECONOMIC UPDATE: Q4 OFF TO SOLID START

This week was chock-full of US economic data which broadly pointed to solid economic momentum at the start of Q4. All the "hard" data released covered the month of October and it will be a few weeks before any post-election "hard" data is reported. In the near term, the outcome of the presidential elections is unlikely to impact economic activity and if there are any swings in the data, they will likely be transient. The Trump Administration's policy initiatives will only impact economic activity further out.

Business survey data for early November, some of which may have included post-election responses were reported this week. The Empire State manufacturing business conditions index turned positive for the first time since July. The details of the Philadelphia Fed manufacturing survey were robust despite the slight decline in the headline index and future capex plans held up in both surveys. October's manufacturing production also improved. On balance, the details of these reports all point to a continued gradual improvement in the industrial sector this quarter.

Consumers opened their wallets in October creating robust momentum for the holiday shopping season. Control retail sales, the category of retail sales which matters most for private consumption in GDP, advanced by a robust 0.8% m/m – the strongest monthly gain since April. October was a good month for households, with average hourly earnings from the employment report posting its strongest yr/yr gain in this recovery. The rally in equity prices could lead consumers to ramp up spending again this month. Consumer sentiment for the second half of November will be released next week and should provide insight on consumers' income expectations and post- election spending.

Housing starts data bounced back nicely in October after an anomalous drop off in the prior month. Residential fixed investment declined for two consecutive quarters, so the bar is low for some improvement in Q4. The fundamentals - strong population growth for age cohorts which form new households, tight inventory of for-sale homes and optimism among home builders - continue to look good for new residential construction and home sales in the medium term. As usual, the housing market recovery will continue to be choppy and an unusually mild (severe) winter could boost (depress)activity.

On prices, the core consumer price index (CPI) fell just shy of expectations in October. The Fed's preferred measure of consumer prices, the core PCE deflator, will be released on November 30th, and the slight downside risk implied by the CPI will not be enough to derail the FOMC from hiking in December, with inflation already so close to 2%.

Bond yields have increased significantly since the US presidential elections and could weigh on interest-rate sensitive sectors of the economy, such as housing. As was the case with the Taper Tantrum of May 2013, there could be an immediate surge in home buying activity, as households try to lock in rates in fear of further increases, followed by a slowdown. But note that rates are still historically low, with the 30yr mortgage rate still under 4%. Consumer sentiment surveys will be key for monitoring any changes in buying plans after this jump in rates.

The Federal Reserve will most likely increase its target for the federal funds rate at its December meeting. The implied probability of a December hike from the fed funds futures market is currently 96%, economic data have been solid, labor markets continue to tighten and inflation is near 2%. Moreover, Fed Chair Yellen in prepared remarks for

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her testimony before the Joint Economic Committee of Congress (takes place later this morning) stated that a rate hike "could well become appropriate relatively soon." She also noted that delaying rate increases for too long could lead to a sharp tightening of policy and excessive risk-taking. Only a significant deterioration in financial market conditions and economic data could prevent a hike in December.

Bottom Line

Domestic demand is set to improve in Q4, but net exports will provide a large drag on Q4 growth after an outsized and unsustainable contribution to Q3 growth. Further out in the outlook, expect more GDP growth near the 2% trend. Any fiscal policy boost from infrastructure spending and tax cuts are at least a year out and the Trump Administration's plans on foreign trade will be key, as diminished trading activity would be detrimental for economic growth. *(We think trade wars are unlikely and that Trump is unlikely to implement extreme policy, see Implications of the Trump victory* and *Prospects under Trump potential positives and negatives).*

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