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If you are simply following the latest economic headlines, you might be excused for concluding that the U.S. economy is finally beginning to break free from a decade of anemic growth. Both the S&P 500 and the Dow Jones Industrial Average sit at all time highs. The value of the S&P is up a stunning 25 percent since Election Day 2016, and each passing day seems to bring a new all-time high. The University of Michigan's Consumer Sentiment Index reached a 13-year high in mid-October, and still stands at a level well above the historical average. The unemployment rate is down to just 4.1 percent, the lowest level since December 2000.

Looking just at these numbers, you might even conclude that the economy is roaring.

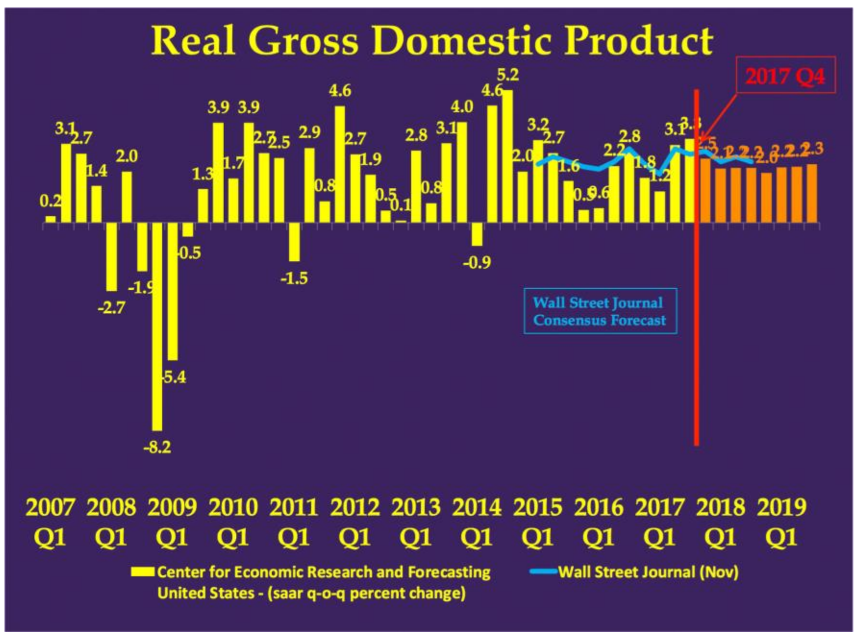
Other recent economic data are more sobering. We must acknowledge that the U.S. managed to grind out two consecutive quarters of 3 percent growth— a significant improvement over the Post-recession average of 2.1 percent. However, it is still below the post World War II average of 3.5 percent.

When considering both the flashy and the more sober indicators, the question that we have had to grapple with is, can the economy sustain increased growth under the status quo? Our answer is, very simply, no.

Readers should recall that one of the convictions underlying CERF's economic forecasts is a belief that the Country's poor economic performance over the past decade is no accident and that only fundamental changes to the policies which drive poor economic activity can hope to lift the prospect of growth. Record stock market highs, surging consumer sentiment, and low unemployment are not substitutes for the fundamental changes to monetary policy, the corporate tax system and government regulation that are required for sustained growth. As of this writing, the current political regime in Washington has not delivered any of the fundamental changes which we believe are necessary. And, as explained below, we see alternative, less optimistic explanations for some of the economic indicators which are being heralded as evidence of economic resurgence.

The current forecast of economic activity calls for growth to average 2.2 percent over the next eight quarters. This represents an increase over the previous forecast's average of 2.0 percent growth and an acknowledgement that the economy appears to be strengthening despite the various ways that government policies constrain economic activity. This is an upward revision to previous forecasts, but it in no way signals a regime change whereby the U.S. economy has broken free of the pattern of anemic growth.

This forecast contains another change from the previous forecast. For the first time since at least the Financial Crisis, there are positive risks to the forecast. Ever since the darkest days of the Financial Crisis, the balance of risks has been decidedly negative—the risk that actual economic activity would exceed our forecast has been relatively low, while the risk that it would significantly underperform our forecast has been relatively high. That pattern no longer holds.



The dominant risk to our forecast during this publication cycle is the possibility of fundamental change of the kind that we have been calling for.

In just the past 24 hours, Congressional Republicans have reached tentative agreement on the outline of a conference bill that, if passed, would substantially reform the U.S. corporate tax system. As discussed in the nearby U.S. Economy essay, the bill is a combination of necessary reforms and a few disappointing compromises which, on net, would increase the rate of economic growth in the United States.

It is too early to assume that the conference bill will pass. As of this writing, Republicans own just a 51 to 49 advantage in the Senate. In addition, every single Democrat will vote against the Republican tax package, despite having supported similar reforms (including a corporate rate reduction and a repatriation tax) when President Obama proposed them in his 2016 budget proposal. It will take previously unseen (unimaginable?) levels of political skill on the part of Republicans to hold the conference together and to send the bill to the President's desk.

If the bill does pass as currently written, we will need to revise our forecast of future growth upward. The upside risk to our forecast is offset by the downside risks that extraordinary monetary policy and burdensome government regulation create. The probability of reform in these two areas is vanishingly small.

Our current forecast is still pessimistic relative to the so-called "consensus." Over the next four quarters, our forecast calls for an average growth rate of 2.1 percent compared to 2.6 percent for the Wall Street Journal consensus and 2.4 percent for the National Association of Business Economists (NABE) consensus. Those two consensus forecasts seem reasonable to us only if you assume that corporate tax reform is inevitable.

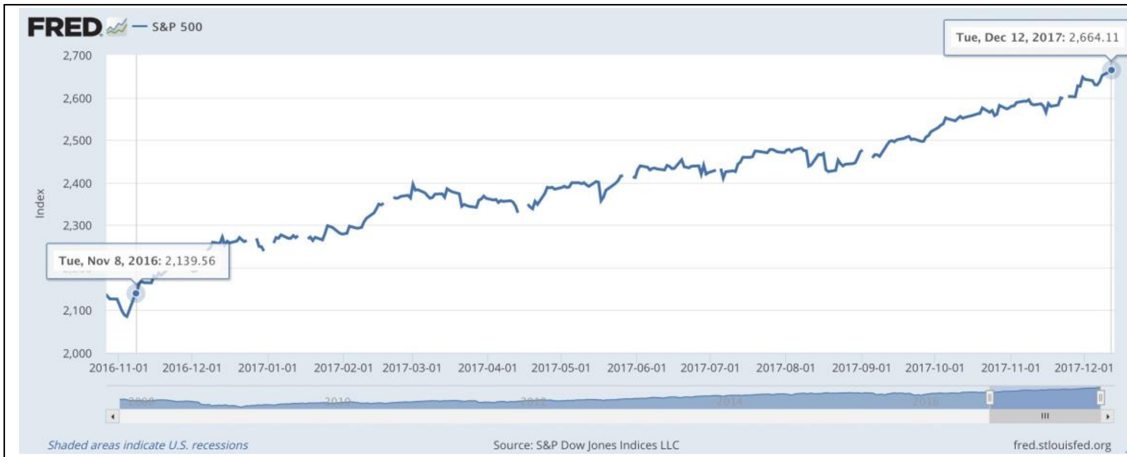
United States
Gross Domestic Product
Real SAAR Growth

Quarter	CERF Forecast	WSJ Forecast	NABE Forecast	Actual - First Estimate
2016 Q1	1.5	2.1	2.0	0.5
2016 Q2	1.5	2.4	2.3	1.2
2016 Q3	2.0	2.9	2.8	2.9
2016 Q4	1.8	2.3	2.1	1.9
2017 Q1	1.7	1.9	2.0	0.7
2017 Q2	2.2	2.9	3.1	2.6
2017 Q3	2.2	2.7	2.8	3.0
2017 Q4	2.4	2.8	2.7	-
2018 Q1	2.1	2.4	2.3	-
2018 Q2	2.0	2.6	2.3	-
2018 Q3	2.0	2.4	2.3	-
2018 Q4	2.1	-	2.4	-
Average	1.84	2.46	2.44	1.83
Average Bias	0.01	0.63	0.61	-

Sources: US Bureau of Economic Analysis, Wall Street Journal, and CERF

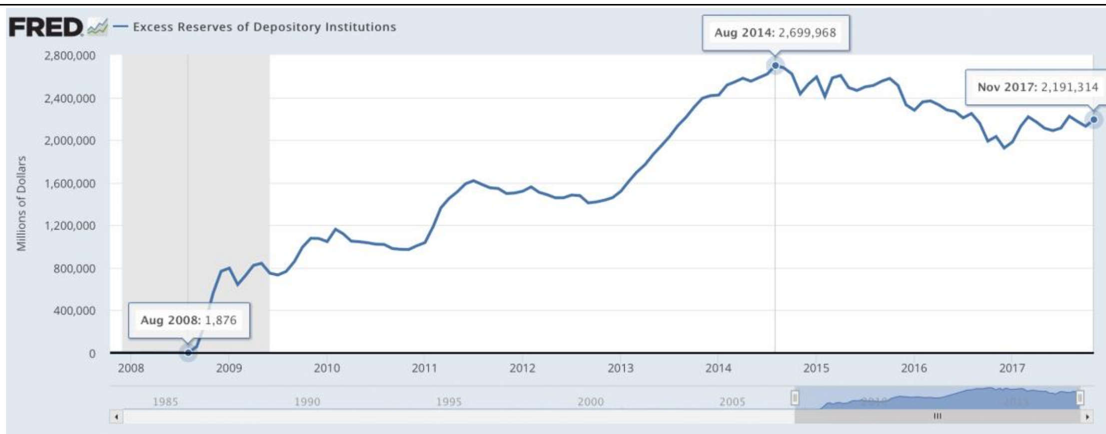
As noted in previous publications, we feel quite comfortable being "below consensus." Since the beginning of 2016, the average bias of CERF forecasts has been just one-hundreth of a percentage point. By comparison, both the WSJ and the NABE consensus have had an average bias of more than six-tenths of a percentage point. That is to say, the consensus has called for economic growth that is on average 0.6 percent higher than actual first readings. In this case, if corporate tax reform passes (an outcome to which we assign no more than 50/50 probability) we expect growth in 2018 to be closer to the consensus than our own forecast.

What follows are discussions of headline-grabbing economic indicators as well as critiques of conventional press and analyst coverage of these concepts.



Stock Market – Record Highs
Both the Dow Jones Industrial Average and the S&P 500 Index stand at all time highs. Since Election Day 2016, the S&P has grown an extraordinary 25 percent, an increase in total market cap of more than $4.7 trillion. The stock market's performance begs the question – Are market participants extraordinarily bullish on the economy? Is this the Market's forecast of future economic growth? We find this hard to believe. As discussed in the nearby U.S. Highlights essay, we believe that one of the primary drivers of market gains is the role of extraordinary monetary policy. Artificially low interest rates drive investors to chase ever-riskier yield. Large gains in asset prices, driven by increased risk-taking, stoke excessive optimism. Excessive optimism begets more risk taking. Rinse and repeat. We see reason for caution not optimism in the recent stock market gains.

Unemployment & Labor Force Participation
The unemployment rate currently stands at 4.1 percent, a low not seen since December 2000. Policy makers and journalists alike routinely refer to the economy as having achieved "full employment," which has traditionally meant that everyone who wants a job can find one. We reject the notion that the economy has achieved full employment. Further, we believe that the unemployment rate is a flawed measure of labor market strength. The Civilian Labor Force Participation Rate measures the actual capacity of the country's workforce. This measure of labor market activity simply divides the number of people active in the workforce by the overall size of the working age population. The participation rate currently stands at 62.7 percent, the lowest level since 1979. A decade of anemic economic growth, crisis-era policies which continue to disincentivize work, and creeping demographic changes have pushed a huge number of working age Americans out of productive economic activity. Sustained, robust economic growth will continue to be a challenge as long as this much human capital is removed from productive activity.



Monetary Policy

On December 13, the U.S. Federal Reserve announced it's second increase this year to the Fed Funds target rate, noting "the labor market has continued to strengthen" and economic activity is rising at "a solid rate." Buried in an *Implementation Note* to the FOMC's press release, and lost in the press coverage, is the fact that the Federal Reserve increased yet again the interest on excess reserves (IOR). Bank's can now collect 1.5 percent interest on any reserves stored at the Central Bank. Prior to the implementation of IOR in 2008, as an extraordinary response to the Financial Crisis, excess reserves of all banks in the U.S. totaled just $1.9 billion. The implementation of IOR caused the level of excess reserves to surge by more than 44,000 percent in just six months. Excess reserves peaked in August 2014 at nearly $2.7 trillion. As of November 2017, the level is still more than $2.1 trillion. That is 2 trillion dollars which have been sidelined from economic activity by the Fed. The Federal Reserve's IOR policy will continue to constrain economic growth until the policy is ended.