

MARKET INTELLIGENCE

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Stronger Sentiment, Higher Interest Rates

Introduction

The election of a president always represents at least the potential that policies and procedures established during the previous administration may change – to a greater or lesser degree. With change, uncertainty materializes. Economic activity, particularly large scale consumer spending or business investment decisions, typically do not perform well in the context of uncertainty of what the future holds.

Given the lack of Trump policy specifics, controversial initiatives, and few clues regarding policy priorities, larger than expected adverse consumer and business sentiment was expected to confront the economy during 2017. This adverse sentiment was expected to result in slightly slower real GDP growth, construction activity and growth in cement consumption –reflected in PCA's fall forecast.

The impact of adverse uncertainty, coupled with increased inflationary expectations was expected to lead to higher long-term interest rates and result in a tempering of overall economic, construction and cement consumption growth for 2017. The increase in interest rates was expected to push single family sales down and commercial nonresidential activity down – to the detriment of cement consumption. These factors resulted in PCA's fall forecast for cement consumption showing only modest gains for 2017 (3.0% year-over-year).

Recent evidence may suggest modest increases in interest rates are likely to unfold, but consumer and business attitudes may actually be stronger than anticipated in the fall forecast. If these trends are sustained, stronger than expected economic growth, not slower, may materialize as a consequence of the election. This, in turn, could result in marginally stronger construction activity and cement consumption.

Recent Evidence on Confidence and Sentiment

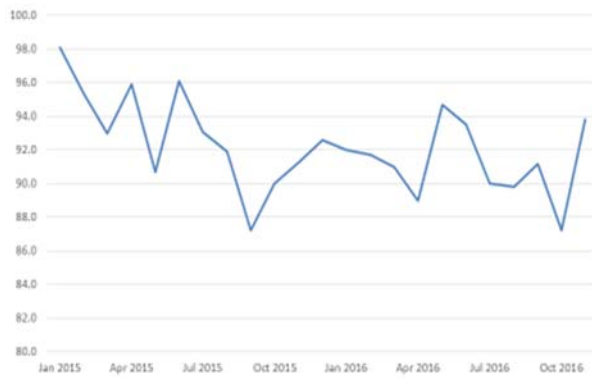
Buoyed by the prospects of aggressive fiscal stimulus initiatives in the form of tax reform and infrastructure spending, and supplemented with an easing of regulatory compliance costs, many believe that Trump's economic policies suggest stronger economic growth in the quarters ahead and is expected to result in higher wages and profits. This logic serves as the foundation for strengthening near-term attitudes.

The near-term economic euphoria has been reflected in data movements of various confidence indices that have been released since the election. The Conference Board, University of Michigan, and NFIB surveys all point to a moderate-to-robust strengthening in attitudes since the election. These gains have been supplemented by strengthening in the Dow, the Purchasing Managers' Index, Philadelphia Federal Reserve diffusion index, and lastly the NAHB's housing index.

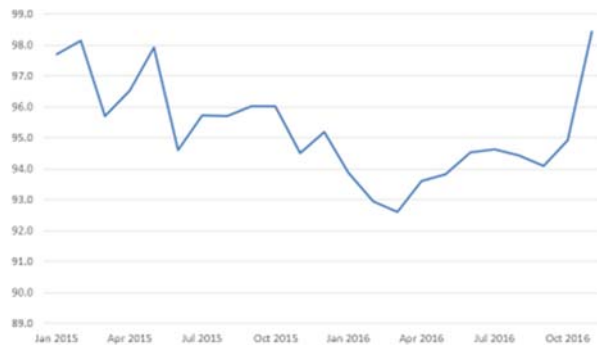
Conference Board: Consumer Confidence
Index: 2010=100



University of Michigan: Consumer Sentiment
Index: 2010=100



NFIB: Small Business Sentiment
Index: 2010=100

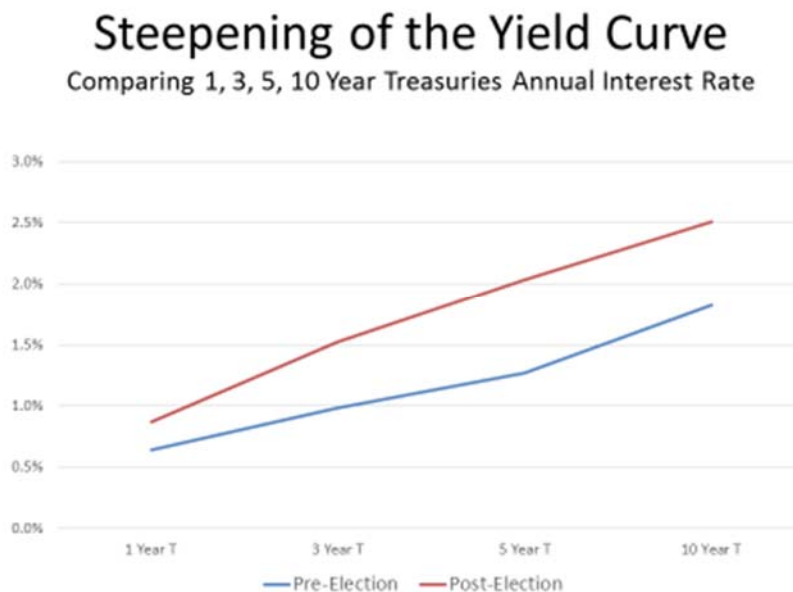


If we are correct that the prospect of stronger near-term growth resulting from Trump’s policy initiatives is the foundation for elevated consumer and business confidence, then it is likely that these trends will continue for some time, if not derailed by other issues. As a result, considering **only** this factor, upside potential exists for the fall forecast projections.

Recent Evidence on Inflation Expectations and Interest

Unfortunately, the prospect of stronger growth and its implications has also raised the attention of the financial community and the Federal Reserve. Trump’s economic policies have led to speculation that aggressive, perhaps debt based, stimulatory fiscal policies may add pressure on already tight labor markets, resulting in inflation. Higher inflation expectations soon get reflected in long-term interest rates – such as mortgage rates.

The financial community, for example, has already embraced the prospect of higher expectations for inflation. These expectations are reflected in the steepening of the yield curve. A yield curve shows the interest rates attached to differing maturities. Longer maturities are typically at greater risk of inflation than shorter maturities. In the context of inflationary expectations, the long end of the maturity typically rises at a faster pace than the short end – leading to what is called a steepening of the yield curve. The steepening of the yield curve often reflects the expectation of stronger inflation rates and/or economic growth in the future.



In addition, the Federal Reserve has also embraced the prospect of higher expectations for inflation. The recent meeting of the Federal Open Market Committee (a key group responsible for formulating Federal Reserve policy actions) not only decided to raise interest rates in December, but suggested that a more accelerated path for increases in the federal funds rate may unfold during 2017 and beyond.

The combination of higher inflationary expectations and monetary policy actions suggest higher interest rates than previously expected will characterize the short-term forecast horizon. This suggests the potential for a powerful offset to heightened consumer and business confidence. Indeed, recent evidence also suggests that this phenomenon has already materialized. Mortgage rates have increased

50 basis points since Trump's election. Pressure on mortgage rates is expected to continue through 2017. Higher mortgage rates is one reason for PCA's conservative outlook for 2017 single family starts projection.

Impact on the Standing Forecast

The Trump administration's economic policies, at this time, lack specifics and detail. The direct and specific impact of the Trump economic initiatives on economic activity, as a result, are difficult to quantify. General and broad assessments of these initiatives and their impact on the economy, however, are being formed. Stimulatory fiscal policy initiatives such as tax reform and increased infrastructure spending will support near-term growth and heighten the outlook for wages, corporate profits and overall optimism.

These policies, placed in the context of a 4.7% prevailing unemployment rate, suggest the planned economic stimulus will increase inflationary pressures and necessitate a financial market and monetary policy reaction – reflected in higher than expected interest rates.

It can be viewed that stronger sentiment levels add strength to the near future, and monetary policy responses offset these influences – resulting in a zero sum. The timing associated with each phenomenon, however, can shape the near and moderate term growth path.

Because interest rates are so low, a threshold level of interest rates may have to be achieved before a significant adverse reaction materializes in economic growth, construction activity and cement consumption. It may take sustained and perhaps larger increases in interest rates to have a meaningful adverse impact on the growth rates associated with construction activity. And this will likely take time to materialize. This suggests that the potential offsetting impacts of rate hikes will occur later in the forecast horizon and not simultaneous to heightened confidence levels.

Considering this, the near-term impact of stronger sentiment and confidence is expected to continue and bolster economic activity including construction activity and cement consumption. If sustained, this implies an upward adjustment to 2017 forecast projections. Beyond 2017, it suggests an economic environment characterized by higher than expected interest rates. By itself, this scenario suggests a boom-bust scenario with stronger activity in 2017, and perhaps softer than expected activity in 2018. As more information is known, the implementation of Trump initiatives could add another level of analysis that is lacking in this report.