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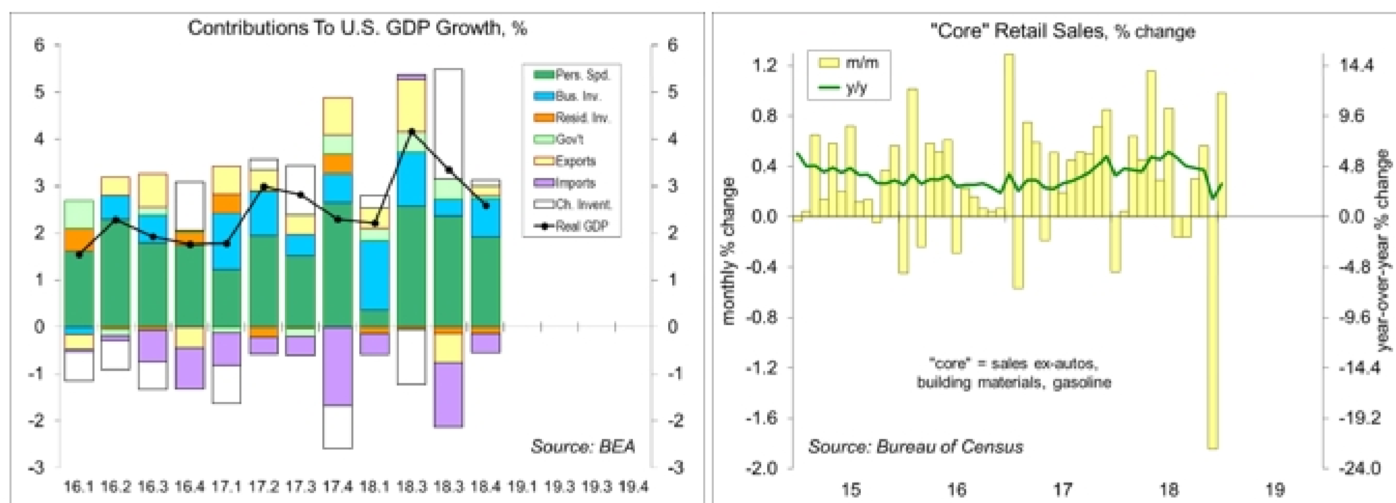
Monthly Economic Outlook -- Risks Recede, But Not Completely

The partial government shutdown led to the delay of economic data releases from the Bureau of Census (retail sales, residential construction, inventories, trade balance) and the Bureau of Economic Analysis (GDP, personal income and spending). Reports from the Bureau of Labor Statistics (nonfarm payrolls, Consumer Price Index) were not affected, nor were those of the private sector (ISM, Conference Board) and the Federal Reserve (industrial production).

The BEA released an "initial" estimate of 4Q18 GDP growth on February 28. In terms of the available source data, that report fell somewhere between the usual "advance" and "2nd" estimates (the "3rd" estimate is due on March 28). Real GDP rose at a 2.6% annual rate in the "initial" estimate, up 3.1% year-over-year. Contrary to expectations, inventory growth, which added a whopping 2.3 percentage points to growth in 3Q18, rose even faster, adding 0.1% to fourth quarter growth. Net exports, which subtracted 2.0 percentage points from 3Q18, widened further, subtracting 0.2 percentage point from growth. Focusing on Private Domestic Final Purchases (PDFP), with is GDP less government spending, the change in inventories, and net exports, rose at a 3.1% annual rate (+3.1% y/y). Real consumer spending growth rose at a 2.8% annual rate, a bit better than anticipated. Business fixed investment rose 6.2%, counter to other data (factory shipments) which had suggested a more moderate pace. Residential fixed investment (mostly homebuilding) fell at a 3.5% pace, down in each quarter last year.



Consumer spending fell 0.5% in the initial report for December (down 0.6% adjusting for inflation), suggesting relatively weak momentum into the new year. Since the GDP report, retail sales figures for December have been revised lower (implying, all else equal, a downward revision to the estimate of 4Q18 GDP growth), while January data showed a partial rebound. Unit sales of motor vehicles fell in January and February. Consumer sentiment fell sharply in January, reflecting concerns about the partial government shutdown, but rebounded in February. Personal income rose 1.0% in December, boosted by farm subsidies and dividends, which reversed in January, as personal income then slipped 0.1%. Aggregate private-sector wages and salaries rose 0.5% in December, followed by a 0.3% gain in the initial estimate for January (+4.4% y/y).

The BLS indicated that the partial government shutdown did not have a discernable impact on the nonfarm payroll figures in January, but did lead to a higher unemployment rate (4.0%). Seasonal adjustment is tricky in the early part of the year, as we normally lose about three million jobs following the end of the holiday shopping season (there are some school year effects as well). However, weather appears to have been the dominant factor this year. Mild weather likely contributed to fewer job losses than usual in January (prior to seasonal adjustment), while adverse weather dampened the gain in February. Weather effects are most pronounced in industries like construction – up by 53,000 in January (seasonally adjusted) and down 31,000 in February.

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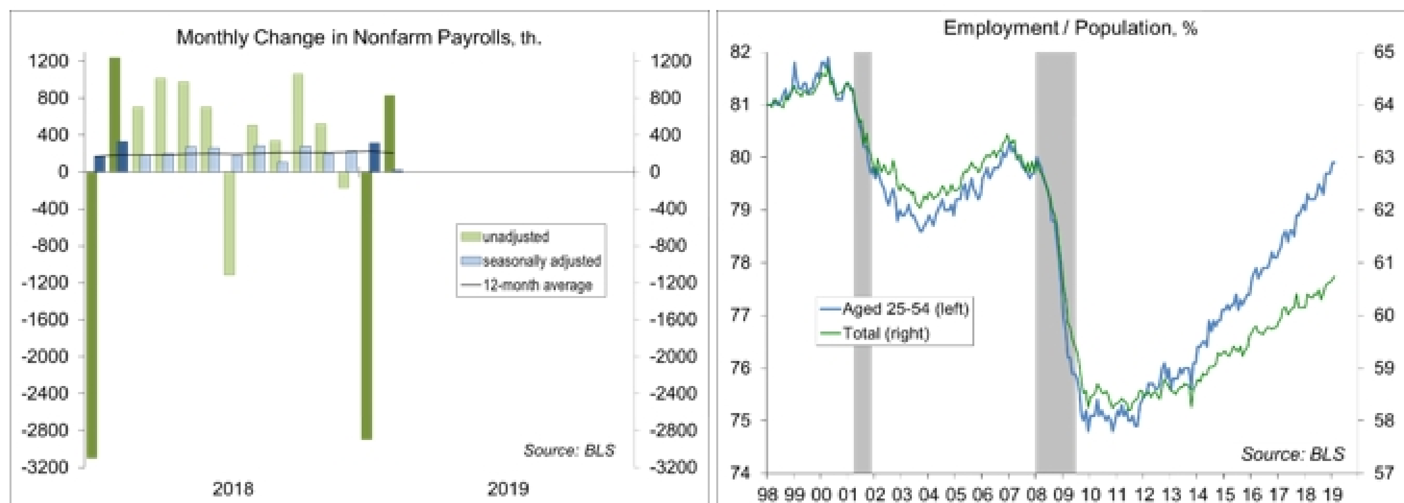


The unemployment rate fell to 3.8% in February, below what Federal Reserve officials would consider a neutral level (most see it between 4.2% and 4.5%, although that may vary over time). The employment-population ratio remains below where it was at the start of the recession, except for the key age cohort (those 25-54 years). The amount of available slack in the job market is a chief concern for the Fed. There is likely more slack than would be suggested by the unemployment rate. Wage growth has continued to pick up (up 3.5% y/y for production workers in February), which indicates that slack is being taking up. The Fed's most recent Beige Book, based on anecdotal information collected on or before February 25, noted that "labor markets remained tight for all skill levels, including notable worker shortages for positions relating to information technology, manufacturing, trucking, restaurants, and construction," and "contacts reported that labor shortages were restricting employment growth in some areas." Wage increases were noted for low- and high-skilled positions across the country. Many firms have relied on non-wage forms of compensation to attract and retain workers, including bonuses, relocation assistance, vacation time, and flexible work arrangements.

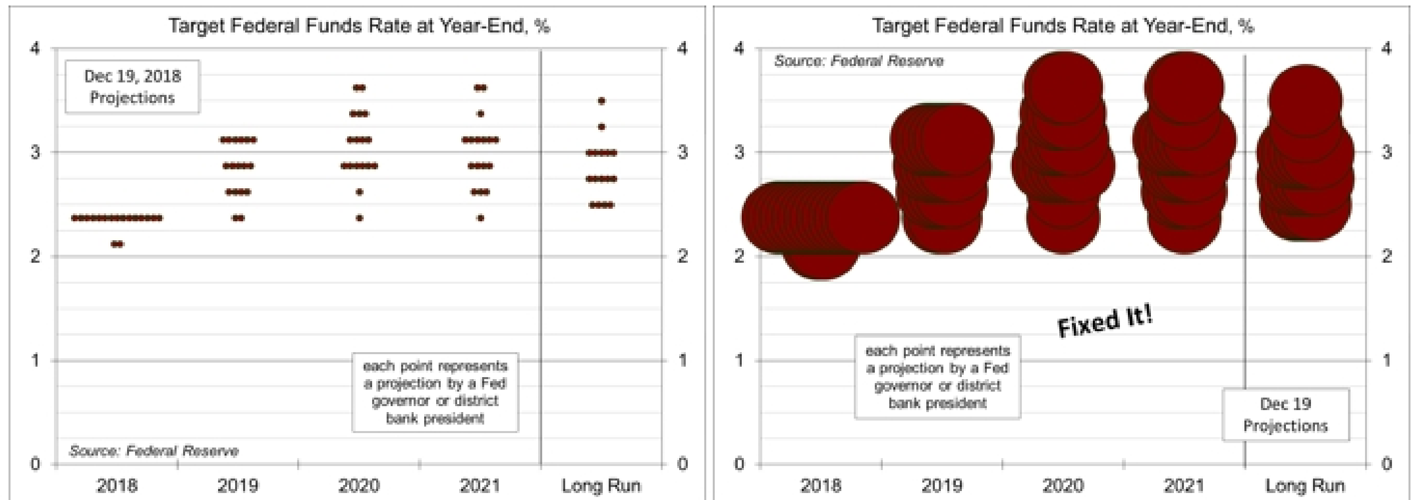
Normally, the tight job market would prompt the Fed to raise short-term interest rates further. Yet, despite increased labor expenses and higher tariffs, "the ability to pass on higher input costs to consumers varied by region and industry." Higher inflation is likely to be a concern for some Fed officials, but not a majority, at least in the near term. While remaining moderately optimistic about U.S. growth, policymakers will still see the risks to the U.S. growth outlook (from trade policy, slower global growth, Brexit) as weighted predominately to downside.

In the January 30 policy statement, the Federal Open Market Committee provided some guidance on the balance sheet. Recall that, from late 2018 to October 2014, the Fed conducted three Large-Scale Asset Purchase programs (QE1-3), adding $3.7 trillion in long-term Treasury and agency securities to the balance sheet. According to Fed Chairman Powell, this helped support the economy "by easing dislocations in market functioning and by driving down longer-term interest rates" (while estimates vary, it's generally believed that these purchases lowered the 10-year Treasury note yield by about 100 basis points). In October 2017, the Fed began the process of normalizing the balance sheet, gradually reducing the reinvestment of maturing securities and prepayments. That process is now well underway, and Fed officials have been discussing when the unwinding of the balance sheet will end and at what level. In January, the FOMC indicated that the end would come sooner and with a higher level of the balance sheet than was seen several months ago. However, the Fed did not say precisely when. That decision is expected soon, possibly at the March 19-20 FOMC meeting. However, at this point, the pace of the balance sheet run-off is widely expected to remain steady – that is, no tapering – until the end of the year. The ultimate size of the balance sheet will be driven by considerations of the appropriate level of bank reserves.

The Fed is conducting a year-long review of its monetary policy framework – its strategy, tools, and communication practices. This will include town-hall style meetings and conferences. A key issue is whether to move from an inflation-targeting system to a price level-targeting system. The Fed has consistently undershot its 2% inflation goal in recent years. That may be partly due to economic agents viewing 2% as a ceiling rather than as a goal. In a price-level targeting system, the Fed would seek a goal for average inflation. A period of below 2% inflation would be followed by a period above 2%. This is likely to be controversial and Chairman Powell indicated that there is high bar for such a change. Nevertheless, we may see a consensus moving in that direction. All else equal, the Fed would be a little less likely to raise short-term interest rates under such a framework.

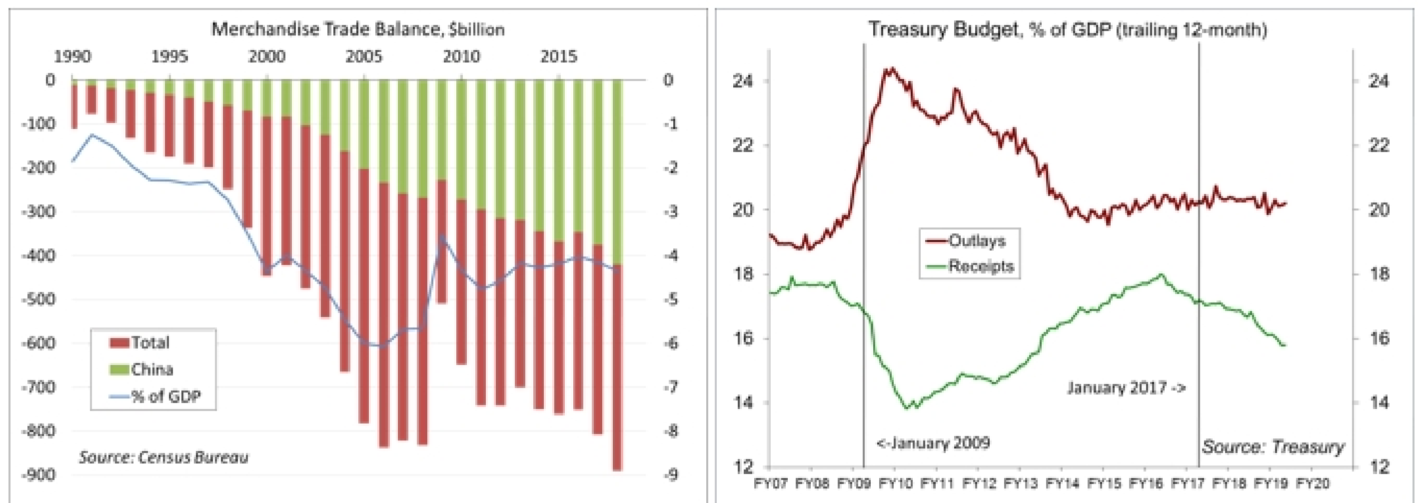
In the revisiting of its communication practices, the dot plot will be a focus. The dots in the plot represent the views of the Fed governors and 12 district bank presidents (not all of the presidents have a say in policy decisions) regarding the appropriate level of the federal funds rate. The policy statement is the primary way that the Fed speaks about its intentions. The dot plot is meant to add color. In contrast, the financial press and

most market participants mistakenly view it as explicit forward guidance. The dots reflect the range of opinion among individual Fed officials – and there is often considerable uncertainty surrounding each dot. Financial market participants obsess about the median of the dots. At one point last year, we saw a significant market reaction to a change in the median even though that change was driven by just one dot. That's just bizarre. A number of Fed officials, including Chairman Powell in December, have contributed to the public misinterpretation by stressing the median. The dot plot is useful, but (as Powell recently noted) the Fed needs to advance the public's understanding of it.



The Fed is also reflecting on the potential policy tools to be used during the next downturn. It's expected that, in the years ahead, the Fed and other central banks are more likely to run up against the zero lower bound on interest rates. During the financial crisis, the Fed relied on two nonstandard tools, forward guidance and large-scale asset purchases. Forward guidance, the conditional promise to keep short-term interest rates low for an extended period is an effective tool. It doesn't cost anything, other than a potential loss of credibility if the Fed has to change course. Long-term interest rates can be thought of as a series of short-term interest rates – hence, forward guidance is an effective means of lowering long-term interest rates. The effectiveness of large-scale asset purchases (quantitative easing) is more controversial and the Fed will look back and evaluate in the months ahead. Two other policy options were available, not used by the Fed during the downturn, but may get more consideration in the future: negative interest rates and caps on long-term interest rates.

Economists have long warned that tariffs are a problematic tool to tackle trade imbalances. Most caution against focusing on bilateral deficits, such as the one between the U.S. and China. Bad behavior is better addressed through an international effort, with a shoring up of the rule-based trading system and enforcement. Tariffs are a tax on U.S. consumers and businesses. They raise costs, disrupt supply chains, and invite retaliation. The uncertainty is a negative factor for business investment and global growth. Moreover, tariffs may do little to reduce the trade balance. That appears to have been the case in 2018, as the trade deficit in goods and services rose 12.5% (the merchandise trade deficit rose by 10.4%, while the surplus in service rose 5.9%). While the overall trade deficit was larger in 2018 ($621 billion), it's at a moderate level relative to GDP (3.0%).



The reason the U.S. is running a large trade deficit is because we consume more than we produce – or equivalently, we don't save enough relative to the level of investment. The federal budget deficit is a part of national savings. Hence, a wider budget deficit would correspond to a wider trade deficit. In the 1980s, these were often spoken of as "twin deficits." Not exactly, but they are related. As with the trade deficit, it's best to look at the budget deficit as a percentage of GDP. The government has run a $925 billion shortfall over the last 12 months, about 4.4% of GDP. It was 2.2% of GDP three years ago. Despite increased spending on entitlements (Social Security and Medicare) and higher interest rates, spending is trending relatively flat as a percentage of GDP. Revenues are trending lower.

The partial government shutdown appears to have had a more substantial effect than initially assumed. The direct effect should be transitory, but the shutdown likely dampened the consumer buying mood more broadly. The Conference Board's Consumer Confidence Index posted a strong rebound in February. While the government shutdown is behind us, future battles over the budget loom on the horizon.

Does the rising federal budget deficit represent a threat to the economy? Not in itself. The concern is that we may see efforts to reign in the deficit at some point – tax increases and cuts in government spending – and as a simple rule, contractionary fiscal policy is *contractionary* (that is, growth would be slower than it would be otherwise). In addition, it's unusual to run higher budget deficits with the economy near full employment. The deficit would rise if the economy slows down, which would reduce the likelihood of expansionary fiscal policy.

From the beginning the expected impact of the 2016 Tax Cut and Jobs Act (TCJA) was difficult to pin down. In hindsight, it appears that the fiscal stimulus of the TCJA was more front-loaded than anticipated – hence, the fade may be quicker than expected in 2019. That would be consistent with GDP growth slowing to a more moderate pace this year. The cut in the corporate tax rates was simple enough. Academic research showed that cuts in corporate tax rates are more likely to show up as an increase in share buybacks and higher dividends than as a boost to capital spending. However, the impact on individual taxes was harder to reckon, made complex by reductions in the mortgage deduction and variable impacts across states. Indeed, as they complete their tax returns, many individuals who are used to getting money back are finding that they owe this year. We won't know the full effect until the tax season is behind us – but, as was widely anticipated, the TCJA will have a wide range of impacts across households.

In any case, too much is typically made about the impact of tax returns on consumer spending growth, which will be temporary at best. The bigger drivers of spending are job and income growth – and the outlook remains promising. Consumer spending is expected to underpin the economic expansion in the months ahead.

The outlook for business fixed investment is more clouded. The monthly factory orders and shipments data softened in the fourth quarter, although the fourth quarter GDP contribution was surprisingly strong (those figures are subject to revision). Still, business fixed investment is often uneven from quarter to quarter, and the fourth quarter softness followed stronger gains earlier in 2018. Domestic demand may be enough to support business investment, but trade policy uncertainty and a softer global growth outlook ought to be a restraint.

Residential fixed investment was weaker throughout 2018. Higher mortgage rate, which peaked in the first half of November, dampened home sales and construction activity. Mortgage rate are significantly lower now, although the strong price increases of the last few years and the limited recovery in the building of start-up homes are still making affordability a key issue.

So, how does this all fit into the investment outlook? On a day to day basis, the stock market did not react much to the economic data reports in the second half of 2018. The low volatility of the late summer gave way to a period of violent market moves, as is often the case as investors attempt to reassess the situation following a period of complacency. In December and January, we saw hyper reactions to minor shifts in the Fed outlook – but monetary policy appears to be on hold for the foreseeable future. More recently, investors have been very sensitive to shifting perceptions regarding the likelihood of a trade deal with China. It was hoped that the trade deal with South Korea and the revised NAFTA would serve as a model for U.S.-China negotiations – that is, accept whatever concession are offered, declare victory, and move on. However, the trade policy risks with China remain substantial and there's been little clarity.

China's economic growth has slowed, but the trade war is only a part of that. In the past, Chinese leaders have always found a way, either through monetary policy or fiscal stimulus. That's the hope this time, but there are a number of longer-term questions surrounding the mix of private entrepreneurship and state-owned enterprises, the strength of the banking system (and the impact of shadow banking), and so on.

Growth has also slowed in Europe, enough to lead the European Central Bank to provide further stimulus (no rate cut, but an extension of its forward guidance on short-term interest rates and an announced series of longer-term refinancing operations). All else equal, easier ECB policy is a negative for the euro (the U.S. dollar has strengthened against the currency, which will affect earnings of U.S. firms doing business in Europe).

The outlook for U.S. economic growth hasn't changed a lot over the last few months. The bigger concern has been the downside risks to the growth outlook. On balance, the downside risks to U.S. growth appear to be less threatening than they were at the start of the year. At the same time, they haven't gone away completely.

Notes on the forecast: The table represents a baseline forecast, but the risks to the growth outlook remain prominently to the downside.

GDP growth figures can be quirky from quarter to quarter. Net exports and the change in inventories make up a relatively small portion of the level of GDP, but they account for more than their fair share of volatility in GDP growth. Investors should focus on Private Domestic Final Purchases (consumer spending, business fixed investment, residential fixed investment).

Early indicators suggest a pickup in consumer spending growth into March, consistent with the strong fundamentals (jobs gains, wage growth, and lower gasoline prices).

Underlying domestic demand is expected to trend down to a more sustainable pace in 2019, largely reflecting the fading impact of fiscal stimulus and labor market constraints. However, the risks appear to be weighted more to the downside (trade policy, global growth, Brexit, Mueller, etc.).

The inflation outlook in moderate. Tariffs, which are reflected indirectly in the inflation data, have added to input costs. Labor costs are rising. However, firms have had mixed success in raising prices of the goods and services they produce.

Once again, long-term interest rates are expected to move somewhat higher, reflecting increased government borrowing and the unwinding of the Fed's balance sheet. We could see a move higher in bond yields if we get some resolution on trade policy and Brexit. However, bond yields may be more likely to remain low, as long-term interest rates have fallen again outside the U.S.

	1Q18	2Q18	3Q18	4Q18	*1Q19*	*2Q19*	*3Q19*	*4Q19*	*1Q20*	*2Q20*	2018	2019	2020
GDP (↓ *contributions*)	2.2	4.2	3.4	2.6	*1.8*	*1.9*	*1.9*	*1.9*	*1.9*	*1.9*	3.1	*1.9*	*1.9*
consumer durables	-0.2	0.6	0.3	0.4	*0.2*	*0.3*	*0.2*	*0.2*	*0.2*	*0.2*	0.3	*0.2*	*0.2*
nondurables & services	0.5	2.0	2.1	1.5	*1.4*	*1.7*	*1.4*	*1.2*	*1.2*	*1.2*	1.5	*1.4*	*1.2*
bus. fixed investment	1.5	1.2	0.4	0.8	*0.2*	*0.1*	*0.3*	*0.4*	*0.4*	*0.4*	0.9	*0.2*	*0.4*
residential investment	-0.1	-0.1	-0.1	-0.1	*0.1*	*0.1*	*0.1*	*0.1*	*0.1*	*0.1*	-0.1	*0.1*	*0.1*
Priv Dom Final Purchases	2.0	4.3	3.0	3.1	*2.1*	*2.5*	*2.2*	*2.1*	*2.1*	*2.1*	3.1	*2.2*	*2.1*
government	0.3	0.4	0.4	0.1	*0.1*	*0.3*	*0.2*	*0.2*	*0.2*	*0.2*	0.3	*0.2*	*0.2*
exports	0.4	1.2	-0.6	0.2	*-0.1*	*0.1*	*0.2*	*0.2*	*0.2*	*0.2*	0.3	*0.1*	*0.2*
imports	-0.5	0.1	-1.4	-0.4	*0.3*	*0.1*	*-0.3*	*-0.3*	*-0.3*	*-0.3*	-0.5	*0.0*	*-0.3*
Final Sales	1.9	5.4	1.0	2.5	*2.1*	*2.6*	*2.1*	*1.9*	*1.9*	*1.9*	2.7	*2.2*	*1.9*
ch. in bus. inventories	0.3	-1.2	2.3	0.1	*-0.3*	*-0.5*	*-0.2*	*0.0*	*0.0*	*0.0*	0.4	*-0.2*	*0.0*
Unemployment, %	4.1	3.9	3.8	3.8	*3.8*	*3.8*	*3.8*	*3.9*	*3.9*	*3.9*	3.9	*3.8*	*4.0*
NF Payrolls, monthly, th.	228	243	189	233	*175*	*165*	*155*	*150*	*145*	*140*	223	*161*	*138*
Cons. Price Index (q/q)	3.2	2.1	2.0	1.5	*0.6*	*2.0*	*1.9*	*2.0*	*2.0*	*2.1*	2.4	*1.5*	*2.0*
excl. food & energy	2.7	1.9	2.0	2.5	*2.4*	*1.8*	*1.9*	*1.9*	*2.0*	*2.0*	2.1	*2.1*	*2.0*
PCE Price Index (q/q)	2.5	2.0	1.6	1.5	*1.3*	*1.9*	*1.9*	*1.9*	*1.9*	*2.0*	2.0	*1.6*	*1.9*
excl. food & energy	2.2	2.1	1.6	1.7	*2.4*	*1.8*	*1.8*	*1.8*	*1.8*	*1.9*	1.9	*1.9*	*1.8*
Fed Funds Rate, %	1.45	1.74	1.92	2.22	*2.40*	*2.40*	*2.40*	*2.40*	*2.40*	*2.40*	1.83	*2.40*	*2.40*
3-month T-Bill, (bond-eq.)	1.6	1.9	2.1	2.4	*2.4*	*2.4*	*2.4*	*2.4*	*2.4*	*2.4*	2.0	*2.4*	*2.4*
2-year Treasury Note	2.2	2.5	2.7	2.8	*2.5*	*2.5*	*2.5*	*2.5*	*2.5*	*2.5*	2.5	*2.5*	*2.5*
10-year Treasury Note	2.8	2.9	2.9	3.0	*2.7*	*2.8*	*2.9*	*3.0*	*3.1*	*3.2*	2.9	*2.9*	*3.3*

Annual growth forecasts are 4Q/4Q

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** Columns may not add to 100% due to rounding.*

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