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Monthly Economic Outlook – Hinging On Trade Policy

Broadly speaking, the economic data reports have not played a major role for the financial markets over the last several months. The bigger factors have been trade tensions and the Federal Reserve, and while there are other uncertainties, the economic outlook, and in turn monetary policy, hinges on what will happen with trade policy.

Trade policy developments, principally the May 10 escalation of tariffs against China, appear to be having a more significant impact on the economy. A trade deal with China, including a rollback of tariffs, would reduce uncertainty and support growth into 2020. A further escalation, such as the imposition of 25% tariffs on the remaining $300 billion or so in Chinese goods (mostly consumer goods), would likely push the U.S. economy close to a recession. An extension of the status quo, including a continuation of the May 10 tariff increase, would be consistent with a lackluster-to-moderate pace of growth through the end of the year.

Through much of this year, financial market sentiment has been driven by shifting trade policy perceptions, and by April, rumor had it that a trade deal with China was imminent. Regardless of the reason that progress toward a deal was derailed, President Trump's May 5 tweet and the May 10 increase in tariffs renewed investor concerns about supply chain disruptions and slower global growth. The added uncertainty further dampened capital spending plans. In early June, Trump's threat to impose tariffs on Mexico (which was unrelated to trade issues!) was vigorously opposed by U.S. businesses, especially the automakers, which rely on the free flow of parts and supplies across the border. President Trump quickly backed down. With the lengthy presidential campaign now underway, there is likely to be enormous pressure on the White House to resolve trade policy uncertainty. Financial market participants hoping for a deal coming out of talks between President Trump and Chinese President XI around the G-20 meeting (June 28-29 in Osaka) are likely to be disappointed, but an agreement to continue negotiations ought to be enough for the time being.

At the start of this year, Fed Chair Powell noted cross-currents, principally concerns about global growth and trade policy uncertainties. Along with muted inflation pressures, these cross-currents allowed the central bank to be *"patient"* in determining its next policy move. In June, the Federal Open Market Committee (FOMC) left short-term interest rates unchanged. In the policy statement, the FOMC said it *"will closely monitor the implications of incoming information for the economic outlook and will act as appropriate to sustain the expansion"* – a phrase that Chair Powell has used earlier in the month. In his June 18 press conference, Powel noted:

"In the weeks since our last meeting, the cross-currents have reemerged. Growth indicators from around the world have disappointed on net, raising concerns about the strength of the global economy. Apparent progress on trade turned to greater uncertainty, and our contacts in business and agriculture report heightened concerns over trade developments. These concerns may have contributed to the drop in business confidence in some recent surveys and may be starting to show through to incoming data. Risk sentiment in financial markets has deteriorated as well. Against this backdrop, inflation remains muted."

While the baseline outlook remains favorable, *"the question is whether these uncertainties will continue to weigh on the outlook and thus call for additional monetary policy accommodation."* Fed officials remained concerned about a low trend in inflation. So why not lower short-term interest rates immediately? Powell said that Fed policymakers *"are going to be monitoring the cross-currents going forward,"* adding that *"we'd like to see whether these risks continue to weigh on the outlook."*

Federal Open Market Committee decisions are usually arrived at through consensus, although there are often disagreements (one official, St. Louis Fed President Bullard, formally dissented in favor of an immediate 25-bp cut in the federal funds target range at the June policy meeting). In the revised dot plot (which shows Fed officials' projections of the appropriate year-end federal funds rate), officials were nearly split in their policy expectations through the end of this year. Of the 17 senior Fed officials, seven expected the federal funds rate to be 50 basis point lower at the end of this year, while eight expected no change (one saw a 25-bp cut, one saw a 25-bp increase). While it's common for the dots to be spread out, it's unusual for officials to be divided into such unique camps. We will know more when the FOMC minutes are released on July 10, but the difference in policy expectations likely reflects different expectations of trade policy developments. It's important to note that there is considerable uncertainty in each of the dots (Fed officials have debated whether the dot plot leads to market misinterpretations of the Fed's intensions), but even those anticipating no change in policy felt that the case for a rate cut has strengthened, according to Chair Powell.

Recent economic data suggest a rebound in consumer spending growth in 2Q19. That's not much of a stretch following the weak results of 1Q19 (inflation-adjusted consumer spending rose at a 1.3% annual rate in the 2nd estimate of 1Q19 GDP growth), but it is consistent with the positive fundamentals of the household sector. Nonfarm payrolls were reported to have risen by 75,000 in the initial estimate for May, but that's just noise (payrolls rose by 224,000 in April). Yet, the underlying trend in job growth appears to have slowed. Anecdotally, firms continue to report difficulties in finding qualified workers.

Business fixed investment has slowed. While this may partly reflect issues in energy exploration and problems at Boeing, softer global growth and trade policy uncertainties have been important factors. Factory output has declined. However, we've often had mini-recessions in manufacturing, without a recession in the overall economy (however, a recession in the overall economy has always coincided with a recession in manufacturing).

The yield curve is the best single indicator of a possible recession, but it's a matter of degrees (it's not like a switched is flipped then the slope goes negative). Currently, the spread between the 10-year Treasury note yield and the federal funds target implies about a 35% chance of entering a recession in the new 12 months. While that suggests that a recession is "not likely," the odds are too high for comfort. Moreover, the low level of interest rates may mean that the odds are higher than the model suggests. We've only had 11 recessions since World War II. That's a ridiculously low sample size. Many "recession gauges" add more variables, which give a better fit in "backcasting" past recessions, but don't help in forecasting the next downturn. Until we start to see an uptrend in the unemployment rate, there's not much worry for the consumer spending outlook. However, confidence is a significant factor in business investment decisions, and prolonged weakness in orders and shipments of capital equipment would be a concern.

Wages are rising, *"but not at a pace that would provide much upward impetus to (consumer price) inflation,"* according to Fed Chair Powell. Weaker global growth would hold inflation down around the world. Fed officials fear that persistent sub-2% inflation (as measured by the core PCE Price Index, which is trending about 0.4% below the core CPI y/y) would lead to a drop in long-run inflation expectations. The proximately to the 0% bound means that the Fed should be more aggressive in lowering short-term interest rates – moving sooner and with steeper cuts – than would occur otherwise. At this point, there's no need for the Fed to panic. The July 31 policy decision will depend on incoming information, but an "insurance" cut in late July is likely to be appropriate.

While Fed policy will be conditional on trade policy and other developments, the financial markets have already priced in a July 31 rate cut (the federal funds futures close of June 24 implied a 72% chance of a 25-bp cut and a 28% chance of a 50-bp cut). Markets have been hypersensitive to trade issues and minor shifts in the Fed policy outlook. That's unlikely to chance anytime soon.

Notes on the forecast: The table represents a baseline forecast. Any forecast will be wrong. Forecasts should be thought of in probabilistic terms – a most likely scenario, but one surrounded by risks. While growth is expected to be moderate in the second half of this year and into 2020, the risks to the growth outlook remain prominently to the downside. Much hinges on trade policy.

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. As Fed Chair Powell recently put it, net exports and inventories are "components that are generally not reliable indicators of ongoing momentum." Investors should focus on Private Domestic Final Purchases, which is consumer spending plus business fixed investment plus residential fixed investment (or equivalently, GDP less government less net exports, less the change in inventories). Powell: "The more reliable drivers of growth in the economy are spending on consumption and business investment."

Underlying domestic demand has been expected to transition to a more sustainable pace in 2019, largely reflecting the fading impact of fiscal stimulus and labor market constraints.

Tariffs and the expectation of further tariffs appear to have pulled imports forward and added to inventory growth. Imports have a negative sign in the GDP calculation (hence, declining imports add to GDP growth). Since U.S. imports are higher than exports, weakness in the U.S. economy would reduce the trade deficit (as we saw during the financial crisis).

Nonfarm payrolls should be boosted by temporary hiring for the decennial census in the first half of 2020 (falling back in the second half of the year).

Once again, long-term interest rates are expected to move somewhat higher. However, a modest-to-moderate inflation outlook and low long-term interest rates outside the U.S. should continue to put downward pressure on U.S. bond yields.

	2Q18	3Q18	4Q18	1Q19	*2Q19*	*3Q19*	*4Q19*	*1Q20*	*2Q20*	*3Q20*	2018	2019	2020
GDP (↓ *contributions*)	4.2	3.4	2.2	3.1	***2.0***	***1.6***	***1.5***	***1.6***	***1.6***	***1.6***	3.0	***2.1***	***1.6***
consumer durables	0.6	0.3	0.3	-0.3	***0.3***	***0.2***	***0.2***	***0.1***	***0.1***	***0.1***	0.2	***0.1***	***0.1***
nondurables & services	2.0	2.1	1.4	1.2	***1.4***	***1.3***	***1.2***	***1.1***	***1.0***	***1.0***	1.5	***1.3***	***1.0***
bus. fixed investment	1.2	0.4	0.7	0.3	***0.2***	***0.2***	***0.3***	***0.3***	***0.3***	***0.3***	0.9	***0.2***	***0.2***
residential investment	-0.1	-0.1	-0.2	-0.1	***0.2***	***0.1***	***0.1***	***0.0***	***0.0***	***0.0***	-0.1	***0.0***	***0.0***
Priv Dom Final Purchases	4.3	3.0	2.6	1.3	***2.4***	***1.9***	***1.8***	***1.7***	***1.7***	***1.6***	3.0	***1.8***	***1.7***
government	0.4	0.4	-0.1	0.4	***0.3***	***0.3***	***0.3***	***0.3***	***0.3***	***0.3***	0.3	***0.3***	***0.3***
exports	1.2	-0.6	0.2	0.6	***-0.1***	***-0.2***	***0.1***	***0.2***	***0.2***	***0.2***	0.3	***0.1***	***0.2***
imports	0.1	-1.4	-0.3	0.4	***0.2***	***0.4***	***-0.2***	***-0.3***	***-0.3***	***-0.3***	-0.5	***0.2***	***-0.3***
Final Sales	5.4	1.0	2.1	2.5	***2.5***	***2.2***	***1.8***	***1.6***	***1.6***	***1.6***	2.6	***2.2***	***1.6***
ch. in bus. inventories	-1.2	2.3	0.1	0.6	***-0.5***	***-0.5***	***-0.2***	***-0.1***	***0.0***	***0.0***	0.4	***-0.2***	***0.0***
Unemployment, %	3.9	3.8	3.8	3.9	***3.6***	***3.6***	***3.7***	***3.7***	***3.8***	***3.9***	3.9	***3.7***	***3.9***
NF Payrolls, monthly, th.	243	189	233	174	***150***	***160***	***155***	***185***	***229***	***14***	223	***165***	***140***
Cons. Price Index (q/q)	2.1	2.0	1.5	0.9	***3.0***	***1.7***	***2.0***	***2.0***	***2.1***	***2.1***	2.4	***1.8***	***2.1***
excl. food & energy	1.9	2.0	2.2	2.3	***1.6***	***1.8***	***1.9***	***2.0***	***2.0***	***2.1***	2.1	***2.0***	***1.9***
PCE Price Index (q/q)	2.0	1.6	1.5	0.4	***2.4***	***1.7***	***1.9***	***1.9***	***2.0***	***2.0***	2.0	***1.5***	***2.0***
excl. food & energy	2.1	1.6	1.8	1.0	***1.7***	***1.8***	***1.8***	***1.8***	***1.9***	***1.9***	1.9	***1.6***	***1.8***
Fed Funds Rate, %	1.74	1.92	2.22	2.40	***2.39***	***2.22***	***1.96***	***1.88***	***1.88***	***1.88***	1.83	***2.24***	***1.88***
3-month T-Bill, (bond-eq.)	1.9	2.1	2.4	2.4	***2.3***	***2.0***	***1.8***	***1.8***	***1.8***	***1.8***	2.0	***2.1***	***1.8***
2-year Treasury Note	2.5	2.7	2.8	2.8	***2.1***	***1.7***	***1.8***	***1.9***	***2.0***	***2.1***	2.5	***2.0***	***2.1***
10-year Treasury Note	2.9	2.9	3.0	3.0	***2.3***	***2.1***	***2.2***	***2.3***	***2.4***	***2.4***	2.9	***2.3***	***2.3***

Annual growth forecasts are 4Q/4Q

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