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Monthly Economic Outlook -- Out of the Soft Patch, But What Lies Ahead?

Real GDP rose at a 2.2% annual rate in the third estimate for 4Q18 (it's called the "third" even though it was the second official estimate), up 3.0% year-over-year. The advance estimate for 1Q19 will be released on April 26. There's always a lot of uncertainty in the advance estimate. We're missing data on a number of components. However, expectations have improved over the last several weeks. A weak reading would likely be dismissed by financial market participants. Unfavorable weather and the partial government shutdown were drags on economic activity. An upside surprise would be taken favorably, but it depends on why (for example, a narrower trade deficit adds to GDP growth, but is not a sign of domestic strength). Investors should focus on the story behind the headline figure.

Unfortunately, the first quarter story is muddled. The partial government shutdown, which lasted from December 22 to January 25, appears to have had a major impact, perhaps subtracting 0.5 percentage point from first quarter GDP growth. Previous shutdowns had only a minor, temporary effect on the overall economy, but this was the longest shutdown on record. Some activity was likely permanently lost.

Consumer spending fell sharply in December, only partly rebounding in January. We are missing figures for February and March. Retail sales improved sharply in the final month of the quarter, but the underlying trend does not appear to be especially strong. Nonfarm payrolls were noisy in January and February, but the underlying trend in job growth has remained moderately strong in the first three months of the year, although somewhat slower than the pace of last year. Nominal wage growth has picked up over the last several months, although less than what was seen in previous episodes of low unemployment. Lower gasoline prices added to consumer purchasing power into the start of this year, but that failed to boost consumer spending growth significantly. Moreover, gasoline prices, which normally rise in the spring, have been rising faster than usual, possibly restraining consumer spending growth to some extent in the near term. Consumers aren't generally feeling good about the Tax Cut and Jobs Act (TCJA). Many have either not received the tax reduction they expected, don't realize that tax cuts were already reflected in lower withholding in 2018, or face a higher tax bill due to the limitations on deductions for state and local taxes. While investors generally expect consumer spending growth to pick up in 2Q19, it will be important to see evidence of that over the next several weeks.

As expected, the TCJA led to an increase in dividends and share buybacks in 2018, both beneficial for investors. However, there's little evidence that the cut in corporate tax rates has boosted business fixed investment or wage growth (beyond what would be suggested by the tightness in labor market conditions). Slower global growth and trade policy uncertainty have been negative factors for capital spending.

Higher mortgage rates contributed to housing market softness in 2018. The sharp drop in mortgage rates in recent months has been helpful, and housing demand remains strong, driven by healthy fundamentals in the household sector. However, supply constraints and affordability issues remain. Tariffs on lumber, steel, and aluminum have added to construction costs. Builders continue to note a skilled labor shortage and a lack of available lots on which to build. There's less profit in building smaller, starter homes and tax policy changes appear to have contributed to some softening at the upper end of the housing market. Housing activity ought to pick up as we move towards the summer, but improvement may be a little slow.

In April's revised World Economic Outlook, the IMF downgraded its outlook for global growth (after having also downgraded its outlook in January). The IMF noted that the global expansion is "losing steam." Risks to the growth outlook are "skewed to the downside." The global economy has grown more intertwined in recent decades. However, the global financial system is also a lot more interconnected. For example, low long-term interest rates outside of the U.S. have put downward pressure on U.S. bond yields (more than offsetting the impact of increased government borrowing and the Fed's balance sheet unwind).

Trade tensions have not been the only issue for China's economy. Investors have taken some encouragement from some recent data suggesting a pickup in China's economy. In the past, slowdowns have been countered by aggressive fiscal and monetary policy – and that may be the case this time as well. However, March improvement followed February weakness, which was likely related to the timing of the Chinese lunar new year. Moreover, recent improvement has likely been built on a shaky foundation – that is, fueled by an expansion of credit and a shift from private enterprise to state-owned enterprises. Unlike in previous decades, credit expansion in China has been an important concern over the last ten years. A few decades ago, non-performing loans were thought to make up about 40% of Chinese bank loans. That's not a systemic problem if the economy is growing at 10-12% per year, but loan difficulties become more of an issue as the economy slows. China's credit has been fueled on and off by the country's shadow banking system.

Faced with a temporary extension of the Brexit deadline, the U.K. asked for an extension to the end of June. Instead, the European Union, which doesn't want the country to leave in an abrupt way, extended the deadline to the end of October (trick or treat), prolonging the current period of uncertainty. European growth has slowed, which may be under pressure in the near term.

As expected, Federal Reserve officials left short-term interest rates unchanged following the March 19-20 policy meeting. Fed officials have been debating whether to jettison the dot plot (which shows senior Fed officials' projections of the federal funds rate for the next few years). Some, including Chairman Powell, believe it to be a worthwhile way to communicate general policy expectations. Others worry that financial market participants often mistake it for a hard-wired plan. In any case, the dots, which normally move glacially from quarter to quarter, fell sharply from December to March: 11 officials expect no change in the federal funds target this year, while four expect one hike and two expected two hikes – a median of zero.

The Fed has also provided more details on its plan to end the balance sheet unwinding. The maximum potential roll-off will fall to $15 billion per month in May (from the current $30 billion pace) and end in September. However, beginning in October, the Fed will continue to run down its holdings of mortgage-backed securities, replacing them with additional purchases of long-term Treasuries. The Fed's decision to end the balance sheet unwinding is based on the desire to maintain an adequate level of bank reserves. It was not due to pressure from President Trump or because of the stock market.

The Fed is in the process of reevaluating its monetary policy frameworks this year. That includes a discussion of whether to shift from inflation-targeting to a system that would seek to counter periods of low inflation with periods of higher inflation. The Fed will revisit is toolkit regarding how to respond to the next economic downturn. It will also work on its communications strategies (such as whether to continue with the dot plot or how to better educate the public on its use). Any changes will not be made until 2020. The Chicago Fed will host a conference on the monetary policy framework on June 4-5.

For veteran Fed watchers, the slight shift in the interest rate outlook (from a mild tightening bias in December to neutral in March) and the decision to end the balance sheet unwinding (which had been under discussion at the fed for some time) were not earth-shattering news, but they were a much bigger deal for the financial markets, which appeared to overemphasize the impact of the balance sheet unwinding in late 2018. In late March, the federal funds futures market had priced in more than a 70% chance of one or more Fed rate cuts by the end of the year. However, the implied odds have fallen to less than 50% more recently (note that these odds can shift pretty quickly).

The 10-year Treasury note yield dipped below the 3-month bill rate briefly, but has since moved up. Still, while an inverted yield curve is a good predictor of recession (12 or more months out), a flattish yield curve is consistent with slow economic growth in the near term.

The Bureau of Economic Analysis (GDP, personal income and spending) and the Bureau of Census (retail sales, residential construction, durable goods orders) will have caught up to their original release schedule in May. Following the distortions of the first quarter, the incoming economic data will be especially important as investors attempt to gauge the underlying strength in the economy. Reports are likely to be mixed, contributing to financial market volatility, but generally consistent with moderate growth in 2019 (slower than last year, but not terrible).

Continued talk of the yield curve and recession risks have generated some concern among investors. However, it's important to stress that we are talking about the risks to the growth outlook later this year and into early 2020. Despite some recent pockets of softness, there are few signs that we are currently in a recession. However, 2020 is an election year. Income inequality, universal healthcare, tax policy, climate change, and the Mueller report will be important topics for the Democrats and are likely to feed into broader national discussions. People tend to vote their pocketbook, but Republican cries of "socialism" may not be enough. The stock market often climbs a wall of worry, but these public discussions could weigh against stock market sentiment (and in some cases, as with the recent reaction to Bernie Sanders' healthcare proposal, appear to already have). This would become more of a concern for investors if economic growth is less than moderate in the second half of the year.

In January, the four former Fed chairs, 15 former chairs of the President's Council of Economic Advisers (Republican and Democrat), 2 former Treasury secretaries, 27 Nobel Laureate economists, and 3500 other U.S. economists signed a letter stating that "global climate change is a serious problem calling for immediate national attention." The group called for a carbon tax as "the most cost-effective level to reduce carbon emissions at the scale and speed that is necessary." We haven't seen any follow-through on Capitol Hill, but the letter coincides with a shift in public sentiment on climate change.

Finally, former Fed Chairman Ben Bernanke and former Treasury Secretaries Tim Geithner and Hank Paulson have written a book on the policy response to the financial crisis (published last week), called "Firefighting":

"A decade later, the vital question to ask is whether the United States is better prepared today. We believe the answer is: yes and no. ***There are better***

safeguards in place to avoid a panic in the first place *– the financial equivalent of more aggressive fire prevention measures and stronger fire-resistant building codes.* ***But the emergency authorities for government officials to respond when an intense crisis does happen are in many ways even weaker than they were in 2007*** *– the financial equivalent of less-well-equipped firefighters and shuttered firehouses… In short, the U.S. economy and financial system today may be less prone to modest brush fires but more vulnerable to a major inferno if, despite updated and improved fire codes, a conflagration were to begin."*

Notes on the forecast: The table represents a baseline forecast, but the risks to the growth outlook remain prominently to the downside, especially for later this year and into early 2020.

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, 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).

Underlying domestic demand is expected to transition 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 especially later this year and in 2020.

Tariffs and the expectation of further tariffs appear to have pulled imports pulled forward. Imports have a negative sign in the GDP calculation. Preliminary trade figures for January and February suggest that net exports could make a sizable contribution to 1Q19 GDP growth (although that partly depends on what is assumed for March).

Nonfarm payrolls should be boosted by temporary hiring for the 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, reflecting increased government borrowing and the unwinding of the Fed's balance sheet. 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.

	1Q18	2Q18	3Q18	4Q18	*1Q19*	*2Q19*	*3Q19*	*4Q19*	*1Q20*	*2Q20*	2018	2019	2020
GDP (↓ *contributions*)	2.2	4.2	3.4	2.2	*2.9*	*2.0*	*1.8*	*1.8*	*1.8*	*1.8*	3.0	*2.1*	*1.7*
consumer durables	-0.2	0.6	0.3	0.3	*-0.3*	*0.3*	*0.2*	*0.2*	*0.2*	*0.2*	0.2	*0.1*	*0.2*
nondurables & services	0.5	2.0	2.1	1.4	*1.2*	*1.6*	*1.2*	*1.1*	*1.1*	*1.1*	1.5	*1.3*	*1.1*
bus. fixed investment	1.5	1.2	0.4	0.7	*0.3*	*0.1*	*0.3*	*0.4*	*0.3*	*0.3*	0.9	*0.3*	*0.3*
residential investment	-0.1	-0.1	-0.1	-0.2	*0.3*	*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	2.6	*1.7*	*2.4*	*2.0*	*2.0*	*1.9*	*1.9*	3.0	*2.0*	*1.8*
government	0.3	0.4	0.4	-0.1	*0.3*	*0.3*	*0.2*	*0.2*	*0.2*	*0.3*	0.3	*0.3*	*0.3*
exports	0.4	1.2	-0.6	0.2	*0.6*	*0.1*	*0.2*	*0.2*	*0.2*	*0.2*	0.3	*0.3*	*0.2*
imports	-0.5	0.1	-1.4	-0.3	*0.7*	*0.1*	*-0.2*	*-0.3*	*-0.3*	*-0.3*	-0.5	*0.1*	*-0.3*
Final Sales	1.9	5.4	1.0	2.1	*3.1*	*2.5*	*1.9*	*1.8*	*1.8*	*1.8*	2.6	*2.3*	*1.7*
ch. in bus. inventories	0.3	-1.2	2.3	0.1	*-0.3*	*-0.5*	*-0.1*	*-0.1*	*0.0*	*0.0*	0.4	*-0.2*	*0.0*
Unemployment, %	4.1	3.9	3.8	3.8	3.9	*3.8*	*3.8*	*3.9*	*3.9*	*3.9*	3.9	*3.8*	*4.0*
NF Payrolls, monthly, th.	228	243	189	233	180	*170*	*165*	*160*	*185*	*229*	223	*169*	*140*
Cons. Price Index (q/q)	3.2	2.1	2.0	1.5	*0.9*	*3.4*	*1.9*	*2.0*	*2.0*	*2.1*	2.4	*1.9*	*2.1*
excl. food & energy	2.7	1.9	2.0	2.2	*2.3*	*1.8*	*1.9*	*1.9*	*2.0*	*2.0*	2.1	*2.0*	*2.0*
PCE Price Index (q/q)	2.5	2.0	1.6	1.5	*0.8*	*2.8*	*1.9*	*1.9*	*1.9*	*2.0*	2.0	*1.7*	*2.0*
excl. food & energy	2.2	2.1	1.6	1.8	*1.6*	*1.8*	*1.8*	*1.8*	*1.8*	*1.9*	1.9	*1.7*	*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	*2.4*	*2.4*	*2.4*	*2.4*	*2.4*	2.5	*2.4*	*2.4*
10-year Treasury Note	2.8	2.9	2.9	3.0	2.7	*2.6*	*2.7*	*2.8*	*2.9*	*3.0*	2.9	*2.7*	*3.1*

Annual growth forecasts are 4Q/4Q

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