Current Economic Conditions

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SIGNS OF SLOWING GROWTH ABROAD

Last year was the best year for global economic growth since 2011, with most of the world participating in a "synchronous global expansion." The global economy carried enough momentum into 2018 that annual growth is likely to be even higher this year, but signs are emerging that growth is starting to slow in some countries. As a result, annual growth in industrial production is likely to peak in 2018.

Growth in global industrial production started to pick up in early 2016 when growth accelerated in China after a 2014-2015 deceleration that was much sharper than reported in official government data. Within a few months, industrial production turned up in Japan, which exports capital goods to China. Industrial production in European manufacturing had turned up in December 2015 after a brief pause in the underappreciated expansion that began in March 2013. Industrial production in U.S. manufacturing turned up in June 2016 after a 2.7% decline over the prior 18 months and has been especially strong since the disruptions caused by last summer's hurricanes. By 2017, industrial production was even growing in Brazil, after a steep decline that took production below the lows reached during the depths of the 2008-2009 global recession.

Growth has slowed in countries that led the acceleration in 2016. China's official measure of industrial production was up 6.0% year-over-year in March, matching the slowest growth rate in 25 months. The median growth rate of 100 industrial products for which China reports production was just 2.1%, versus 5.8% in the first two months of 2017 and 4.6% as recently as last September. Electricity output slowed sharply in March. Policy was used to juice the economy before the Communist Party Congress in October. Since then, growth has slowed. Gross Domestic Product suggests the broad economy is still doing well, but one should take Chinese GDP data with a grain of salt. Year-over-year growth in real GDP has been between 6.7% and 7.0% for 11 consecutive quarters. No economic time series in the world is that stable.

Industrial production in Japanese manufacturing fell sharply in January after hitting a nine-year high in December. It rebounded in February but has been essentially flat over the last six months. I don't think the expansion is over, but there has been a clear break in upward momentum. Industrial production in European Union manufacturing fell sharply in February. While one shouldn't make too much of a one-month decline, two surveys that have historically led EU industrial production, from IFO in Germany and INSEE in France, both are signaling slower growth ahead, as are purchasing managers' indexes.

So far, growth has not slowed in the United States. Real GDP has grown at a 3% annual rate over the last three quarters. Reported growth for the first quarter will be slower because of seasonal-adjustment problems at the Commerce Department, but growth will likely rebound in the second quarter. Industrial

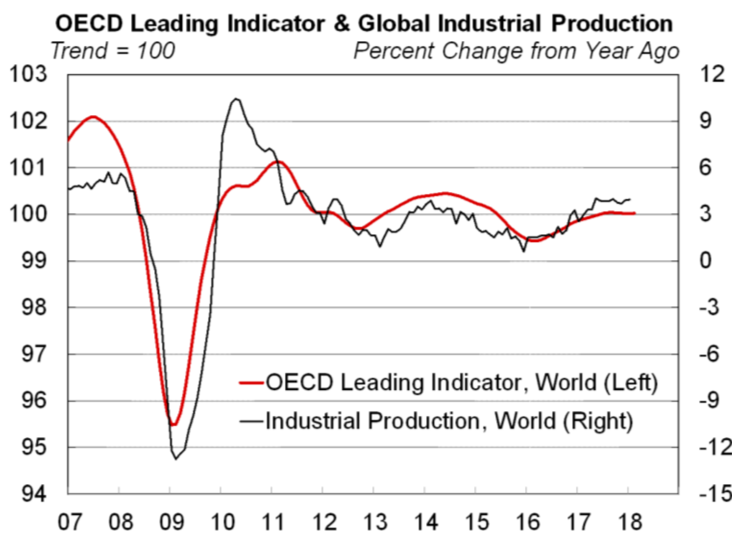
production in U.S. manufacturing grew 0.1% in March after a 1.5% increase in February, the biggest monthly increase since 2005. Over the last six months, production has grown at a 5.8% annual rate.

Why would growth slow in Europe and Asia, but not in the United States? I can think of four reasons. The first is that increased U.S. oil production means that higher oil prices hurt U.S. economic growth much less than in the past and much less than in European and Asian countries that produce little or no oil. The price of Brent crude oil has risen from below $50/barrel last July to almost $75 today. The increase in oil prices may be slowing growth in Europe and Asia. In the United States, the negative impacts of higher oil prices are being offset (for now) by the boost to production of steel (for well casings) and oil-field machinery.

The second reason is the decline in the value of the dollar since early 2017. This has made U.S.-manufactured goods more competitive in global markets and has allowed them to take market share from foreign competitors. This impact has been bolstered this year by the recently enacted tax reform. Lower corporate tax rates and changes in the taxation of foreign-source income provide an incentive for firms to shift production to the United States, both in fact and on the books. I find it hard to believe that **physical** production could be shifted to the United States quickly enough to explain the symmetrical strength in U.S. manufacturing and weakness in European manufacturing in February, but directionally they are consistent with the impact of tax reform. (If tax reform causes accountants to allocate more production and profits to the United States, it could reduce the U.S. trade deficit even if there is no change in physical trade flows.)

The fourth possible reason for slower growth in Europe and Asia but not in the United States is that the former are leading the global business cycle while the latter is lagging. If that's the case, growth in U.S. manufacturing will soon slow. My leading index for U.S. manufacturing suggests that could happen over the next six months. Recent declines in my index reflect declines in stock prices, a shrinking spread between long-term and short-term interest rates, and slowing growth in orders, albeit to still-strong levels. Because the value of the U.S. dollar has historically affected U.S. industrial production with a long lag, last year's decline in the dollar is not yet reflected in my index. That decline and continued growth in housing permits could offset declines in the other leading indicators and cause my index to turn up again.

Future growth in the U.S. economy hinges to a large extent on the housing market. Builders are not building enough houses to meet demand. That partly reflects difficulties in finding construction workers, but the big issue is the availability of land. Local zoning and permitting regulations have made it harder and more expensive to build houses. Local government officials who think their role is to defend property values don't realize that when house prices rise, losses to people who want to buy homes exactly offset the gains to those who own homes. Big national builders acquired lots during the financial crisis, making it more difficult for small local builders to build. As is generally the case, increased industry concentration (in home building and especially in land ownership) has reduced output and increased prices.



While the Conference Board's Leading Economic Index for the United States points to continued growth, a recent revision in the Organization for Economic Cooperation and Development's broadest leading indicator is sending a cautionary signal for global growth. Before the revision, the OECD indicator was rising at an accelerating rate. The revised indicator peaked last September and has declined slightly since then. Given the way the index is constructed, this does **not** imply an impending recession, but does signal that global growth may have peaked. Only if investment in plant and equipment rises strongly in response to tax reform will U.S. growth continue to accelerate.

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