Current Economic Conditions

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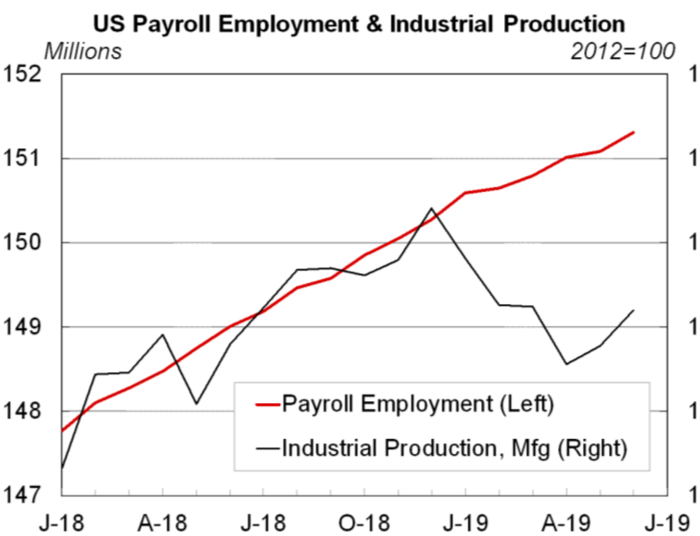
MANUFACTURING UNDERPERFORMING DESPITE RECENT BOUNCE

Industrial production in U.S. manufacturing rose 0.4% in June, on top of a 0.2% increase in May. While these increases were certainly welcome, they erased only a third of the 1.7% decline over the first four months of 2019. For the second quarter as a whole, industrial production fell at a 2.2% annual rate. It fell at a similar 1.9% rate in the first quarter. Production of primary metals, machinery, electrical equipment, paper, and printing all suffered big declines in both the first and second quarters. The first three have been affected by a downturn in business fixed investment; the last two are in long-term declines caused by the shift from books, magazines, and newspapers to electronic media.



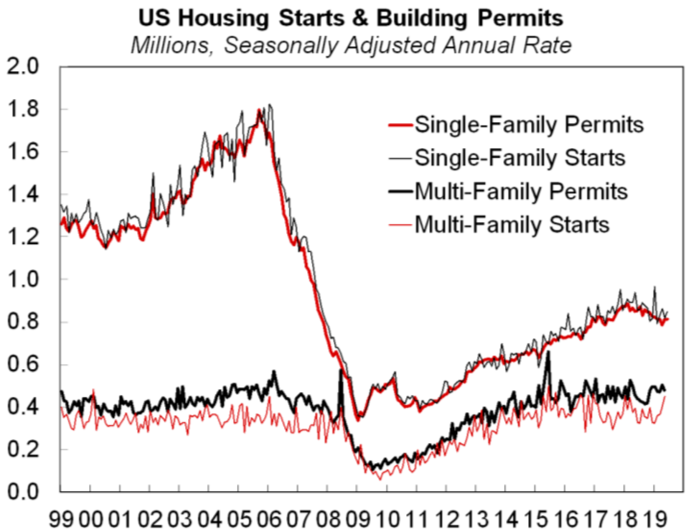
The decline in manufacturing occurred even though the U.S. labor market remains strong and consumer spending continues to grow. Nonfarm payrolls grew by an average of 172,000 a month in the first half of 2019. While that is less than the 202,000 average of the previous eight years, it is remarkably strong for an economy with a 3.7% unemployment rate that has entered its record 11th year of expansion. It's also much more than is needed to absorb growth in the adult population and signals that people who had previously been considered retired, disabled, or just discouraged have reentered the labor force in large numbers, a very encouraging sign. And while employment growth has slowed a little, wages have accelerated, especially for lower-paid production and nonsupervisory workers. With employment and (real, inflation-adjusted) wages growing, consumers continue to spend. Retail sales rose 0.4% for a third straight month in June. Retail sales for the "control group," used to calculate consumer spending in Gross Domestic Product, rose 0.7%, the fourth straight month of sales growth of at least 0.5%. This means that GDP growth for the second quarter is likely to be higher than most of us expected during the quarter.

The underperformance of manufacturing relative to the rest of the U.S. economy is part of a global slowdown in manufacturing. The year-over-year growth rate in global industrial production, as reported by the CPB Netherlands Bureau for Economic Policy Analysis, slowed from 4.1% in February 2018 to 0.8% in April 2019 (latest data available). For the Advanced Economies, production declined from October 2018 to April 2019, leaving it below prior-year levels for the first time since 2016. The slowdown reflects both the negative impact of tariffs on trade in manufactured goods and the need to work off inventories of manufactured goods imported in anticipation of the tariffs. Inventory adjustments soon run their course, but tariffs could weigh on global manufacturing, shifting economic activity to non-traded goods and services, for an extended period.

While manufacturing tends to grow less rapidly than GDP in mature economies with growing service sectors, a big divergence between industrial production and consumer spending can't persist forever.

Either industrial production will pick up or the labor market and consumer spending will weaken. Ominously, manufacturing has turned down in advance of the last three business-cycle peaks, but it has also turned down without the economy following it into recession, most recently in 2016. Whether manufacturing picks up or the rest of economy slows this time depends on the economy's response to Federal Reserve monetary policy and, more importantly, on the resolution of the trade dispute between the United States and China.

Mortgage rates have fallen more than a full percentage point since last November. Housing starts have risen little in response, but they have stopped declining after a year-long downturn. A recovery in housing would boost production of building materials (wood products, nonmetallic mineral products), electrical equipment and appliances, and furniture and furnishings. After years of underbuilding relative to population growth, there is room for a large and/or lengthy increase in single-family housing construction. But housing won't realize its full potential and provide its normal cyclical boost to the economy unless local governments ease up on zoning and permitting regulations that make it difficult and expensive to build new houses. The cost and availability of lots are currently a bigger impediment to the housing recovery than are the cost and availability of loans.



Uncertainty about tariffs has put investment in equipment on hold, causing the downturn in production of machinery and electrical equipment. (The downturn in primary metals production also reflects a decline in oil and gas drilling.) I expect an uncertainty-reducing trade deal to unleash a surge in business investment, the delayed/interrupted response to the 2018 tax cut. If we don't see such a surge, the tax cut will have been a budget-busting mistake, and antitrust investigations of concentrated industries that are not expanding capacity despite strong demand and rising prices will be appropriate.

The Fed is expected to cut its federal funds rate target at the end of this month, but because monetary policy works with a lag, this will have little impact on the economy until next year. I expect the United States and China to reach a trade agreement, but President Trump might be intentionally dragging his feet until later this year so that the post-agreement surge in investment has its biggest impact on economic growth in the first three quarters of 2020, when it will do his reelection chances the most good. Consequently, my forecast is for manufacturing to be flattish (and below year-ago levels) through the rest of this year, held down by weak spending on capital goods, but to grow strongly next year as residential construction recovers, business investment picks up, and production of the Boeing 737-MAX rebounds.

There are three key risks to my above-consensus forecast for 2020. First, the yield curve is still inverted, i.e., the federal funds rate is still above the 10-year bond yield. The quarter-point cut in the funds rate expected next week won't be enough to end the inversion. Unless bond yields rise, the Fed will need to cut by another quarter point. (I think the Fed should continue to shrink its balance sheet, which might put upward pressure on bond yields, but I don't think it will.) Second, the failure to reach a trade agreement by year-end would prevent the stronger growth I expect (and because growth in the first three quarters of an election year is an important determinant of election results, it would make it very difficult for President Trump to win reelection). Finally, the U.S. economy may be running out of workers. This hasn't happened yet because of the large number of people reentering the labor force. Eventually, however, we will exhaust this source of labor. When labor force growth slows, economic growth will become more reliant on productivity growth. Productivity is showing signs of accelerating, but that probably won't continue without an increase in business investment in plant, equipment, and software.