Current Economic Conditions

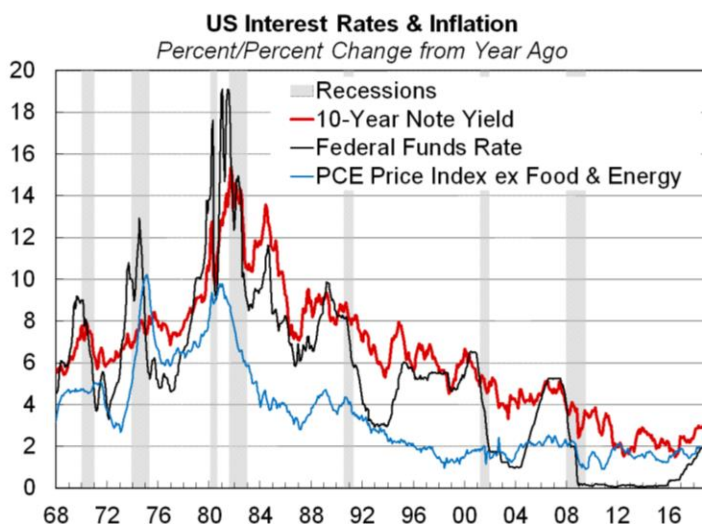
Robert C. Fry, Jr., Ph.D. October 18, 2018

RISING RISKS OF SLOWER GROWTH

U.S. real Gross Domestic Product grew at a 4.2% annual rate in the second quarter and likely rose at a similarly strong rate in the third quarter. The unemployment rate fell to 3.7% in September, the lowest since 1969. New claims for unemployment insurance, the best weekly measure of economic conditions, fell in September to their lowest level since 1969, when the labor force was half as large as it is now. The Institute of Supply Management's Non-Manufacturing Business Activity index, the ISM index with the strongest correlation with GDP growth, rose in September to 65.2, its second-highest reading ever.

Despite these strong numbers, the S&P500 stock price index fell 6.7% from October 3 to October 11. This decline was sparked by comments made on October 2 by Federal Reserve Chairman Jerome Powell at the annual meeting of the National Association for Business Economics, which I attended. Powell reiterated that the Fed is likely to raise its target Federal Funds rate in December and three times next year and, most importantly, said the Fed would likely have to raise the funds rate above its "neutral" level. The yield on 10-year Treasury notes surged on October 3 and the stock market plummeted on October 4. The decline in stock prices prompted criticism of the Fed by President Trump and by former hedge fund manager and CNBC personality Jim Cramer, who presciently criticized the Fed for raising rates in August 2007. Cramer cited anecdotal evidence from companies and data on railcar loadings that suggest that growth has slowed recently, but that slowdown has yet to show up in official data. (Full disclosure: I knew Jim when I was in graduate school and sometimes discussed stocks with him over dinner.)

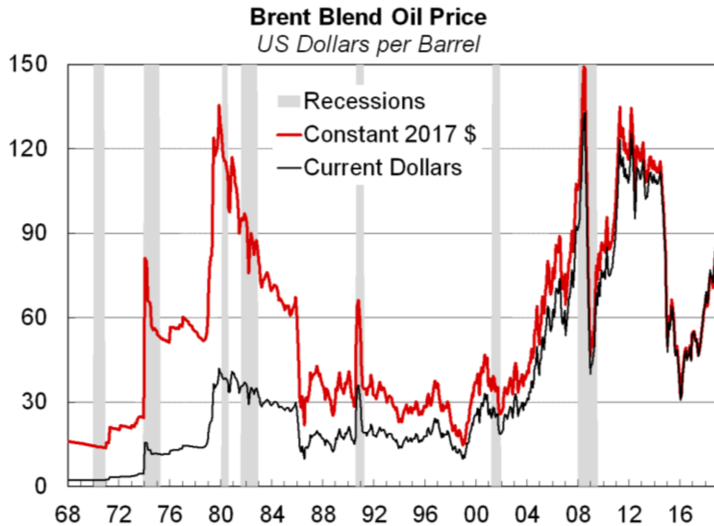
Stock prices are a useful leading indicator for economic growth; they are both predictive, because they depend on forecasts of future growth in corporate earnings, and causal, because consumer spending and business investment are both affected by stock prices. But stock prices are far from a perfect leading indicator; Paul Samuelson observed in his classic economics textbook that stock prices had correctly forecast nine of the last five recessions. Furthermore, in the overall scheme of things, a 7% decline in stock prices **from all-time highs** isn't a very strong signal of anything.



The Fed's interest-rate policy should be evaluated on the basis of its likely impact on the economy, not on what it does to the stock market over an eight-day period. Evidence from the economy is mixed. The most interest-sensitive sector, housing, has softened over the last several months. Single-family building permits were lower in September 2018 than they were in October 2017. Motor vehicle sales were also weakening before a surge in replacement demand following Hurricane Florence. On the other hand, the real (ex post) Federal Funds rate (Fed Funds minus inflation) is approximately zero, seemingly too low for a rapidly growing economy that is at, near, or beyond full employment. More importantly, the Federal Funds rate is still well below

the 10-year note yield. The funds rate has risen above the note yield before every recession since 1969. (Please ignore the alarmists who focus on the spread between the 10-year note yield and the 2-year note yield.) Dovish critics of the Fed should remember that the Fed's job is to promote maximum employment and stable prices, not to reelect a President or vindicate the bullishness of a market analyst.

Every recession since 1973 has also been preceded by a big increase in oil prices. The price of Brent Blend crude oil rose from below $30/barrel in February 2016 to over $85 earlier this month. Prices have risen in response to a collapse in Venezuelan production, continued disruptions in Libya, a strike in Nigeria, and U.S. sanctions against Iran. They would have risen even more if not for big increases in U.S. oil production. In the past, price increases of this magnitude have been enough to cause a recession. But U.S. oil production has risen significantly since 2008; the negative impact of higher oil prices on consumer spending is now largely offset by the positive impact on oil drilling and production. Still, if oil prices rise enough to push gasoline prices rise above $4/gallon, I'll reevaluate my forecast of continued growth. And while booming oil production offsets much of the direct negative impact of higher oil prices on the United States, there is no similar offset in other major oil importing countries, including Japan, Western Europe, China, and India. Emerging markets are also being hurt by the recent strength in the U.S. dollar. Slower growth in the rest of the world will reduce demand for U.S. exports and slow growth in the United States. Growth in the rest of the world is also slowing because the Tax Cut and Jobs Act is causing companies to shift production to the United States, but this is good for U.S. growth and an intended result of tax reform.



The other major threat to U.S. economic growth is trade policy. The new trade agreement with Canada and Mexico is probably slightly worse than the North American Free Trade Agreement it replaces – one speaker at the NABE meeting called it "NAFTA 0.5" – but it is much better than no agreement at all and takes the worst-case trade scenario off the table. Tariffs on steel and aluminum remain in effect and are hurting companies that use steel (but benefitting companies and workers that make it). But the big remaining issue is U.S. tariffs on imports from China, currently at 10% but scheduled to rise to 25% on January 1, and Chinese retaliatory tariffs on imports from the United States. Economic theory holds that the loss in economic efficiency resulting from a tax – what economists call deadweight loss – is proportional to the square of the tax rate. A 25% tariff is 6.25 times as harmful as a 10% tariff, not 2.5 times. There will be winners and losers from a 10% tariff, but the net economic impact will be negligible. However, if China and the United States can't reach an agreement that avoids or at least postpones the increase in tariffs to 25%, growth will slow. Perhaps worse, inflation will rise, leaving the Fed unable to counter the slowdown in growth. (Even though the impact of 10% tariffs is small, I suspect that the anecdotes Jim Cramer hears about slowing growth come from companies that are being hurt by tariffs; they are much more likely to speak up than companies that are benefitting. These anecdotes are very recent and seem to coincide with the imposition of 10% tariffs on $200 billion of imports from China on September 24.)

I still believe the current economic expansion has several more years to run, but high oil prices and bad trade policies could slow the expansion or even end it. If the economy can avoid or withstand these headwinds, this expansion, like most expansions before it, will **eventually** be terminated by higher interest rates, likely prompted by an unexpected and undesirable increase in inflation. But there is no reason to believe that will happen soon. Unless negotiations fail and tariffs rise to 25% on January 1, I expect growth to remain strong in 2019. Growth will slow in 2020 as fiscal stimulus fades, but until we see the policy mistake or oil price shock that will end the expansion, it makes no sense to forecast a recession.

Copyright © 2018 Robert Fry Economics LLC. All rights reserved.
Distribution, reproduction or copying of this copyrighted work without express written permission of Robert Fry Economics LLC is prohibited.