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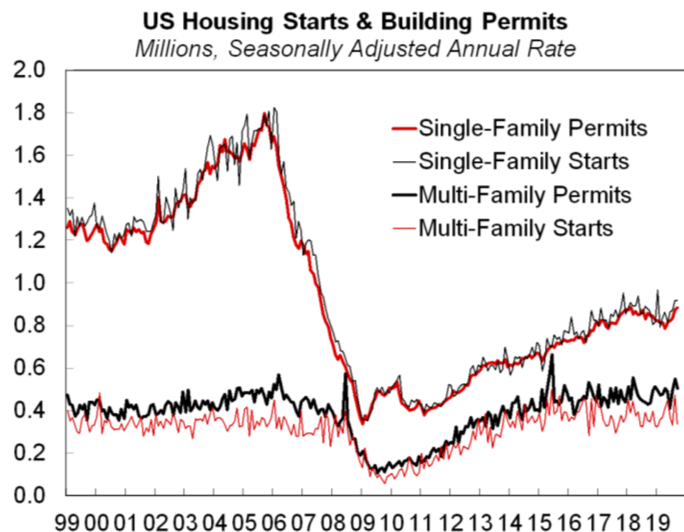
Current Economic Conditions

Robert C. Fry, Jr., Ph.D. October 18, 2019

TAIL RISKS DIMINISHING

On October 11, President Trump announced a tentative "Phase 1" trade deal between the United States and China. The "deal", better characterized as a "truce", would cancel a planned increase in tariffs on $250 billion of goods imported from China, scheduled for October 15, in return for increased purchases of U.S. agricultural products by China. Other details, including agreements on financial services and intellectual property (the single most important issue) and the fate of tariffs scheduled to be imposed on December 15, remain to be worked out in coming weeks, with signing of the agreement by President Trump and Chinese President Xi Jinping likely at the APEC summit in mid-November.

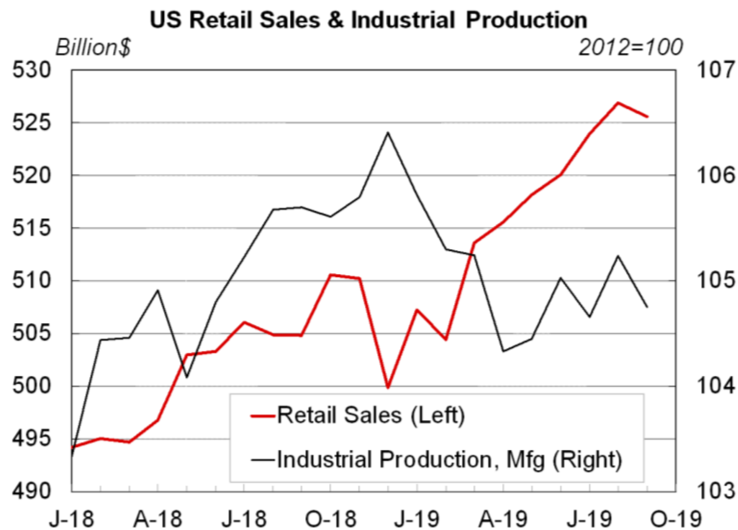
Meanwhile, the Federal Reserve has cut its federal funds rate target twice since mid-year. The two rate cuts, combined with a small increase in long-term bond yields, have left yields on 3-month Treasury bills and 2-year Treasury notes below yields on 10-year Treasury notes. If 10-year yields stay where they are, one more quarter-point cut would leave the federal funds rate below the 10-year, meaning that none of the commonly used yield spreads would show a recession-signaling yield curve inversion. (I prefer the spread between the 10-year note yield and the funds rate, so I think one more rate cut, or a further increase in the 10-year, is needed to "normalize" the yield curve.) Housing starts and home sales have already responded to lower interest rates. The seasonally adjusted annual rate of single-family housing starts rose 15.9% from February to September. Building permits for single-family homes, the most important measure in the monthly housing report, also rose in September. Except for one month (February 2018), they were at their highest level in 12 years.



The tentative partial trade deal, the Fed's rate cuts, and stable and moderate oil prices despite the September attack on Saudi oil facilities and continued tensions in the Middle East significantly reduce the probability of a recession over the next year. The last six U.S. recessions have all been preceded by both an inverted yield curve and an oil price shock. If oil prices stay low and the yield curve inversion ends soon, a 2020 recession would be very unlikely. While usually discussed separately as competing rationales for a recession forecast, the inverted yield curve and tariffs are not independent. By reducing business investment and optimism about the economy, tariffs have put downward pressure on long-term bond yields. The tentative partial trade deal has raised bond yields by reducing the probability of a recession. A more comprehensive trade deal would further raise yields by boosting business investment. That would be a good thing, not a bad thing. Most other indicators do not point to a recession. Housing and other cyclical sectors of the economy remain well below the boom levels that have preceded previous recessions, and it's hard to have a bust without first having a boom. After a few months of uncomfortably large increases, price indexes were subdued in September. Accordingly, I have lowered my inflation forecast for the next two years. Inflation is unlikely to push the Fed to tighten anytime soon.

But the partial trade deal isn't good enough to give us the best-case scenario: a surge in business investment that yields a few quarters of strong (3%?) growth and long-run potential growth much higher than the sub-2% growth the Congressional Budget Office expects. That would require a deal that removes the tariffs the Trump Administration has already imposed and reduces uncertainty about future trade policy. That uncertainty has put business investment on hold, causing business investment in equipment to stall in the first half of the year and orders for nondefense capital goods ex aircraft to decline 1.9% from July 2018 to April 2019. They have recovered little since then and remain below year-ago levels.

Without an end to the Trump tariffs and associated trade policy uncertainty, growth in real Gross Domestic Product is probably stuck in the 2% rut it has been in since 2010 (except for the five-quarter surge after President Trump was elected but before his tariffs started to hurt the economy). Growth in the second half of 2019 is coming in below 2% as manufacturers cut production to shrink inventories. Industrial production in U.S. manufacturing, which rose 0.9% from April to August after declining 2.0% from December to April, fell 0.5% in September. This decline was accurately predicted by the weak Institute of Supply Management Manufacturing PMI® for September, released on October 1. The index came in at 47.8, the lowest since 2009. The production and new orders indexes came in at 47.3, well below the neutral level of 50 that separates contraction from expansion. A decline in retail sales in September seemed to suggest that the economic slowdown was spreading from manufacturing production and business investment to consumer spending, but this came after six strong monthly increases and is no cause for panic.



President Trump would never admit it, but the tentative trade agreement might have been a response to the weak ISM Manufacturing report and the 838-point decline in the Dow Jones Industrial Average over the first two days of October. While President Trump publicly denies that his tariffs are hurting the U.S. economy, the timing of the trade deal and the earlier decision to delay tariffs on consumer goods so they wouldn't affect the holiday shopping season suggest he knows they are.

The International Monetary Fund recently lowered its forecast for global economic growth, reflecting the slowdown that has already occurred. U.S. tariffs and Chinese retaliatory tariffs have hurt economic growth around the world, but the slowdown also reflects U.S. tax reform, which has (intentionally) shifted economic activity to the United States, and bad economic policies around the world. These policies include Brexit, (counterproductive) negative interest rates in Europe and Japan, and the statist economic policies of a Chinese President who seems more inclined to follow the failed policies of Mao Zedong than the successful polices of Deng Xiaoping. Chinese GDP growth slowed further in the third quarter.

When I lowered my forecast for U.S. growth in 2020 to 2%, I viewed 2% as a weighted average of two scenarios I found more likely than 2% growth: strong growth if a trade deal was reached that eliminated President Trump's tariffs and a recession if no trade deal was reached and the Fed didn't eliminate the inversion of the yield curve. Although I'm an economic forecaster, not a political prognosticator, the strong-growth scenario would make President Trump an odds-on favorite for reelection; the recession scenario would give him no chance. Recent developments have significantly reduced the probabilities of both the recession scenario and the strong-growth scenario and increased the likelihood that growth will actually be close to 2%. Such a growth rate would probably make the election a toss-up, and election uncertainty, like trade policy uncertainty, is not good for business investment and economic growth more generally. We could stay in a slow-growth funk until the 2020 election, then break out in one direction or the other.

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