Current Economic Conditions

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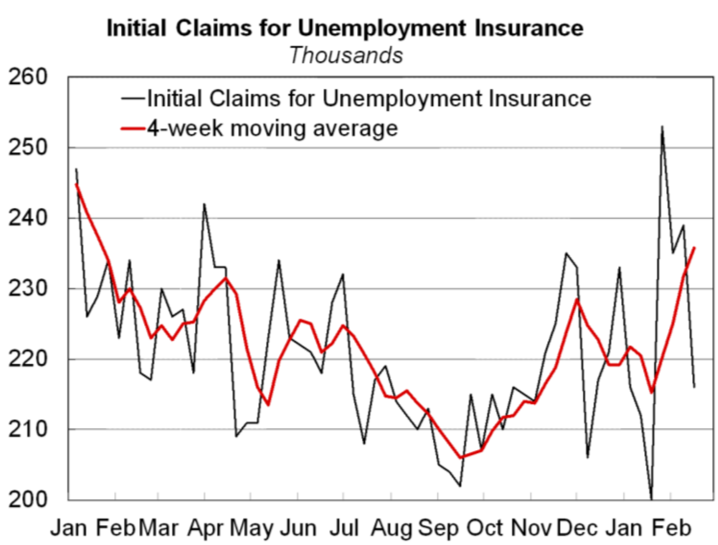
REMOVING THE CAUSE BUT NOT THE SYMPTOM

The forces that pushed down stock prices by 20% from September 20 to December 24 and raised fears that the U.S. economy would fall into a recession have largely dissipated. The Federal Reserve has put a halt to interest rate hikes, at least for now, and is no longer suggesting that the shrinking of its balance sheet will continue "on autopilot." The government shutdown that ran from December 22 to January 25 has ended, and the budget deal signed last week will avert further shutdowns for this fiscal year. And while a trade deal between the United States and China is not imminent, positive comments suggest that enough progress is being made that the increase in tariffs scheduled for March 2 will be postponed. In response, the stock market has regained most of its losses. However, the damage to the economy has been done. Recent economic data suggest the economy slowed in December and was weak in January and early February. Leading indicators suggest that weakness could extend through the first half of 2019.

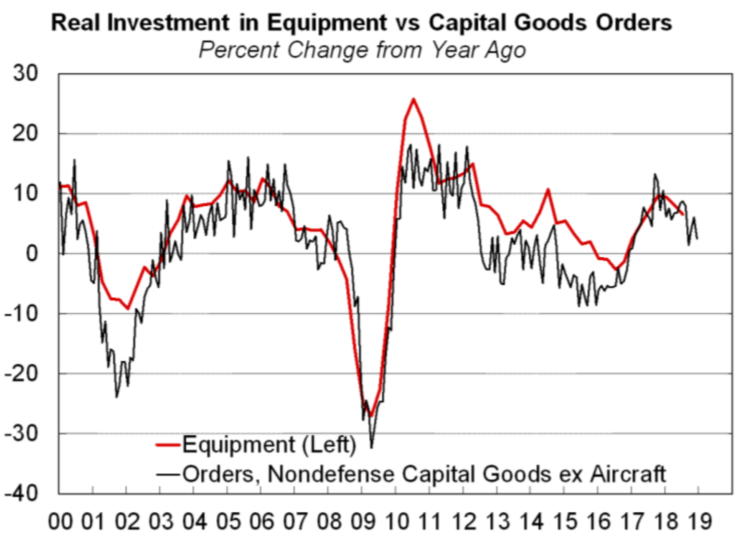
Until February 14, most forecasters thought that U.S. real Gross Domestic Product, which will not be reported until next week because of the government shutdown, grew at a 2.5-3.0% annualized rate in the fourth quarter of 2018. Then the Commerce Department issued its report on December retail sales, also delayed by a month. It showed (seasonally adjusted) sales down 1.2% from November to December. The report was so bad that many analysts simply don't believe it; some speculate that the government shutdown affected data collection. But regardless of whether the decline was due to data-collection problems or reflects an actual weakening, it will adversely affect the initial estimate of fourth-quarter GDP, cutting it to 1-2%. Consumers might have cut back on their holiday (and post-holiday) shopping in response to the sharp decline in stock prices and the beginning of the government shutdown. Credit-card data and a decline in light vehicle sales suggest that retail sales remained weak in January.



A rebound in the Institute of Supply Management's Manufacturing PMI and a 304,000 increase in nonfarm payrolls, both reported on February 1, raised hopes that January was a good month for the U.S. economy, but a big increase in initial claims for unemployment insurance, the best weekly measure of economic activity, and a weak industrial production report have since dampened those hopes. Industrial production in U.S. manufacturing fell 0.9% in January, the largest monthly decline since last May. Most of the decline was due to a big decline in motor vehicle production. Despite stronger-than-expected light vehicle sales in the last four months of 2018, vehicle manufacturers have lowered their guidance for 2019 and seem to be changing their focus from volume to price. This is a rational response to tariffs on aluminum and steel, which raise the cost of all vehicles. But even excluding motor vehicles, industrial production in manufacturing was down 0.2%. Cold weather associated with the polar vortex closed manufacturing plants in late January **and** early February, raising the likelihood of another weak month for industrial production.

Leading indicators and composite leading indexes suggest the U.S. economy will remain soft in the near term. Housing construction and home sales, which lead the overall economy, remain weak. The federal funds rate never rose above the yield on 10-year Treasury notes, inverting the yield curve and signaling a recession, but the spread narrowed significantly in December and remains narrow by historical standards. The Conference Board's Leading Economic Index declined 0.1% in December. It was the second decline in three months, following a 0.3% decline in October that was the first decline in about three years. The Organization for Economic Cooperation and Development's Composite Leading Indicator for the United States declined for a ninth straight month in December and has been below 100, indicating below-trend growth, for four months. The Economic Cycle Research Institute's Weekly Leading Index, while off its December bottom, is still in a downward trend. My own leading index for U.S. industrial production fell sharply from August to December before recovering slightly in January. These leading indicators are not pointing to a recession, but they suggest below-trend growth in the first half of 2019.

Even if stock prices, which are included in most leading indexes, continue to rebound, growth in the first half of 2019 will be slower than growth in 2018. Investment projects have been delayed because of uncertainty about trade policy and about economic growth more generally. Because many investment goods, both equipment and structures, are made of steel, tariffs on steel are having a bigger impact on investment than tariffs on Chinese goods. Energy companies building pipelines to get oil and natural gas from booming U.S. oil fields and chemical companies building plants to take advantage of an abundance of natural gas liquids from those fields are among those most likely to delay or cancel investment projects in response to tariffs. Even after trade uncertainty is resolved, by a trade agreement with China and the removal of Section 232 tariffs on steel and aluminum from Canada and Mexico (and perhaps other countries), it will take a while to restart or reconsider investment projects that were put on hold because of tariffs.



So far, tariffs have had a bigger adverse impact on small businesses than on larger ones, which generally have more ability to pass higher costs on to customers. As a result, the National Federation of Independent Business's Small Business Optimism Index, which surged when President Trump was elected and then gradually rose to an all-time high last August, has fallen for five straight months.

Eventually, if trade-policy uncertainty is resolved, I expect an investment-led rebound in U.S. economic growth. Investment should increase as companies shift economic activity to the United States in response to tax reform, but mostly it will increase because tight labor markets will necessitate investment in equipment and software that replaces scarce workers or makes them more productive. If the United States-Mexico-Canada trade agreement (USMCA) is ratified, I also expect Canada and Mexico to do well.

I'm less optimistic about growth in Europe and China. Both have suffered from the shift in economic activity in response to U.S. tax reform, but most of their problems are self-inflicted. Policy uncertainty, regarding local politics and global trade policies, particularly Brexit, may be an even bigger problem in Europe than in the United States. But Europe still has some slack in its labor markets and room for fiscal stimulus, so it isn't facing a continent-wide recession. China's problems are more intractable. Because of the one-child policy, China's working-age population is shrinking. The Chinese government has tried to resist the consequent reduction in potential growth with debt-financed fiscal stimulus, but with diminishing success. China needs to accept much slower growth (and raise its retirement age). With a shrinking working-age population and total population expected to peak by 2030, 6% growth is not a realistic goal.