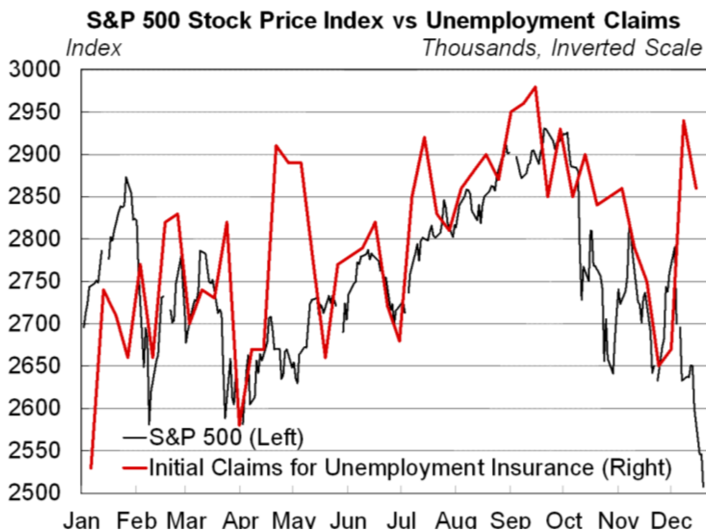
Current Economic Conditions

Robert C. Fry, Jr., Ph.D. December 20, 2018

RECONCILING THE STOCK MARKET WITH THE REAL ECONOMY

The S&P 500 stock price index has declined 14.5% since its record close on September 20. While the financial press focuses on the stock price decline itself, economic forecasters like me are more concerned about what the decline means for real (non-financial) economic activity. The stock price decline could reflect a slowing in U.S. economic growth that is already underway. It could signal or even contribute to a coming slowdown. It could reflect or signal a slowdown in earnings growth due to something other than a slowdown in U.S. economic growth. Or it could simply reflect a change in stock market valuations due to higher interest rates or increased risk aversion (and a larger equity risk premium).



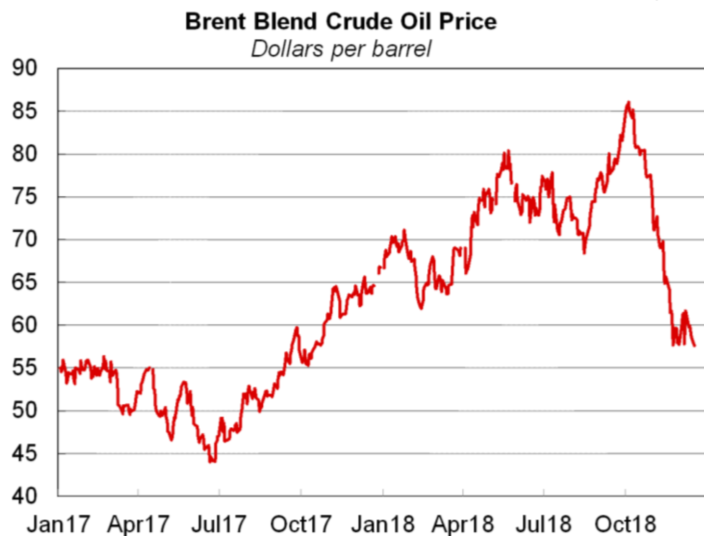
Residential construction has declined, and business investment has stagnated, but most of the U.S. economy continues to grow. Retail sales excluding food, autos, gasoline, and building materials – the "control group" used to calculate consumer spending in Gross Domestic Product – rose 0.8% in November, the biggest increase of the year, and October sales were revised up. The Federal Reserve Bank of Atlanta has reacted to the reported strength in retail sales and implied strength in consumer spending by boosting its GDPNow estimate for fourth-quarter GDP growth to 2.9%. While analysts and auto companies have been talking about declining vehicle sales, light vehicle sales have surprised on the high side for three straight months, coming in above a 17 million seasonally adjusted annual rate. Sales for the year will come in about where they were last year and will exceed 17 million for a fourth straight year, something that has never happened before. Reports of declining vehicle sales are exaggerated and/or premature. New claims for unemployment insurance, the best weekly measure of economic activity, seemed to be signaling a slowdown when they spiked in late November, but they've since fallen back towards cyclical lows, suggesting that the spike might have been due to difficulties in seasonally adjusting data around the (early) Thanksgiving holiday. Less positively, industrial production in U.S. manufacturing was flat in November, and October's 0.2% gain was revised down to a 0.1% decline. However, a big increase in the Institute of Supply Management's manufacturing index (and specifically in the New Orders component of the index) suggests that most U.S. manufacturers continue to grow.

Even though the U.S. economy has slowed only slightly so far, the stock market could be signaling a more serious slowdown ahead. The stock market sometimes sends false signals – hence Paul Samuelson's quip that it has predicted nine of the last five recessions – but it is still a useful leading indicator that should not be ignored. Stock prices could be forecasting that growth will slow in response to interest rate hikes (past or future) and/or tariffs. Stock prices turned down after hawkish comments by Federal Reserve Chairman Jerome Powell on October 3 and fell sharply when the Fed raised its federal funds rate target on December 19 and suggested it would raise rates further in 2019. Prices have

repeatedly fallen/risen on bad/good trade news. Regardless of the reason (or lack thereof), a stock market decline can **cause** economic growth to slow by reducing consumer spending and business investment.

I believe the decline in stock prices primarily reflects slower growth in corporate earnings resulting from slower economic growth **outside** the United States. S&P 500 companies get almost half of their earnings from outside the United States. Economic growth outside the United States has been slowing all year. Real GDP declined in Japan, Germany, and Italy in the third quarter. While purchasing managers indexes and auto sales remain solid in the United States, both have plummeted in Europe. Perhaps more concerning is the ongoing slowdown in China and the realization that U.S. companies will never make as much money in China as they thought they would. (Some of us realized that two decades ago.) China reported on December 14 that year-over-year growth in retail sales slowed in November to its slowest rate since 2003. Growth in industrial production, at 5.4%, matched its slowest year-over-year growth rate since 2009. (Excluding January/February data, which are distorted by the variable timing of the Lunar New Year, growth in industrial production matched its slowest rate since the data series began in 1995!) Despite an announcement that China would reduce tariffs on U.S. motor vehicles and the better-than-expected report on U.S. retail sales, U.S. stock prices fell sharply in response to the weak Chinese data on December 14.

Growth in Europe has been hurt by concerns about the United Kingdom's "Brexit" from the European Union and by the new Italian government's rejection of fiscal discipline. The slowdown in China reflects a shrinking working age population (the result of the single-child policy), excessive government debt (the result of repeated fiscal stimulus), and slower growth in exports because of slowing in the rest of the world. U.S. tariffs have had little impact . . . so far. But perhaps the biggest reason for the slowdown in global growth is the increase in oil prices. The average monthly price of Brent Blend crude oil rose from $46.37/barrel in June 2017 to $81.03 in October 2018. For many developing countries, whose currencies have depreciated versus the dollar, local-currency prices rose even more. Because of higher domestic oil production, high oil prices don't hurt the U.S. economy as much as they used to, but they hit oil-importing countries with little or no domestic production very hard. The sharp decline in oil prices since October 4 will hurt oil producers, including those in the United States, but will provide some relief to most economies in the world.



U.S. inflation was already declining before oil prices peaked. It will fall further in coming months. This will allow the Fed to slow (or halt) interest-rate hikes until inflationary pressures build again. At its September meeting, the Federal Open Market Committee's median projection was for three quarter-point hikes in the federal funds rate next year. FOMC members now expect two rate hikes. (I also expected three; I now expect just one.) As the expected number of rate hikes has declined, so have long-term bond yields and mortgage rates. This should help end the recent decline in home sales and housing starts.

Despite the lower expected trajectory for oil prices and interest rates, I've lowered my forecast for U.S. real GDP growth forecast to 2% in the first half of 2019 in part because of the damage done by lower stock prices but mostly because of the continuing threat to the economy from tariffs. My forecast assumes U.S. tariffs on Chinese goods either rise to 25% for only a few months or remain at 10% indefinitely. If tariffs go to 25% and stay there, growth will fall below 2%, and the risk of a recession will rise. If a successful trade deal is reached and the 10% tariffs are removed, growth will stay near 3% through 2019, especially if businesses respond to trade policy certainty, tax reform, and tight labor markets with productivity-enhancing investments in plant, equipment, and software.

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