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Current Economic Conditions

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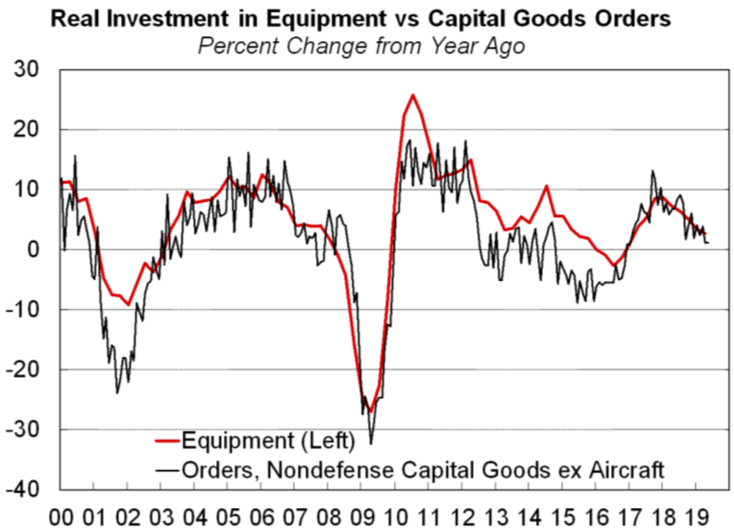
ON A KNIFE'S EDGE

The annual revision in the U.S. National Income and Product Accounts, released in late July in conjunction with the first estimate of second-quarter Gross Domestic Product, shows a much sharper deceleration in economic growth over the last three quarters than did pre-revision data. GDP grew at a 3.1% annual rate over the second half of 2017 and first three quarters of 2018. That is much faster than the 2.1% growth rate that had prevailed since the end of 2010 when the initial rebound from the Great Recession ended. Over the last three quarters, growth has returned to that anemic 2.1% rate.

There are three popular interpretations of the recent slowdown. Democrats (and some main-stream economists of other political persuasions) consider the short burst of strong growth an unsustainable "sugar high" caused by the impact of tax reform on consumer spending. They never expected growth to remain significantly above 2%, either because they didn't believe tax reform would cause a significant increase in business investment or because they thought the economy was so close to full employment that employment growth would soon slow sharply, limiting overall growth. The Trump Administration credits the acceleration in growth to its tax and regulatory policies and blames Federal Reserve rate hikes and "quantitative tightening" for the recent slowdown. Traditional free-market, free-trade Republicans agree with the President on the benefits of tax reform and regulatory policy but attribute the slowdown mostly to the tariffs he has imposed on imports from China and on imports of steel, aluminum, and other items.

Revised data show a bigger acceleration in consumer spending than did prior data. This seems consistent with the sugar-high argument, but it's more likely the result of the big increase in wages and salaries (and the offsetting decline in corporate profits) shown in the revised data. This is consistent with the argument that labor markets are tight and employment growth must slow. Revised data still show an acceleration in business investment, suggesting that tax reform and deregulation were boosting investment and shifting economic activity to the United States. I still believe that potential growth is significantly above the sub-2% estimate from the Congressional Budget Office. Productivity growth was abnormally weak during the 2010-2016 period, held down not just by tax and regulatory policies but also by extremely high oil prices. Oil prices fell in the second half of 2014. Policies changed in 2017. Productivity has accelerated in response and has surged this year. I do not believe the recent slowdown is a return to normal.

If the recent slowdown isn't a return to normal after a sugar high, the Fed and President Trump's tariffs (and slowdowns/recessions abroad) must share the blame. The Fed's December 2018 rate hike, when the inflation rate was below the Fed's 2% target and falling, was clearly a mistake. (Even though housing, the most interest-sensitive sector of the economy, was declining throughout 2018, the Fed's prior rate hikes were consistent with data that showed inflation rising at the time.) But worse than the Fed's December rate hike is its willing to tolerate an inverted yield curve. The federal funds rate has been above the yield on 10-year Treasury notes since late May. Over the last five decades, every yield curve inversion that lasted more than a few months has been followed by a recession six to 18 months later. Some people argue that because of continued quantitative easing and negative interest rates in Europe and Japan, the U.S. bond yield is artificially low, so that the yield curve isn't sending its usual reliable signal. But given the forecasting track record of the yield curve (and the fact that the Fed has been wrong every time it has dismissed its signal in the past), the Fed is taking a big risk with the economy in leaving the yield curve inverted. It needs to either cut its federal funds rate by at least half a percentage point at its next meeting **or** boost bond yields by selling long-term securities from its portfolio (and buying short-term securities).



While the inverted yield curve is a big threat to **future** growth, much of the recent slowdown has been in business investment. This slowdown is almost certainly the result of the uncertainty caused by President Trump's tariffs. (Business investment is not particularly interest-sensitive, especially at large companies, so it's hard to blame the Fed.) New orders for nondefense capital goods ex aircraft, the monthly series that economists use as a proxy for the quarterly series on investment in equipment in GDP, turned down about the time the tariffs were announced. Investment in equipment has been essentially flat over the last two quarters; it had risen at a 6.8% annual rate over the prior eight quarters. Businesses are not going to make big investments until the trade war with China is resolved.

The combination of an inverted yield curve and the expansion of tariffs scheduled for September 1 significantly increases the risk that the U.S. economy will fall into a recession in 2020. I've lowered my forecast for U.S. GDP growth to 2% or less over the second half of 2019 and the four quarters of 2020. While this forecast could play out – if planned tariffs are shelved but existing tariffs aren't rescinded – it really represents an average of two more extreme forecasts that I find more likely. If the Fed uninverts the yield curve at its September meeting (or sooner) and the United States and China reach a trade deal that eliminates President Trump's tariffs by January 1, I expect strong growth in 2020, in line with my previous above-consensus forecast. If the Fed fails to promptly uninvert the yield curve and if tariffs are eventually extended to all Chinese goods and raised to 25%, a 2020 recession is likely. The economy is balanced on a knife's edge. Whether we topple into recession or settle into a more favorable growth trajectory depends on Federal Reserve monetary policy and, more importantly, President Trump's trade policy.

Some point to strong retail sales and rising employment to discount the risk of recession, but retail sales and employment don't lead, and data are often revised significantly. (The unemployment rate is a better indicator; if it rises more than half a percentage point from its cyclical low, we're in a recession.) Industrial production in manufacturing, which often turns down before the overall economy, fell 0.4% in July, leaving it down 1.6% from December's peak. Leading indicators do not point to an upturn.

Monetary and trade policies won't just determine the outcome of the economy; they'll likely determine the outcome of next year's Presidential election. Research by Ray Fair at Yale University shows that growth in the three quarters before an election is an important determinant of election results. If tariffs are repealed by January and business investment surges, President Trump has a good chance of being re-elected. A big rate cut might also boost growth soon enough to help his re-election chances. But if the economy falls into recession, Trump's chance of being re-elected falls to zero. The last President to be re-elected during a recession was William McKinley . . . in 1900. (He was assassinated 10 months later.)