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Monthly Economic Outlook -- Trade Tensions Escalate

Real GDP rose at a 3.2% annual rate in the advance estimate for 1Q19 (+3.2% y/y). However, that figure overstates the strength of first quarter activity. GDP growth was boosted by a narrower trade deficit and faster inventory growth, which likely reflected an impact from trade policy (as imports were pulled forward into 2018 ahead of an expected increase in tariffs). Imports have a negative sign in the GDP calculation, so the pullback added to GDP growth (that doesn't mean that trade policy has "boosted growth"). Private Domestic Final Purchases (consumer spending, business fixed investment, and residential fixed investment) rose at a 1.3% pace (+2.8% y/y). Consumer spending rose at a 1.2% annual rate. Business fixed investment rose 2.7%. Residential fixed investment fell 2.8%, the fifth consecutive quarterly decline.

Halfway through the current quarter, we don't have any official figures on foreign trade and inventories in 2Q19. So, the near-term GDP picture is a bit clouded. However, underlying domestic demand appears to be at a lackluster-to-moderate pace. Strong job gains and a pickup in wage growth were expected to propel consumer spending. However, retail sales results for April were disappointing, although possibly distorted by the late Easter. Consumers appeared to roll down the scale (shopping more at discount stores), while internet sales continued to capture share from bricks and mortar stores (as retail employment fell). Orders and shipments of nondefense capital goods was at a lackluster pace through March. Factory output, down in 1Q19, weakened further in April. Housing starts rose 5.7% in April -2.5% y/y), but single-family permits (which are reported much more accurately than starts) fell 4.2% (-7.1% y/y).

Last year, President Trump imposed a 25% import tariff on $50 billion in Chinese goods (mostly industrial inputs) and a 10% tariff on another $200 billion (including capital equipment and some consumer goods). The tariff on the second round rose to 25% on May 10. In addition, Trump has threatened to impose a 25% tariff on the remaining imports from China (around $300 billion, mostly consumer goods).

China does not pay these tariffs. U.S. consumers and business do. Tariffs raise costs, disrupt supply chains, and invite retaliation against U.S. exports. The increased uncertainty dampens business investment. Douglas Irwin, a trade economist at Dartmouth, estimates that the average tariff on Chinese goods was about 3% before Trump took office, rose to 12% in 2018, and to 18% with the May 10 tariff increase – and would increase to 29% if Trump imposes a 25% tariff on the remaining amount of Chinese goods. The New York Fed estimates that annual cost per household of the 2018 tariffs was $414, with the May 10 ratcheting up of tariffs cost another $831 (total impact: over 2% of median household income).

At face value, tariffs on Chinese goods may shave a percent or more from GDP growth this year – not enough, by themselves, to push the U.S. economy into a recession. However, with restrictions on certain companies (Huawei, etc.), trade tensions are expanding beyond tariffs. So, the risks to the overall growth outlook remain weighted to the downside.

Presumably, Trump's hope is that trade tensions will be resolved through a "better" trade deal. However, pushing against China is not necessarily the best strategy and there is a long history of miscommunications between the two countries. China foreign trade is not out of balance with the rest of the world – the country imports raw materials and exports intermediate and finished product. It's also a fast growing economy, and trade tensions risk leaving the U.S. out of a growing slice of the global pie. Restricting trade with China ought to lead to increased trade with other

countries (Vietnam's trade surplus has jumped 45%), but should do little to shift the U.S.'s overall trade balance (all else equal). However, China's unique advantage over other countries is its scale. It will take time to shift production to other countries. China has behaved badly on trade, but the proper way to address that is through a coordinated international effort (as other countries have similar complaints).

The reason the U.S. runs a trade deficit is that we don't save enough. In running a trade deficit, the U.S. borrows from the rest of the world. There's nothing inherently wrong with that. The current account deficit, the widest measure of foreign trade, is running at about 2.0-2.5% of GDP, moderate by historical standards (it rose to over 6% of GDP in 2005). However, it's important to remember that the federal budget deficit, which is expected to reach $1 trillion in the current fiscal year, is part of national savings.

Tariffs may add to consumer price inflation in the short-term, but are unlikely to result in a higher underlying trend in inflation. We are more likely to see added costs dampen the pace of consumer spending growth and business investment. As, expected, the Federal Open Market Committee left short-term interest rates unchanged following the April 30-May 1 policy meeting. Fed officials have given little indication that they are about to cut short-term interest rates anytime soon. However, the federal funds futures market has been pricing in a greater chance of one or more rate cuts by the end of the year.

The Federal Reserve is rethinking its monetary policy framework (strategies, tools, and communication policies) this year, but any formal changes are not expected until next year. Fed policy decisions will remain data-dependent. With the federal funds target rate currently at the lower end of the range of estimates of neutral, officials generally view policy as a bit accommodative. It would take a string of softer data, including labor market indicators, for the Fed to begin easing policy.

The PCE Price Index, ex-food & energy, rose 1.5% over the 12 months ending in March, falling further below the Fed's 2% goal. However, Fed officials see the recent low trend in inflation as "transitory." The Dallas Fed's Trimmed-Mean PCE Price Index (an alternative measure of "core" inflation which excludes the largest monthly increases and decreases in prices), rose 2.0%, matching the Fed's goal.

As a general rule, debt doesn't matter until it does. That is, high debt levels are not a catalyst for economic weakness, but debt can make a downturn worse, especially if it has been fueled by leverage.

"Business debt is near record levels," noted Fed Chair Powell on May 20, *"and recent issuance has been concentrated in the riskiest segments."* Hence, *"some businesses may come under severe financial strain if the economy deteriorates"* and *"a highly leveraged business sector could amplify any economic downturn as companies are forced to lay off workers and cut back on investments."* However, according to Powell, *"business debt does not currently appear to present significant risks to financial stability."* Business debt-to-GDP is still less than 75% (vs. 65% at its recent low), in line with previous expansions. Banks and other financial institutions have greater buffers to absorb losses. The growth in business debt has not been fueled by short-term funding. Still, Powell emphasized that *"we cannot be satisfied with our current level of knowledge about these markets, particularly the vulnerability of financial institutions to potential losses and possible strains on market liquidity and prices should investors exit investment vehicles holding leveraged loans."*

Net new issuance of high-yield bonds was about flat in 2018, but leveraged loans outstanding rose 20% and now stand at more than $1 trillion. Mutual funds, which account for about 20% of the leveraged loan market, allow investors to redeem their shares on a daily basis, although the underlying loans take longer to sell. Powell noted that *"widespread redemptions by investors, in turn, could lead to widespread price pressures, which could affect all holders of leveraged loans,"* including collateral loan obligations (CLOs), the largest holder of leveraged loans. According to Powell, only $90 billion of the $700 billion in total CLOs are held by the largest U.S. banks. Much of the rest is held outside of the U.S., including foreign banks and asset managers.

The federal budget deficit is projected to hit $1 trillion in the current fiscal year (ending September). The proper way to look at deficit figures is a percentage of nominal GDP, and that should be about 4.6% -- relatively high by historical standards (we ran at about 5% of GDP during the 1980s and hit 10% of GDP in the aftermath of the Great Recession). Debt does not cause higher inflation (recall that inflation trended lower in the 1980s). The Chinese have no incentive to dump their holdings of U.S. Treasuries, but trade policy disruptions ought to lead to slower Chinese purchases of U.S. debt (this appears to be already happening and bond yields remain low).

On a positive note, household debt-to-income ratios have steadily declined. A rising fraction of this debt is rated prime. Household debt service burdens are generally much more manageable.

Trump has rolled back tariffs on Canadian and Mexican steel and aluminum, which was a precondition for the U.S. Mexico Canada Agreement (the NAFTA replacement, which must still be ratified by Congress). Trump postponed by six months the decision to impose tariffs on all imported motor vehicles.

The escalation of U.S./China trade tensions have increased anxieties about global economic growth in general. Brexit, the United Kingdom's trade war with itself, is going nowhere and the last days of May appear likely to be the last days of May.

Softer global growth will, in turn, lead to somewhat slower growth in the U.S., but not by a lot. To date, U.S. growth has been disappointing in 2019, although hardly a disaster. The lagged impact of fiscal stimulus (expected to boost GDP growth by half a percent in the first half of the year) failed to show up. Investors clearly benefited from tax policy changes, but taxpayers were generally unpleased with this tax season. Some individuals had reduced tax withholding in 2018, leading to smaller-than-expected refunds (so they got a tax cut but didn't notice). Some didn't get the reduction in taxes they had anticipated. Others paid more due to the limitations on deductions for state and local taxes. Consumer sentiment remain high, but surveys show that most don't see tax cuts as a factor.

The partial government shutdown, weather, and the late Easter appear to have had an impact of growth in the first four months of the year. Looking ahead, we should see a pickup, but we're more likely to be back to the longer-term sustainable trend (1.5-2.0% GDP growth).

The job market data will remain key.

Notes on the forecast: The table represents a baseline forecast. Forecasts should be thought of in probabilistic terms. There is considerable uncertainty looking out to the second half of this year, but the risks to the growth outlook remain prominently to the downside.

GDP growth figures can be quirky from quarter to quarter. Net exports and the change in inventories make up a relatively small portion of the level of GDP, but they account for more than their fair share of volatility in GDP growth. Investors should focus on Private Domestic Final Purchases, which is consumer spending plus business fixed investment plus residential fixed investment (or equivalently, GDP less government less net exports, less the change in inventories).

Underlying domestic demand has been expected to transition to a more sustainable pace in 2019, largely reflecting the fading impact of fiscal stimulus and labor market constraints.

Tariffs and the expectation of further tariffs appear to have pulled imports forward and added to inventory growth. Imports have a negative sign in the GDP calculation (hence, declining imports add to GDP growth).

Nonfarm payrolls should be boosted by temporary hiring for the census in the first half of 2020 (falling back in the second half of the year).

Once again, long-term interest rates are expected to move somewhat higher, reflecting increased government borrowing and the unwinding of the Fed's balance sheet. However, a modest-to-moderate inflation outlook and low long-term interest rates outside the U.S. should continue to put downward pressure on U.S. bond yields.

	2Q18	3Q18	4Q18	1Q19	*2Q19*	*3Q19*	*4Q19*	*1Q20*	*2Q20*	*3Q20*	2018	2019	2020
GDP (↓ *contributions*)	4.2	3.4	2.2	3.2	*1.4*	*1.6*	*1.6*	*1.6*	*1.6*	*1.6*	3.0	*1.9*	*1.6*
consumer durables	0.6	0.3	0.3	-0.4	*0.2*	*0.2*	*0.2*	*0.2*	*0.1*	*0.1*	0.2	*0.0*	*0.1*
nondurables & services	2.0	2.1	1.4	1.2	*1.3*	*1.1*	*1.1*	*1.0*	*1.0*	*1.0*	1.5	*1.1*	*1.0*
bus. fixed investment	1.2	0.4	0.7	0.4	*0.2*	*0.2*	*0.3*	*0.3*	*0.3*	*0.3*	0.9	*0.3*	*0.2*
residential investment	-0.1	-0.1	-0.2	-0.1	*0.2*	*0.1*	*0.1*	*0.0*	*0.0*	*0.0*	-0.1	*0.0*	*0.0*
Priv Dom Final Purchases	4.3	3.0	2.6	1.3	*2.1*	*1.7*	*2.0*	*1.7*	*1.7*	*1.6*	3.0	*1.7*	*1.6*
government	0.4	0.4	-0.1	0.4	*0.3*	*0.3*	*0.3*	*0.3*	*0.3*	*0.3*	0.3	*0.3*	*0.3*
exports	1.2	-0.6	0.2	0.5	*-0.1*	*-0.2*	*0.1*	*0.2*	*0.2*	*0.2*	0.3	*0.1*	*0.2*
imports	0.1	-1.4	-0.3	0.6	*0.2*	*0.4*	*-0.2*	*-0.3*	*-0.3*	*-0.3*	-0.5	*0.3*	*-0.3*
Final Sales	5.4	1.0	2.1	2.5	*2.3*	*2.0*	*1.7*	*1.6*	*1.6*	*1.6*	2.6	*2.1*	*1.6*
ch. in bus. inventories	-1.2	2.3	0.1	0.7	*-0.9*	*-0.4*	*-0.1*	*0.0*	*0.0*	*0.0*	0.4	*-0.2*	*0.0*
Unemployment, %	3.9	3.8	3.8	3.9	*3.7*	*3.8*	*3.8*	*3.8*	*3.9*	*3.9*	3.9	*3.8*	*3.9*
NF Payrolls, monthly, th.	243	189	233	186	*190*	*165*	*160*	*185*	*229*	*14*	223	*175*	*140*
Cons. Price Index (q/q)	2.1	2.0	1.5	0.9	*3.3*	*1.9*	*2.0*	*2.0*	*2.1*	*2.1*	2.4	*1.9*	*2.1*
excl. food & energy	1.9	2.0	2.2	2.3	*1.7*	*1.9*	*1.9*	*2.0*	*2.0*	*2.1*	2.1	*2.0*	*2.0*
PCE Price Index (q/q)	2.0	1.6	1.5	1.5	*0.6*	*2.4*	*1.9*	*1.9*	*1.9*	*2.0*	2.0	*1.5*	*2.0*
excl. food & energy	2.1	1.6	1.8	1.8	*1.3*	*1.3*	*1.8*	*1.8*	*1.8*	*1.9*	1.9	*1.6*	*1.8*
Fed Funds Rate, %	1.74	1.92	2.22	2.22	*2.40*	*2.40*	*2.25*	*2.16*	*2.16*	*2.16*	1.83	*2.36*	*2.16*
3-month T-Bill, (bond-eq.)	1.9	2.1	2.4	2.4	*2.4*	*2.3*	*2.2*	*2.1*	*2.1*	*2.1*	2.0	*2.3*	*2.1*
2-year Treasury Note	2.5	2.7	2.8	2.8	*2.2*	*2.1*	*2.1*	*2.0*	*2.0*	*2.2*	2.5	*2.2*	*2.1*
10-year Treasury Note	2.9	2.9	3.0	3.0	*2.4*	*2.4*	*2.5*	*2.6*	*2.7*	*2.8*	2.9	*2.5*	*2.8*

Annual growth forecasts are 4Q/4Q

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