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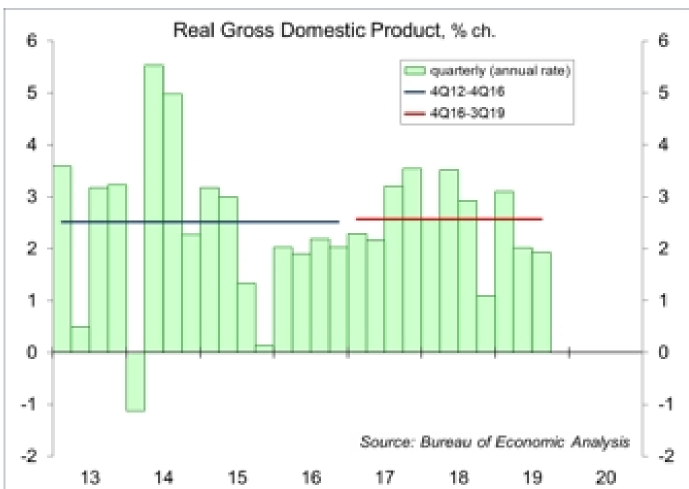
Monthly Economic Outlook -- Fed Reduces Recession Odds

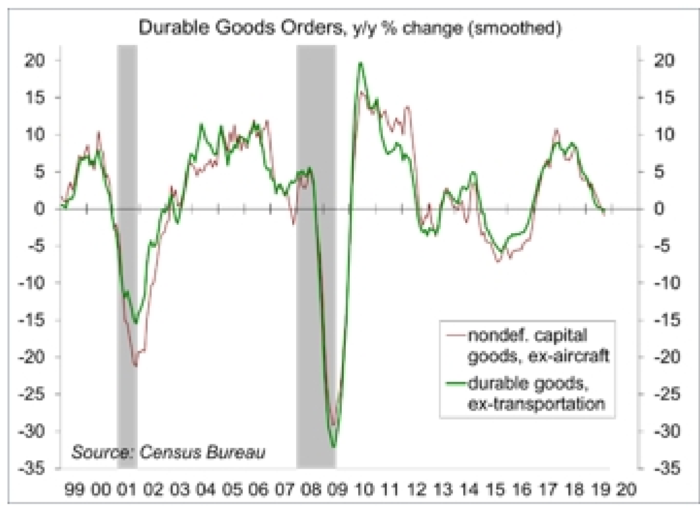
U.S. economic activity has remained mixed, with moderate strength in consumer spending and general weakness in business fixed investment and manufacturing.

The Federal Reserve lowered short-term interest rates by another 25 basis points on October 30, the third cut this year. In his press conference, Fed Chair Powell said that *"the policy adjustments we have made are providing, and will continue to provide, meaningful support to the economy – we believe that monetary policy is in a good place."*

Fed rate cuts should provide insurance against downside risks in 2020. A mini-trade deal would help to reduce uncertainty, which has been a negative factor for business investment. However, ongoing weakness in the global economy, political uncertainty, and labor market constraints can be expected to limit the pace of U.S. growth over the next several quarters.

Real Gross Domestic Product rose at a 1.9% annual rate in the advance estimate for 3Q19, up 2.0% over the last four quarters. Consumer spending, 68% of GDP, rose at a 2.9% pace, up 2.5% year-over-year. Business fixed investment fell at a 3.0% annual rate, vs. -1.0% in 2Q19 (+1.3% y/y). Second quarter weakness was more pronounced in mining structures (down at a 29.3% annual rate), which includes oil and gas well drilling, and in transportation equipment (-9.9%, reflecting ongoing problems at Boeing). Residential fixed investment (mostly homebuilding) rose at a 5.1% annual rate, the first increase since 4Q17. Government continued to add to overall growth. Inventory growth was little changed from the second quarter pace and net exports fell slightly – each subtracting only a small amount from overall GDP growth. Note that these figures will be revised, but the underlying story isn't likely to change much. In recent years, revisions from the advance estimate to the 2nd and 3rd estimate have been relatively small. Larger revisions are seen in annual benchmark revisions (due in late July).





The manufacturing sector has been weak this year, reflecting slower global growth and the impact of trade policy. Tariffs are a tax paid by U.S. consumers and businesses. Tariffs raise costs, disrupt supply chains, invite retaliation against U.S. exports, and add to uncertainty, undermining business investment. Anecdotal evidence through the summer pointed to increased disruptions following the increase in tariffs in May. In his press conference following the Fed policy meeting in mid-September, Chair Powell noted that *"our business contacts around the country have been telling us that uncertainty about trade policy has discouraged them from investing in their businesses."* Yet, despite all the hand-wringing, factory sector weakness currently appears more muted than in the 2015 manufacturing downturn, which had reflected a sharp correction in energy exploration.

The White House has recognized that tariffs have had a negative impact on the economy. That was evident in the decision to delay most of the final round of tariffs on Chinese goods until December 15. There is an election next year, so efforts to shore up economic growth should be a priority – and that includes reducing trade tensions. A full trade deal with China still appears unlikely, but there are prospects for a mini deal, one that would prevent a further escalation and possibly lower some of the tariffs that have been put in place.

The Federal Reserve attempts to arrive at its policy decisions by forming a consensus view. Formal dissents are still relatively rare. Since the early summer, officials have been split on the appropriate path for monetary policy. All 17 senior Fed officials participate at the policy meetings, but not every official has a vote. The Federal Open Market Committee is made up of the five governors, the New York Fed president, and four of the other 11 district bank presidents (who rotate on and off each January). By construction, the balance of power is weighted more toward the governors (the NY Fed president is more in tune with the governors). There were two dissenting votes for no change in policy in September and October.

Chair Powell cited three reasons for cutting rates this year: 1) *"to insure against downside risks from weak global growth and trade policy uncertainty;"* 2) *"to help offset the effects these factors are currently having on the economy;"* and 3) *"to promote a faster return of inflation to our symmetric 2% objective."* Following three rate cuts, the federal funds futures market is pricing in no change in December and a small chance (about 35%) of another cut by the middle of next year. In his post-FOMC press conference, Powell noted *that "since monetary policy operates with a lag, the full effects of these adjustments on economic growth, the job market, and inflation will be realized over time."* Moreover, *"we see the current stance of monetary policy as likely to remain appropriate as long as incoming information about the economy remains broadly consistent with our outlook of moderate economic growth, a strong labor market, and inflation near our symmetric 2% objective – we believe monetary policy is in a good place to achieve these outcomes."* Of course, *"if developments emerge that cause a material reassessment of our outlook, we would respond accordingly – policy is not on a preset course."*

Fed rate cuts have reduced recession fears. In August, a simple yield curve model for predicting recessions had indicated about a 40% chance of entering a downturn within the next 12 months. By October, that had fallen to 30%, and it's down to 25% in early November -- still relatively high by historical standards, but less fearful.

Psychology is thought to play a key role in the development of recessions. If consumers believe a downturn is coming, they will postpone major purchases, such as a new car or home. If businesses fear a recession, they will be less inclined to invest in new plant and equipment or hire new workers. Hence, recession expectations can become self-fulfilling. While business investment has been weak over the last couple of quarters, it's not falling off a cliff. Moreover, the job market has remained strong.

Nonfarm payrolls rose 128,000 in the initial estimate for October, despite the subtraction of 42,000 striking General Motors workers (who will return to the total in November) and the exit of 20,000 temporary workers hired to prepare for the 2020 census. Private-sector payrolls rose by 131,000 (median forecast: +80,000), leaving the three-month average at +154,000, or about +168,000 accounting for the GM strike (a +152,000 average for the first 10 months of 2019, vs. +215,000 in 2018). We need less than 100,000 per month to absorb new entrants into the labor force. The unemployment rate was essentially unchanged in October (3.6%, v. 3.5% in September, but the difference was a rounding error). The employment/population ratio for prime-age workers (those aged 25-54) is back to where it was before the recession. The ratios for teenagers and young adults are not back to where they were, but the ratio for older workers (55+) is higher. Some of this may be structural, but it's consistent with a tighter job market. Note that the payroll figures are based on a statistical sample. The Bureau of Labor Statistics can't observe employment related to business formation and destruction, but estimates these through what's called the birth/death model. The model does a good job under normal circumstances, but tends to miss at turning points. For example, the pace of job losses during the financial crisis was much sharper than initially reported – and the Fed's policy response was less aggressive than it would have been if the true weakness had been known (the Fed now looks at weekly payroll data, not available to the rest of us, to better gauge changes in the labor market's strength). Looking at the broader range of labor market indicators, it doesn't look like we've reached a turning point, but the birth/death model may exaggerate the payroll figures in a slow patch. One should take the reported figures with a grain of salt.

Other labor market figures point to some moderation in job growth. Job openings, while still very high, have been trending lower since October of last year. Announced corporate layoff intentions were up 36% in the first eight months of this year (although down y/y in September and October) – still relatively low. It's unclear how much slack remains in the labor market, but slower growth in the workforce (driven by the demographics) implies that job conditions may become more binding in the months ahead. Wage growth has picked up, but is still relatively moderate. Firms have continued to use non-wage incentives to attract and retain workers, including signing bonuses, increased vacation, and other perks.

Notably, the recovery has now reached low- and middle-income communities that had been largely bypassed over the last several years. This observation seems to have made a strong impression on Fed Chair Powell: *"many who struggled to find work are now getting opportunities to add new and better chapters to their lives."* For Powell, *"this underscores for us the importance of sustaining the expansion so that the strong job market reaches more of those left behind."* A year ago, the Fed had been moving gradually toward what it thought was a neutral policy position. Officials now generally believe that there is little connection between the job market and inflation and that policy can remain accommodative until higher inflation in consumer prices becomes evident.

The near-term economic outlook remains mixed, with consumer spending growth likely to moderate (unit motor vehicle sales fell in October) and softness in business fixed investment. The expansion appear likely to continue in 2020. The risks to the growth outlook are still weighted to the downside, but appear less fearful than a couple of months ago.

Notes on the forecast: The table represents a baseline forecast. Any forecast will be wrong. Forecasts should be thought of in probabilistic terms – a most likely scenario, but one surrounded by risks. While growth is expected to be moderate into 2020, the risks to the growth outlook remain prominently to the downside. Much has hinged on trade policy and there is a general expectations that we will see some positive developments.

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. As Fed Chair Powell has put it, net exports and inventories are “components that are generally not reliable indicators of ongoing momentum.” **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). Powell: “The more reliable drivers of growth in the economy are spending on consumption and business investment.”

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

Trade data are notoriously choppy, making it difficult to discern the impact from trade policy. Trade policy uncertainty appears to have led to some temporal shifts in activity and a stockpiling in inventories, but more so in the second half of last year and the first half of this year.

Nonfarm payrolls should be boosted by temporary hiring for the decennial census in the first half of 2020, falling back in the 3Q20.

Once again, long-term interest rates are expected to move somewhat higher, but more gradually than previously. A moderate inflation outlook and low long-term interest rates outside the U.S. should continue to put downward pressure on U.S. bond yields (although those rates have risen more recently).

The Fed appears to be on hold for the foreseeable future, but would respond with more rate cuts if there are more significant signs of weakness. The hurdle for a rate increase appears to be high for the time being. (M19-2813173)

	4Q18	1Q19	2Q19	3Q19	*4Q19*	*1Q20*	*2Q20*	*3Q20*	*4Q20*	2018	2019	2020	2021
GDP (↓ *contributions*)	1.1	3.1	2.0	1.9	*1.5*	*1.8*	*1.7*	*1.7*	*1.4*	2.5	*2.1*	*1.7*	*1.9*
consumer durables	0.1	0.0	0.9	0.5	*0.2*	*0.1*	*0.1*	*0.1*	*0.1*	0.3	*0.4*	*0.1*	*0.2*
nondurables & services	0.9	0.8	2.2	1.4	*1.2*	*1.1*	*1.1*	*1.1*	*1.0*	1.5	*1.5*	*1.1*	*1.2*
bus. fixed investment	0.6	0.6	-0.1	-0.4	*0.1*	*0.2*	*0.2*	*0.1*	*0.2*	0.8	*0.0*	*0.1*	*0.3*
residential investment	-0.2	-0.0	-0.1	0.2	*0.2*	*0.1*	*0.0*	*0.0*	*0.0*	-0.2	*0.1*	*0.0*	*0.0*
Priv Dom Final Purchases	1.7	1.6	3.3	2.0	*2.0*	*1.7*	*1.6*	*1.5*	*1.4*	2.8	*2.2*	*1.6*	*1.9*
government	-0.1	0.5	0.8	0.4	*0.3*	*0.3*	*0.3*	*0.3*	*0.3*	0.3	*0.5*	*0.3*	*0.3*
exports	0.2	0.5	-0.7	0.1	*-0.1*	*0.1*	*0.1*	*0.2*	*0.2*	0.1	*-0.1*	*0.1*	*0.1*
imports	-0.5	0.2	0.0	-0.2	*-0.2*	*0.1*	*-0.2*	*-0.2*	*-0.2*	-0.5	*0.0*	*-0.1*	*-0.2*
Final Sales	1.0	2.6	3.0	2.0	*1.7*	*2.0*	*1.7*	*1.6*	*1.4*	2.2	*2.3*	*1.7*	*1.9*
ch. in bus. inventories	0.1	0.5	-0.9	-0.1	*-0.2*	*-0.1*	*0.0*	*0.0*	*0.0*	0.3	*-0.2*	*0.0*	*0.0*
Unemployment, %	3.8	3.9	3.6	3.6	*3.6*	*3.5*	*3.5*	*3.6*	*3.7*	3.9	*3.7*	*3.8*	*3.8*
NF Payrolls, monthly, th.	233	174	152	188	*135*	*150*	*190*	*-20*	*90*	223	*162*	*103*	*85*
Cons. Price Index (q/q)	1.5	0.9	2.9	1.8	*1.6*	*2.1*	*2.1*	*2.1*	*2.2*	2.4	*1.8*	*2.0*	*2.2*
excl. food & energy	2.2	2.3	1.8	3.0	*2.1*	*2.0*	*2.0*	*2.1*	*2.1*	2.1	*2.2*	*2.2*	*2.1*
PCE Price Index (q/q)	1.3	0.4	2.3	1.8	*1.9*	*1.8*	*1.8*	*1.8*	*1.9*	2.1	*1.4*	*1.8*	*1.8*
excl. food & energy	1.7	1.1	1.7	2.2	*1.9*	*1.7*	*1.7*	*1.8*	*1.8*	2.0	*1.6*	*1.8*	*1.8*
Fed Funds Rate, %	2.22	2.40	2.40	2.20	*1.67*	*1.57*	*1.57*	*1.57*	*1.57*	1.83	*2.17*	*1.57*	*1.79*
3-month T-Bill, (bond-eq.)	2.4	2.4	2.3	2.0	*1.6*	*1.6*	*1.6*	*1.7*	*1.7*	2.0	*2.1*	*1.7*	*1.8*
2-year Treasury Note	2.8	2.8	2.1	1.7	*1.6*	*1.7*	*1.7*	*1.8*	*1.9*	2.5	*2.0*	*1.8*	*2.1*
10-year Treasury Note	3.0	3.0	2.3	1.8	*1.8*	*1.9*	*1.9*	*2.0*	*2.1*	2.9	*2.1*	*2.0*	*2.3*

Source: Raymond James

Annual growth forecasts are 4Q/4Q

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The **S&P 500** is an unmanaged index of 500 widely held stocks that is generally considered representative of the U.S. stock market.

The **Dow Jones Industrial Average (DJIA)** is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the NASDAQ.

The **NASDAQ Composite** is a stock market index of the common stocks and similar securities listed on the NASDAQ stock market.

The **MSCI World All Cap Index** captures large, mid, small and micro-cap representation across 23 Developed Markets (DM) countries. With 11,732 constituents, the index is comprehensive, covering approximately 99% of the free float-adjusted market capitalization in each country.

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The **Barclays Intermediate Government/Credit Bond** index measures the performance of U.S. Dollar denominated U.S. Treasuries, government-related and investment grade U.S. corporate securities that have a remaining maturity of greater than one year and less than ten years.

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The **S&P 500 Futures** is a capitalization-weighted index of 500 stocks. The index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The **DJIA Futures** is a stock market index futures contract traded on the Chicago Mercantile Exchange`s Globex electronic trading platform. Dow

Futures is based off the Dow 30 stock index.

The **Nasdaq 100 Futures** is a modified capitalization-weighted index of the 100 largest and most active non-financial domestic and international companies listed on the NASDAQ.

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