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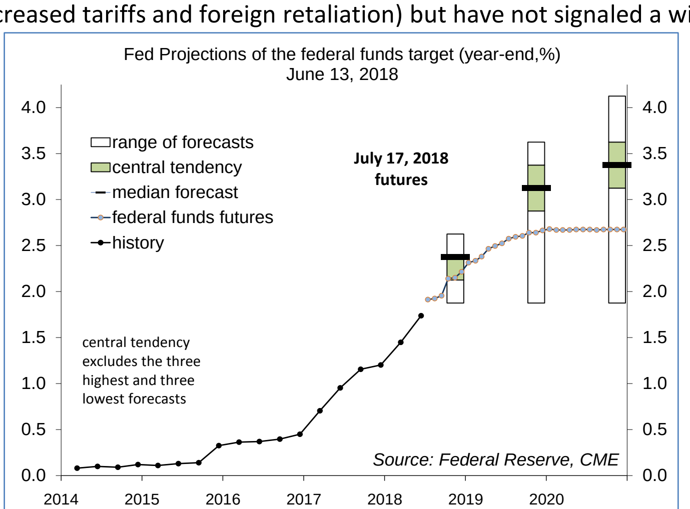
Economic Trends

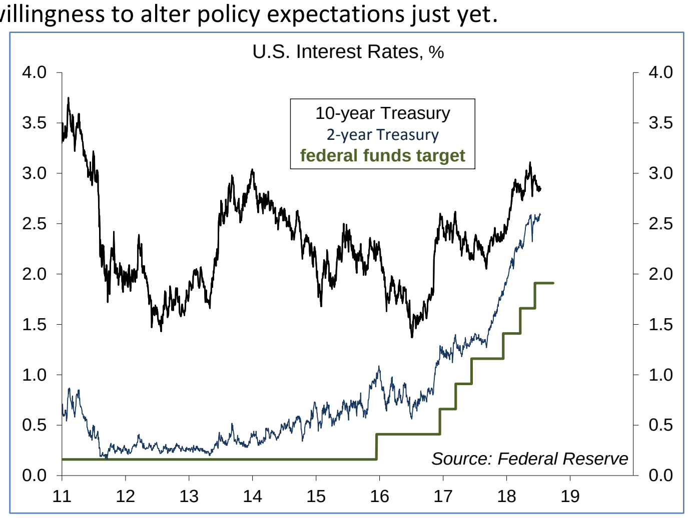
Trade Policy and the Economic Outlook

- *Economic growth appears to have been relatively strong in the second quarter, with a robust pace of job growth. Comprehensive benchmark revisions to the GDP data are due (along with the advance estimate for 2Q18) on July 27.*
- *The Federal Reserve raised short-term interest rates further after the June 12-13 policy meeting, and the revised dot plot showed that officials were divided on whether there would be one or two more rate increases by the end of this year. Most policymakers expected that conditions will warrant an above-neutral federal funds target in 2019 or 2020.*
- *To date, increased tariffs and retaliatory responses from China, Canada, Mexico, and the European Union have had only a very minor impact on U.S. growth. However, the escalation of trade tensions in early July, along with a lack of clearly stated goals, raises the risks of a more substantial impact in the months ahead.*

As Fed Chair Powell noted in his June 13 press conference, *"the U.S. economy is doing very well."* Job growth has remained strong (although beyond a long-term sustainable pace given the demographics). The June ISM surveys noted faster growth in new orders and production, but supply managers expressed greater concerns about the impact of tariffs, rising input costs, and difficulties in shipping goods by truck. Despite a tighter job market, wage growth has remained moderate (2.7% y/y in June) – not enough to keep pace with inflation (+2.9% y/y in June). Consumer spending growth picked up in the second quarter, but that followed a subpar pace in the first quarter. Business fixed investment appears mixed. Despite corporate tax cuts, shipments of nondefense capital goods have risen at a more moderate pace in the first half of 2018. However, that follows exceptional strength in the second half of 2017 (and new orders for capital equipment picked up somewhat in 2Q18). Residential homebuilding has been uneven in recent months, but building permits and new home sales continue to exhibit strength on a year-over-year basis. However, rising home prices have reduced affordability and builders continue to note supply constraints. The trade deficit narrowed in 2Q18 (don't read too much into that; quarterly import and export data tend to be choppy), and that means that net exports will add significantly to second quarter GDP growth. Inventory growth was likely a little faster.

Federal Reserve officials see a number of factors supporting above-trend economic growth and expect that conditions will warrant further gradual increases in short-term interest rates. The June 13 policy statement indicated that the Fed sees the current stance of monetary policy as "accommodative," meaning further rate increases will be required to get to "neutral." Officials believe that there is still some slack remaining in the job market, which allows them to raise rates gradually. However, the revised dot plot and the June 12-13 policy meeting minutes indicated that most officials expect to eventually raise the federal funds target rate a bit above a neutral level in 2019 or 2020. The Fed recognizes that there are downside risks to the economic outlook from trade policy (increased tariffs and foreign retaliation) but have not signaled a willingness to alter policy expectations just yet.





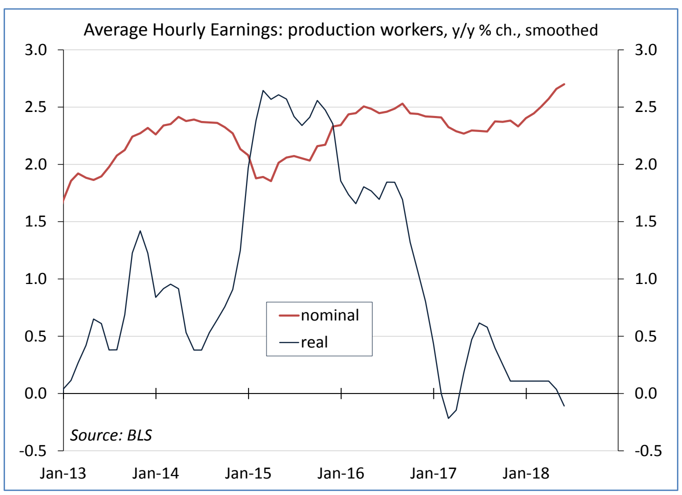
While the Fed is raising short-term interest rates, long-term interest rates have remained moderate. That partly reflects a global flight to safety into the dollar and U.S. Treasuries (reflecting uncertainty in Europe and strains for emerging economies). Trade tensions have begun to disrupt global supply chains, which ought to have a negative impact on a number of emerging market economies. Fed rate increases are having a negative impact on emerging economies, many of which have borrowed in U.S. dollars.

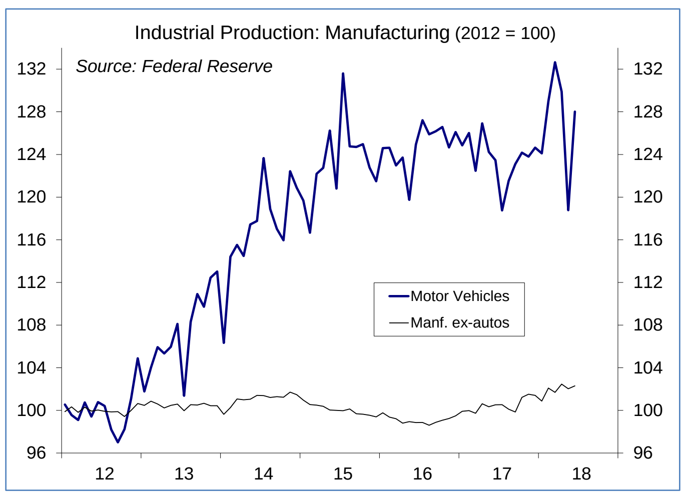
Trade policy has had a very minor impact on the overall economy (although more pronounced for some industries), but increased tensions have raised the risk of more substantial disruptions in the months ahead. Prices of washing machines have risen 20% in the last three months. Tariffs on lumber have boosted the average price of a new home by $9,000 since January 2017, according to the National Association of Home Builders. Increased tariffs on steel and aluminum have had a negative impact on the industries that use those inputs. On July 6, the White House imposed 25% tariffs on $34 billion in Chinese goods (mostly industrial inputs). China has indicated it will respond with comparable tariff increases on $34 billion in U.S. exports, and the White House has said that it will retaliate against the Chinese retaliation, with 10% tariff increases on $200 billion in Chinese goods (mostly consumer goods). President Trump has also threatened to impose tariffs on $350 billion of imported motor vehicles and parts.

The administration is waging a trade war on three fronts: China, Canada and Mexico, and the European Union. Foreign trade negotiators have all complained that the White House's trade policy goals are undefined. Some administration officials have suggested that increased tariffs are merely a negotiating tactic. Others believe they are an end to themselves – a necessary means to reduce the U.S. trade deficit. However, the root cause of large U.S. trade deficits is not foreign tariffs or unfair trade practices. While one can cite issues for many products, tariffs on U.S. exports are generally low and have fallen significantly over the years. The U.S. runs large trade deficits because we consume more than we produce (or equivalently, we don't save enough – and remember, the federal budget deficit, which is rising rapidly, is part of national savings). Focusing on bilateral trade deficits is missing the point. China, for example, imports parts and materials and assembles products to send to the U.S. Launching a trade war on multiple fronts is ignorant, misguided, and dangerous. Exports, which include services, have become increasingly important for U.S. firms and are expected to expand further as emerging economies develop their own internal demand.

Financial market participants have been generally complacent on trade policy, believing that everything will work out (with minor tweaks to existing trade agreements). However, the end result is far from clear. Increased tariffs are a tax on U.S. consumers and businesses. They raise costs, invite retaliatory tariffs on U.S. exports, and disrupt supply chains. Most importantly, increased trade tensions create greater uncertainty for capital investment at home and abroad. While the economic fallout from increased trade tariffs may be small in the aggregate, at least initially, it will likely be severe for some industries and communities (soybean farmers, for example) – and that is likely to be front page news – not what Republican lawmakers want to see heading into the November election. With that in mind, the White House may accept some token concessions from our trading partners, declare victory, and move on. However, trade tensions could intensify, restraining growth into 2019.

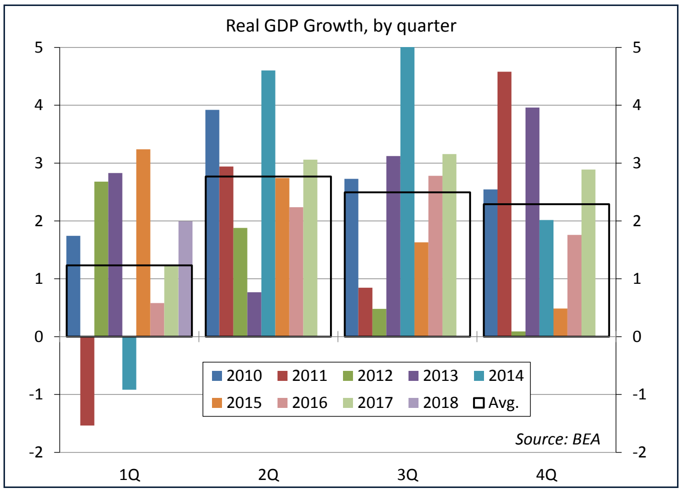
Private-sector payrolls averaged a 213,000 monthly pace of growth in the first half of 2018 (vs. +180,000 in 2017). That's more than double the pace needed to absorb new entrants into the workforce (a trend that cannot continue indefinitely). Wage inflation has picked up in recent months but remains moderate (surprisingly so given the low unemployment rate). Increased tariffs have added to costs to some extent but in general takes a huge increase in commodity prices to have much of an impact at the consumer level. The bigger concern for most firms is the scarcity of skilled labor, the rising cost of labor, and difficulties in shipping goods by truck. For workers, wage gains have not kept pace with inflation over the last year (partly reflecting higher gasoline prices, which should moderate in the months ahead) – suggesting limits for consumer spending growth.

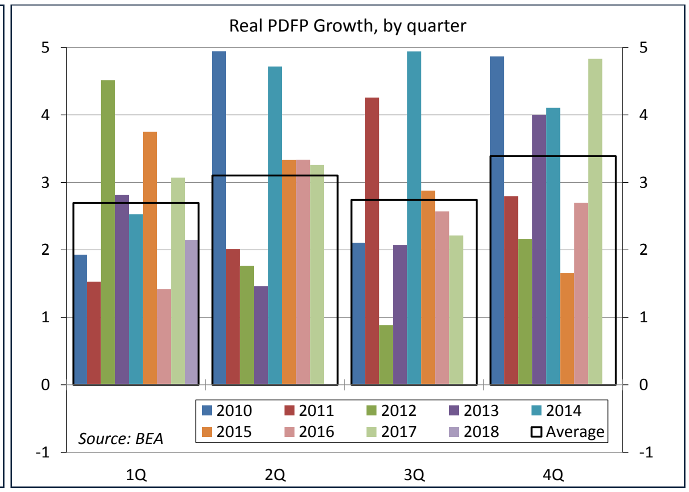




Beyond trade policy uncertainty, there are no significant signs of trouble on the immediate horizon. The yield curve (10-year to 2-year Treasury yields) has flattened, although most economists look to the broader curve (10-year Treasury to federal funds rate) as a better indicator. The Office of Management and Budget (the White House) recently revised its projection of the FY19 budget deficit to $1.127 trillion. Increased government borrowing and the Fed's balance sheet unwind ought to put some upward pressure on long-term interest rates. Inflation, while a bit higher, is not expected to get out of hand. Long-term interest rates remain low outside the U.S. However, we could see bond yields rise if trade policy uncertainty is reduced.

The advance GDP estimate of 2Q18 GDP growth is set for July 27. Benchmark revisions will also be released, but this will be more than the typical revision (where data are revised for the past five years). This will be a comprehensive revision, incorporating improvements to the methodology. The most significant item is the change in the seasonal adjustment. First quarter GDP growth figures for the last several years have tended to be below the average for the rest of the year, indicating some residual seasonality. This discrepancy isn't apparent in Private Domestic Final Purchases (consumer spending, business fixed investment, plus residential investment). The complete history of GDP data will be revised and the Bureau of Economic Analysis will also release (for the first time) unadjusted GDP figures. One consequence of this revision may be to shift second quarter growth into the first quarter. Hence, market participants should not be surprised if the 2Q18 figure falls short of economists' forecasts. However, since there is a fair amount of noise in these data, it's always best to average GDP growth figures over two or more quarters. A narrower trade deficit (more noise and not a reflection of trade policy) is expected to add significantly to second quarter GDP growth.





While the quarterly figures may shift a bit with the comprehensive revision, the recent trend in GDP growth is likely to remain moderately strong. The forecast is driven by a number of factors. Tax cuts are widely expected to provide support for growth this year and next, and a strong pace of capital investment (should it occur) could boost productivity growth to some extent. Job market constraints should become binding at some point, although it's difficult to say how much slack remains. Fed officials generally regard the current stance of monetary policy as "accommodative." Further rate increases will be needed to get to "neutral." Many believe that the federal funds rate will need to be raised above a neutral rate in 2019 or 2020 to get the economy back on an even keel (that is, to get the economy back in line with its long-term potential). Trade policy has not had much of an impact on the overall economy, but there are downside risks. The combination of these forces will determine how the economy evolves in the months and quarters ahead. Investors should remain optimistic, but the downside risks are expected to increase into 2019.

	3Q17	4Q17	1Q18	2Q18	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19	2017	2018	2019
GDP (↓ *contributions*)	3.2	2.9	2.0	4.0	2.3	2.0	1.9	1.9	1.8	1.8	2.3	2.8	2.1
consumer durables	0.6	1.0	-0.2	0.3	0.3	0.3	0.2	0.3	0.2	0.2	0.5	0.4	0.3
nondurables & services	0.9	1.8	0.8	1.5	1.3	1.3	1.2	1.2	1.1	1.1	1.4	1.3	1.2
bus. fixed investment	0.6	0.8	1.3	0.6	0.4	0.4	0.4	0.4	0.4	0.4	0.6	0.8	0.4
residential investment	-0.2	0.5	0.0	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Priv Dom Final Purchases	2.2	4.8	2.1	2.9	2.6	2.3	2.2	2.2	2.1	2.1	3.0	2.9	2.3
government	0.1	0.5	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.0	0.2	0.1
exports	0.3	0.8	0.4	1.0	0.3	0.3	0.3	0.3	0.3	0.3	0.4	0.6	0.3
imports	0.1	-2.0	-0.5	-0.1	-0.6	-0.5	-0.4	-0.4	-0.4	-0.4	-0.6	-0.6	-0.4
Final Sales	2.4	3.4	2.0	3.6	2.2	1.9	1.8	1.9	1.8	1.8	2.4	2.7	2.0
ch. in bus. inventories	0.8	-0.5	0.0	0.4	0.1	0.0	0.0	0.0	0.0	0.0	-0.1	0.1	0.1
Unemployment, %	4.3	4.1	4.1	3.9	3.7	3.6	3.6	3.7	3.7	3.8	4.4	3.8	3.7
NF Payrolls, monthly, th.	128	221	218	211	155	140	135	125	121	118	182	181	125
Cons. Price Index (q/q)	2.1	3.3	3.5	1.7	2.1	2.1	2.0	2.1	2.1	2.2	2.1	2.5	2.1
excl. food & energy	1.8	2.2	3.0	1.8	2.0	2.2	2.2	2.2	2.2	2.1	1.8	2.1	2.1
PCE Price Index (q/q)	1.5	2.7	2.5	2.0	2.1	2.2	2.3	2.3	2.2	2.1	1.7	2.1	2.2
excl. food & energy	1.3	1.9	2.3	2.1	2.0	2.1	2.2	2.2	2.1	2.0	1.5	1.9	2.1
Fed Funds Rate, %	1.16	1.20	1.45	1.74	1.92	2.20	2.44	2.69	2.91	2.97	1.00	1.83	2.75
3-month T-Bill, (bond-eq.)	1.0	1.2	1.6	1.9	2.1	2.2	2.5	2.7	2.9	3.0	1.0	1.9	2.8
2-year Treasury Note	1.5	1.7	2.2	2.5	2.7	2.8	2.9	2.9	3.2	3.3	1.4	2.5	3.1
10-year Treasury Note	2.2	2.4	2.8	2.9	3.0	3.1	3.2	3.3	3.3	3.4	2.3	3..0	3.3