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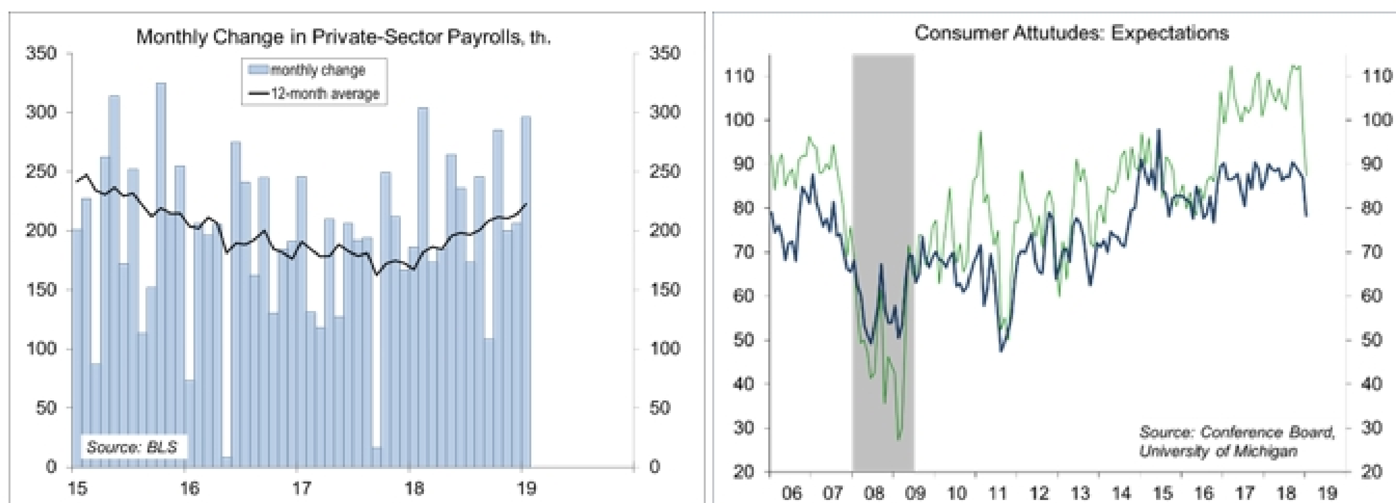
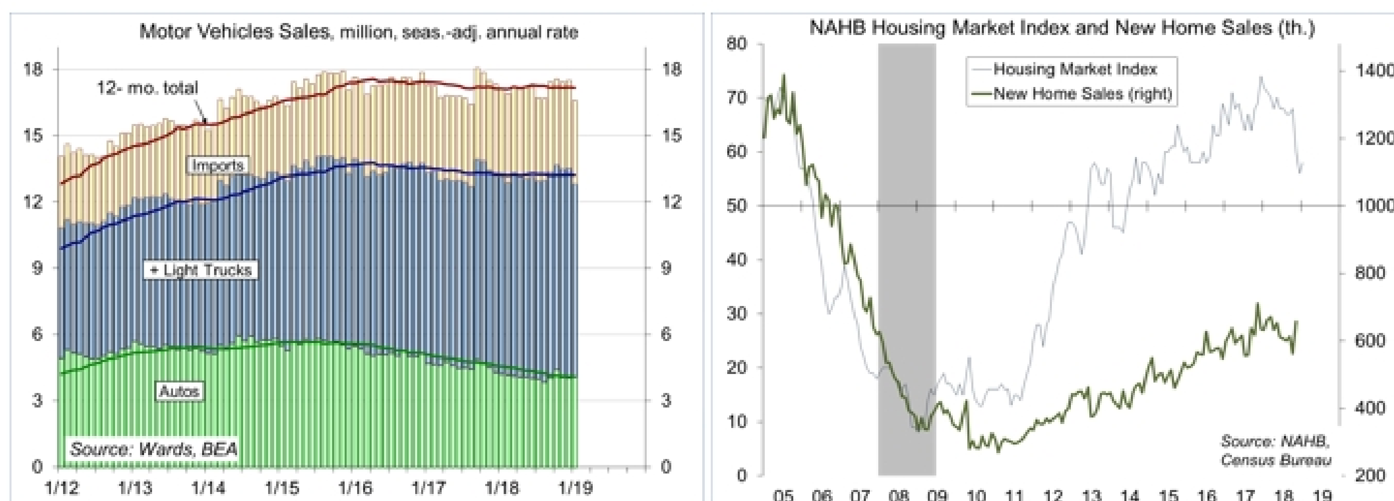
Monthly Economic Outlook -- Risky Business

The partial government shutdown has resulted in an incomplete economic picture of the fourth quarter. Reports from the Bureau of Census (retail sales, residential construction, inventories, trade balance) and the Bureau of Economic Analysis (GDP, personal income and spending) have been delayed. Reports from the Bureau of Labor Statistics (nonfarm payrolls, Consumer Price Index) were not affected, as were those of the private-sector (ISM, Conference Board) and the Federal Reserve (industrial production).

The labor market data remain the critical element of the near-term outlook. Nonfarm payrolls were reported to have risen by 304,000 in the initial estimate for January. However, that number is seasonally adjusted. We lost nearly three million jobs before adjustment, reflecting the end of the holiday shopping season and some school year effects, not much different than a year ago. Unseasonably mild weather may have led to fewer seasonal job losses than in January 2018 (as suggested by the 52,000 seasonally-adjusted gain in construction jobs). Take the adjusted payroll figure with a grain of salt. The bigger test will come in the spring. The partial government shutdown did not have a discernable effect on the nonfarm payroll figure, but it did boost the unemployment rate in January (to 4.0%, from 3.9% in December and 3.7% in November), according to the BLS. Average hourly earnings rose a mild 0.1%, but these figures are often revised the next month and the trend is higher (3.4% y/y for production workers). Strong job growth, the pickup in wage growth, and lower gasoline prices should provide support for consumer spending growth and the overall economic expansion in the near term.



Stock market volatility, the government shutdown, and trade policy uncertainty contributed to declines in business and consumer confidence in January. For consumers, the drop was concentrated in expectations, which are thought to be a key driver of big-ticket purchases, such as a new home or motor vehicle. The housing sector had already softened in the second half of 2018, but not due to a lack of demand. Home price appreciation and higher mortgage rates (4.94% in the first half of November) added to affordability issues. However, mortgage rate have since retreated (4.45% recently) and job growth should remain supportive. Motor vehicle sales fell sharply on a seasonally-adjusted basis last month, but January is the weakest month and seasonal adjustment may have been an issue. The pace of vehicle sales appears to have plateaued in the last couple of years, with sales now based largely on replacement needs. Most likely, January's drop in consumer expectations will prove to be temporary, but it will pay to watch the survey results closely in the next couple of months. Over time, consumer attitudes don't drive spending, which is fueled mostly by wage and salary income. However, a drop in sentiment could be reflective of broader economic weakness.

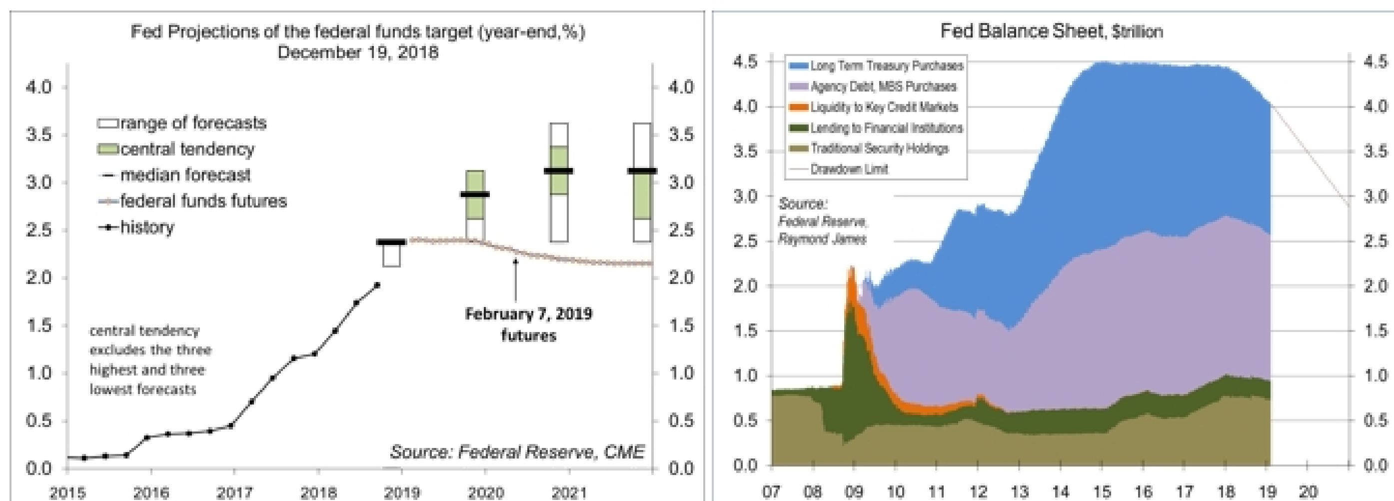


Expectations are a major driver of business fixed investment. Firms need to have confidence that the demand for the goods and services they produce will increase before investing in new plant and equipment. Uncertainty can be expected to curtail capital spending plans. Factory orders and shipment data through November suggest a more modest trend in business fixed investment in 4Q18. We could see a pickup if we get some resolution on trade policy and the federal budget. There are signs of slower global growth. China and Brexit remain key question marks.

In mid-December, the Federal Open Market Committee raised the federal funds target range for the fourth time in 2018. The policy statement noted that *"some further gradual increases"* in short-term interest rates would likely be warranted. The revised dot plot (senior Fed officials' projections of the appropriate year-end federal funds rate for each of the next few years) showed the five Federal Reserve Governors and twelve district bank presidents to be split in their expectations of how many rate increases would be likely in 2019: two officials expected no rate hikes; four expected one increase; five expected two; and six expected three. The financial press has long emphasized the median, which was two. However, the focus on the median masks the inherent uncertainty in the monetary policy outlook. The correct answer is "it depends." Monetary policy decisions remain data-dependent, meaning what the incoming data (hard economic reports and anecdotal information) imply for the economic outlook. However, in his post-FOMC press conference, Chairman Powell said that the moderate inflation outlook fives the FOMC *"the ability to be patient in moving forward."* Powell stressed that *"there's significant uncertainty about both the path and the ultimate destination of any further rate increases."*

Stock market participants were disappointed that the Fed retained a tightening bias, even a fragile one, in mid-December. Investors were also discouraged because the FOMC did not alter the pace of its balance sheet reduction. Powell noted *"I think that the runoff of the balance sheet has been smooth and has served its purpose – and I don't see us changing that."* Outside of the Fed, there had been some discussion of the impact of the balance sheet unwind on financial conditions, including credit markets and share prices. However, Powell stated that *"we don't see, you know, the balance sheet runoff as creating significant problems."*

As expected, the Fed left short-term interest rates unchanged at the policy meeting in late January. In its policy statement the FOMC indicated that it *"will be patient as it determines what future adjustments to the target range for the federal funds rate may be appropriate to support these outcomes."* Powell noted that *"the economy is in a good place,"* but "*we have seen some cross-currents and conflicting signals about the outlook,"* including slower growth abroad (*"particularly in China and Europe"*), uncertainty regarding Brexit and trade policy, and the effects of the partial government shutdown. Financial conditions *"tightened considerably"* in late 2018, and *"remain less supportive of growth that they were earlier in 2018."* In addition, *"while most of the incoming domestic economy data have been solid, some surveys of business and consumer sentiment have moved lower, giving reason for caution."* Faced with evidence of generally strong U.S. economic growth and the list of cross-currents, "common sense risk management suggests patiently awaiting greater clarity." While many interpreted this a U-turn, or shift to a "dovish" stance, the monetary policy stance is closer to neutral for the time being.



Through its three Large-Scale Asset Purchase programs (QE1-3), the Fed purchased mortgage-backed securities and long-term Treasuries, increasing the size of its balance sheet by about $3.5 trillion (to around $4.5 trillion). Starting in October 2017, as part of its monetary policy normalization, the Fed began reducing the size of its balance sheet by allowing a certain portion of maturing securities to roll off each month. The pace started slow ($10 billion per month), but increased each quarter, reaching its maximum ($50 billion per month) in October 2018. Quantitative easing was meant to add reserves to the banking system, reduce long-term interest rates, and help boost asset prices. One might expect the reverse with balance sheet reduction (which some call quantitative tightening). Bank reserves have fallen significantly, but these are excess reserves (far beyond the level banks are required to hold). That reflects increased bank lending and purchases of Treasuries. Instead of rising, bond yields have declined, reflecting a moderate inflation outlook and low long-term interest rates abroad. The stock market has declined, but the impact of balance sheet movements appear to be asymmetric. That is, a more negative impact through balance sheet reduction than the positive impact of balance sheet accumulation. Share prices may have been overvalued in the summer of 2018, reflecting an exceptional level of complacency (as suggested by the low level of market volatility) or an over-enthusiastic economic outlook.

As Chairman Powell noted, financial conditions have tightened in general, and “it’s not just one or two things – it’s interest rates, risk spreads, the stock market, credit availability, many factors.” The Fed’s concern is whether this will be a sustained change. Powell: “Our policy works through changing financial conditions, so it’s the essence of what we do.”

At the beginning of its balance sheet reduction, there were two key unknowns. How would the financial markets react and what would be the endpoint? Fed officials have been debating these issues internally for some time. By starting slow and increasing the pace gradually, the Fed could see how the market would respond. There were no signs of trouble through the summer, but senior Fed officials seemed dismissive of the unsettled financial market action in the fall. Still, it’s unclear whether the tightening of financial conditions toward the end of 2018 reflects the balance sheet unwind or other factors (notably, trade policy uncertainty and the partial government shutdown). While the ultimate size of the balance sheet is unknown, the initial broad consensus was that we would see about half of the asset purchases roll off, a process that would take a few years. In his press conference, Powell indicated that the Fed would focus on bank reserve, but *“the implication is that the normalization of the size of the portfolio will be completed sooner, and with a larger balance sheet, than in previous estimates.”* Powell refrained from stating the end date of the balance sheet unwind, but that will come, perhaps as early as the March 19-20 policy meeting, although we may get some hints in his Monetary Policy Testimony to Congress on February 27.

For the Fed, the unwinding of the balance sheet is not active monetary policy. It’s “background,” and will not be adjusted in response to changing economic conditions. The federal funds rate remains the main tool for monetary policy. Should the economy fall into a severe recession, the Fed would be expected to lower short-term interest rates. If the federal funds target reaches zero and further monetary stimulus is warranted, the expectation is that the Fed would be more likely to adopt negative interest rates, something it avoided in the financial crisis, rather than embark on another round of large-scale asset purchases.

For investors, the focus should not be on the baseline forecast, which is still optimistic. Rather, it’s the downside risks that matter. Most likely, expectations will partially rebound in February, which would help consumer spending growth and business fixed investment. However, there is considerable uncertainty about trade policy, the budget impasse, Brexit, Chinese growth, and so on. Three principles stand out: 1) diversification

(don't put all of your eggs in one basket); 2) buy fixed income for the fixed income (be happy with the rate of return and don't try to guess where interest rates are headed); and 3) think globally (while the rest of the world looks shaky in the short-term, much of global growth is expected to come from emerging market economies in the decade ahead).

Notes of the forecast: The table represents a baseline forecast, but the risks to the growth outlook remain prominently to the downside.

We are missing some of the fourth quarter data due to the partial government shutdown. Foreign trade and inventories make up a relatively small portion of Gross Domestic Product, but they account for more than their fair share of volatility in quarterly growth. Net exports (a wider trade deficit) subtracted 2 percentage points from 3Q18 GDP growth, but appear likely to make a small addition to 4Q18 growth. Inventories rose sharply in the third quarter, likely reflecting stockpiling ahead of tariff increases, adding 2.3 percentage points to GDP growth. A slower pace is likely in 4Q18, subtracting from growth.

GDP growth figures can be quirky. Investors should focus on Private Domestic Final Purchases (consumer spending, business fixed investment, residential fixed investment). Consumer spending growth was strong through the first two months of 4Q18. Unit auto sales were weak in January and there was likely some impact from the partial government shutdown. However, job growth and wage gains should remain supportive. Capital goods orders and shipments exhibited a weak trend through November and nervous expectations ought to have been a restraint into early 2019. Residential homebuilding was on a lower trend in 2018, reflecting affordability issues, but mortgage rates have fallen from where they were in November and job growth remains supportive.

Underlying domestic demand is expected to trend down to a more sustainable pace, but the risks appear to be more weighted to the downside (trade policy, global growth, Brexit, Mueller, etc.).

The inflation outlook has softened recently. Prices of industrial supplies and materials more sharply in the first half of 2018, but moderated in the second half of the year. Tariffs, which are reflected directly in the inflation data, added to input costs, but firms had mixed success in raising prices of the goods and services they produce.

Once again, long-term interest rates are expected to move higher. That could come in a sharp move if we get some resolution on trade policy, the federal budget, and Brexit, but could remain low if downside risks come to pass.

	1Q18	2Q18	3Q18	*4Q18*	*1Q19*	*2Q19*	*3Q19*	*4Q19*	*1Q20*	*2Q20*	2018	2019	2020
GDP (↓ *contributions*)	2.2	4.2	3.4	*2.6*	*1.4*	*2.2*	*2.0*	*2.0*	*1.9*	*1.9*	*2.9*	*2.3*	*1.9*
consumer durables	-0.2	0.6	0.3	*0.4*	*0.2*	*0.3*	*0.2*	*0.2*	*0.2*	*0.2*	*0.4*	*0.3*	*0.2*
nondurables & services	0.5	2.0	2.1	*2.0*	*1.4*	*1.7*	*1.4*	*1.2*	*1.2*	*1.2*	*1.4*	*1.7*	*1.3*
bus. fixed investment	1.5	1.2	0.4	*0.4*	*-0.1*	*0.1*	*0.3*	*0.4*	*0.4*	*0.4*	*0.9*	*0.2*	*0.3*
residential investment	-0.1	-0.1	-0.1	*-0.1*	*0.1*	*0.1*	*0.1*	*0.1*	*0.1*	*0.1*	*0.0*	*0.0*	*0.1*
Priv Dom Final Purchases	2.0	4.3	3.0	*3.0*	*1.8*	*2.5*	*2.2*	*2.1*	*2.1*	*2.1*	*3.2*	*2.5*	*2.1*
government	0.3	0.4	0.4	*0.3*	*0.1*	*0.1*	*0.2*	*0.2*	*0.2*	*0.2*	*0.3*	*0.2*	*0.2*
exports	0.4	1.2	-0.6	*0.1*	*-0.1*	*0.1*	*0.2*	*0.2*	*0.2*	*0.2*	*0.5*	*0.0*	*0.2*
imports	-0.5	0.1	-1.4	*0.1*	*0.3*	*0.1*	*-0.3*	*-0.3*	*-0.3*	*-0.3*	*-0.6*	*-0.1*	*-0.3*
Final Sales	1.9	5.4	1.0	*3.2*	*1.8*	*2.4*	*2.1*	*1.9*	*1.9*	*1.9*	*2.8*	*2.3*	*1.9*
ch. in bus. inventories	0.3	-1.2	2.3	*-0.5*	*-0.4*	*-0.2*	*-0.1*	*0.0*	*0.0*	*0.0*	*0.1*	*0.0*	*0.0*
Unemployment, %	4.1	3.9	3.8	3.8	*3.8*	*3.8*	*3.8*	*3.9*	*3.9*	*3.9*	*3.9*	*3.8*	*4.0*
NF Payrolls, monthly, th.	228	243	189	232	*175*	*165*	*155*	*150*	*145*	*140*	*223*	*161*	*138*
Cons. Price Index (q/q)	3.5	1.7	2.0	1.8	*1.2*	*2.0*	*1.9*	*2.0*	*2.0*	*2.1*	*2.4*	*2.0*	*2.0*
excl. food & energy	3.0	1.8	2.0	2.0	*2.3*	*1.8*	*1.9*	*1.9*	*2.0*	*2.0*	*2.1*	*1.9*	*1.9*
PCE Price Index (q/q)	2.5	2.0	1.6	*1.5*	*1.5*	*1.9*	*1.9*	*1.9*	*1.9*	*2.0*	*2.0*	*1.7*	*1.9*
excl. food & energy	2.2	2.1	1.6	*1.6*	*2.0*	*1.8*	*1.8*	*1.8*	*1.8*	*1.9*	*1.9*	*1.8*	*1.8*
Fed Funds Rate, %	1.45	1.74	1.92	2.22	*2.40*	*2.40*	*2.40*	*2.40*	*2.40*	*2.40*	*1.83*	*2.40*	*2.40*
3-month T-Bill, (bond-eq.)	1.6	1.9	2.1	2.4	*2.4*	*2.4*	*2.4*	*2.4*	*2.4*	*2.4*	*2.0*	*2.4*	*2.4*
2-year Treasury Note	2.2	2.5	2.7	2.8	*2.5*	*2.6*	*2.5*	*2.5*	*2.5*	*2.5*	*2.5*	*2.5*	*2.5*
10-year Treasury Note	2.8	2.9	2.9	3.0	*2.8*	*3.0*	*3.1*	*3.2*	*3.3*	*3.3*	*2.9*	*3.0*	*3.3*

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