THE ECONOMIC OUTLOOK GROUP

475 Wall Street
PRINCETON, NEW JERSEY 08540 Tel: 609 - 529 - 1300
www.economicoutlookgroup.com

ECONOMIC TALKING POINTS

Bernard Baumohl
Chief Global Economist

April 25, 2018

A Consumer-Led Economic Slowdown is Underway — and It Could Last

Consider this cautionary note in the aftermath of the advance report on first quarter GDP. While some analysts may breath of a sigh of relief that economic activity in Q1 turned out to be more robust than consensus forecast (2.3% vs. 1.8%) what stood out for us is how the GDP release reinforced other data that a consumer-led economic slowdown is in the works. The question now is whether the seeds have been planted for a recession to commence in the next two years.

What was so concerning in this GDP report?

Let's start by looking at one current source of strength in the economy, which are business outlays. The single biggest contributor here was spending on "structures." It increased a solid 12.3% rate last quarter, the most in a year, and likely went to repair or replace facilities that were damaged or destroyed from recent hurricanes. Those expenditures alone contributed 0.34 percentage points to overall GDP growth the first quarter.

Companies also ramped up purchases of inventories, perhaps thinking the December-passed tax cuts would stimulate more consumer and business demand. As a result, inventory investments climbed at a $33.1 billion rate, double the pace of the previous quarter. But good luck paring those stocks down if consumers are in less of a mood to go shopping. (More on that in a moment.) The build up in inventories tacked on another 0.43 percentage points to headline GDP.

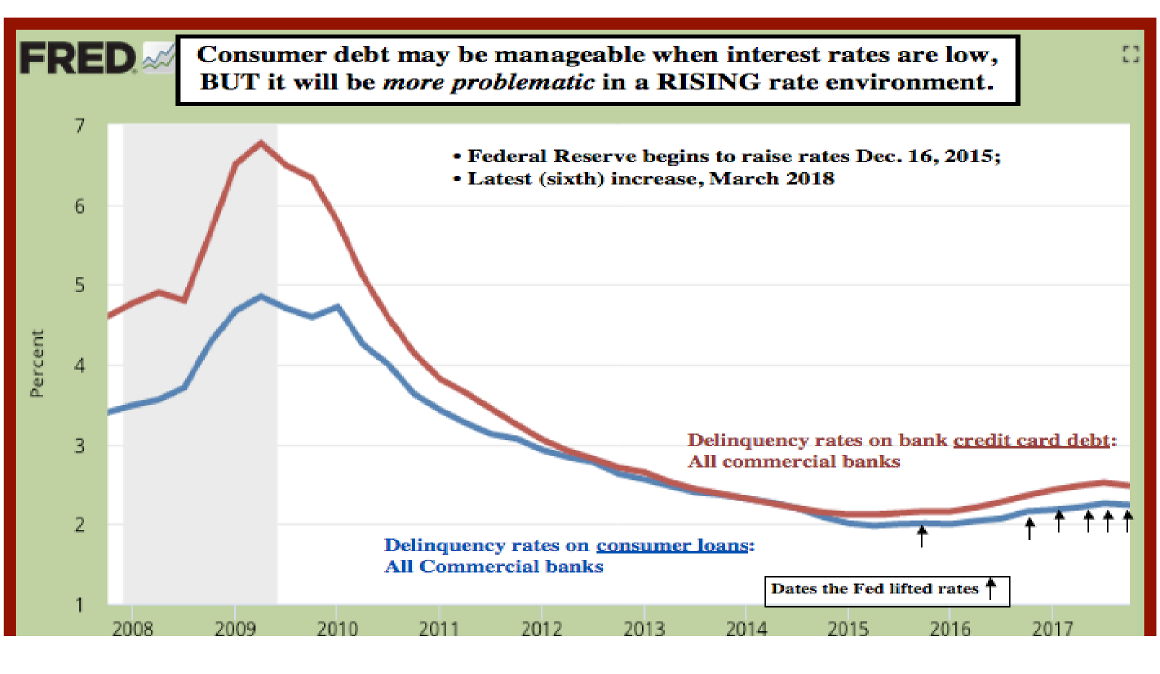
But let’s remember that expenditures on structures and inventory are highly volatile and cannot be relied upon to support growth in subsequent quarters.

By far the most critical component that determines the health and future path of the economy is consumer spending. It accounts for at least two-thirds of all economic activity. So if this sector fades the economy is, by definition, in deep trouble.

We have already seen retail sales plummet in three of the last four months. With the GDP report comes further confirmation that households are pulling back. Total consumer expenditures in Q1 inched up just 1.1%, the smallest increase in five years. Behind this depressed performance was a 3.3% plunge in purchases of durable goods, which are typically pricey goods. It was the steepest fall for such spending since 2009. Historically, any meaningful cut back in durable goods purchases (which include consumer electronics, furniture, home appliances) can be an early sign that Americans are beginning to experience financial strains. To be sure, it's possible shoppers simply took a momentary breather after the holidays. The problem with that conclusion is we have seen more data that suggests household spending could remain fundamentally weak the rest of the year.

To begin with, much of the spending by households the last several years was financed with debt and from savings. Household debt, for example, now stands at a record high $13.2 trillion. Included in that figure is credit card debt, which recently surpassed the $1 trillion mark for the first time. Servicing all that debt may be manageable when interest rates were historically low. For that you can thank the Fed's zero-bound interest rate policy, which lasted nearly 7 years. But short and long term rates are now marching higher and servicing that debt can become more problematic. Indeed, the average interest rate on credit card debt now stands at an all time high of 16.62%!!

One sign of distress already showing up in the data is the upturn in delinquencies on credit card debt and also total bank loans to consumers. (See chart below). After hitting a post-Great Recession low of 1.98% in the second quarter of 2015, the delinquency rates have turned up the instant the Fed started to lift short term rates in December of that year. By the end of 2017, those delinquencies rose to 2.24%, and for credit cards, 2.48%. True, these are not yet alarming numbers. But there is no mistake that an inflection point has occurred.



In addition to carrying that debt, Americans also dug deep into their savings to cover their consumption. In just two years, personal savings fell from $828 billion to $380 billion by the fourth quarter of 2017. Alarmed by how much their savings have been depleted, shoppers chose to curb spending in Q1. That lifted personal savings slightly, but it still stands at a relatively low of $462 billion.

There is yet another key factor to consider. This is only the second time in American history that an economic expansion has lasted nine years, which means we have precious little data on now consumers are expected to behave at this late stage in the business cycle. It is fair to assume that after nearly a decade of uninterrupted increases in spending, consumer demand may be satiated. How many more cars, TVs, laptops, cell phones does a household need?

Finally, there's the matter of wages. The lack of any genuine increase in pay --- even with a low 4.1% unemployment rate --- must also be part of the calculus that will shape spending. Average hourly pay for all employees in the private sector has hovered between 2.5% to 2.8% for more than three years! Many economists are struggling to make sense of the paucity of wage growth given how much employers complain about the shortage of workers. Let me underscore this puzzle over wages even more: In October 2009 the unemployment rate reached 10%, yet average hourly earnings rose much the same pace as now, at 2.5%! The key point here is that the anemic rise in wages will hardly encourage overstretched households to beef up consumption.

Yes, we do have a strong job market and consumer confidence levels remain high. And yes, these factors would normally support greater household spending. But that is no longer a sure bet when you combine (1) the record amount of household debt, (2) higher cost of borrowing, (3) rising delinquencies, (4) an inclination to replenish savings, (5) lackluster wage growth and (6) a shopping spree that has lasted for nine years.

It should therefore come as no surprise if consumers choose to substantially rein in spending the rest of 2018. That reversal, plus the ongoing political turmoil in Washington, threat of a trade war and rising geopolitical tensions, all put the US economy on a much more treacherous course this year and next.

=======================================

United States

	I 2017	II 2017	III 2017	IV 2017	I 2018	II 2018	III 2018	IV 2018	I 2019	II 2019	III 2019	IV 2019
Real Gross Domestic Product (GDP):												
%	1.2	3.1	3.2	2.9	2.3	3.0	2.6	2.6	1.9	2.1	2.0	2.4
Personal Consumption Expenditures:												
PCE %	1.9	3.3	2.2	4.0	1.1	2.1	2.2	2.4	1.4	2.0	2.2	2.3
Inflation, end of period, year-over-year:												
CPI %	2.4	1.6	2.2	2.1	2.4	2.5	2.6	2.6	2.7	2.6	2.5	2.5
Unemployment Rate (end of period):												
%	4.5	4.4	4.2	4.1	4.1	3.8	3.6	3.8	4.0	4.4	4.4	4.5
Non-farm Payrolls, monthly avg. thousand:												
	166	187	128	204	202	185	160	160	150	145	140	140
Treasury 10-yr Note Yield % (end of period):												
	2.39	2.30	2.33	2.41	2.74	3.01	3.05	3.15	3.10	3.10	3.05	2.95
Federal funds rate % (end of period):												
	0.88	1.13	1.13	1.38	1.63	1.63	1.88	2.13	2.38	2.63	2.63	2.63

GDP Growth - Global Economy

Country	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
US	-2.8	2.5	1.6	2.2	1.7	2.6	2.9	1.5	2.3	2.6	2.1
Eurozone	-4.1	1.7	1.4	-0.9	-0.3	1.2	1.6	1.7	2.5	2.4	1.7
United Kingdom	-5.2	1.7	0.7	0.3	1.8	2.9	2.2	1.9	1.8	1.4	1.6
Japan	-5.4	4.6	-0.4	1.6	1.5	-0.1	1.1	1.0	1.6	1.2	0.9
Canada	-2.8	3.1	3.1	1.7	2.2	2.5	0.9	1.4	3.0	2.2	1.9
India	6.3	8.4	8.6	6.7	4.9	7.4	7.9	7.1	6.6	7.4	7.6
China	9.2	10.5	9.5	7.8	7.7	7.3	6.9	6.7	6.9	6.5	6.3
Brazil	-0.3	7.5	2.7	0.9	2.3	0.1	-3.5	-3.5	1.0	2.5	2.7
Mexico	-4.7	5.2	4.0	3.9	1.4	2.3	2.7	2.9	2.1	2.1	2.7
Australia	1.2	2.8	2.6	3.6	2.4	2.6	2.5	2.4	2.4	2.8	3.1
Russia	-7.9	4.0	4.3	3.4	1.3	0.6	-2.8	-0.2	1.5	1.6	1.7
World	-1.9	4.2	3.0	2.6	2.9	3.0	2.7	2.4	3.2	3.7	3.3

Economic & Geopolitical Events That Can Disrupt U.S. GDP Growth

Any scenario above 50% will be incorporated in our baseline economic forecasts for 2018 and 2019.

PROBABILITY (%)	U.S.
50	White House implements new tariffs and triggers a trade war
45	President Trump departs before his first term expires
25	Federal Reserve raises interest rates too rapidly; Yield curve inverts
75	President Trump withdraws from the Iran nuclear deal in May; New talks begin
40	U.S. inflation accelerates faster than expected
	FOREIGN
35	War on the Korean Peninsula
40	China mismanages efforts to deleverage; debt bubble bursts
40	U.S. - Chinese confrontation in the South China Sea
35	Saudi - Iran tensions escalate to direct military conflict: Oil prices surge
25	War erupts between Israel & Lebanon's Hezbollah
15	Brexit talks collapse and imperils global trade
30	Catastrophic act of terrorism involving WMDs