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

July 27, 2018

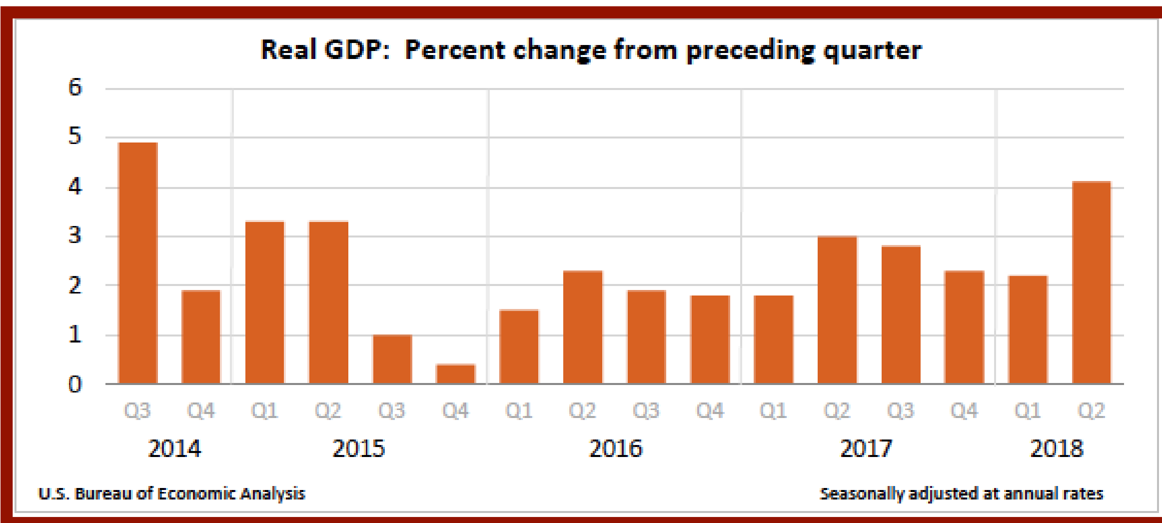
The economy is "the greatest ever"!
Aren't massive fiscal deficits and trade wars just swell?

The White House has been gleefully pointing out how the 4.1% GDP growth last quarter is definitive proof their economic and trade policies are working. And in a perverse sense that is true. The economy expanded at the fastest pace in about four years this past spring. Better still, it came against the backdrop of the lowest joblessness in nearly two decades and the fewest filings for unemployment benefits in half a century. So it's perfectly understandable why the White House would grab a bull horn and boast how this economy is "the greatest ever."

But business leaders and money managers, whose careers depend on when and where to deploy capital, can't simply rely on the ebullient rhetoric of the Trump Administration. Decision makers in the private sector typically have more incisive questions. What really was behind this growth? Did last quarter's performance reveal a healthy and sustainable business climate? More importantly, where is the economy headed over the next 12 to 24 months?

So let's begin with last quarter's activity. What were the main forces that catapulted second quarter growth past 4%?

We don't have to dig much for that answer. Massive deficit spending, sugary tax cuts for consumers, a panic-like rush by US exporters to ship out goods before the onset of a full-blown trade war --- all worked to forcibly boot this aging expansion to move faster. By our estimate, those three factors alone added 1.6 percentage points to the rise in GDP. In the absence of these near term effects, the economy would have expanded close to 2.5%.



As expected, the most important contributor to GDP growth was the consumer. Personal consumption expenditures (PCE) jumped by an impressive 4% rate, the best since late 2014. So it appears last year's passage of the Tax Cuts and Jobs Act did manage to squeeze more spending from households this past spring. Only don't expect to see anything close to that figure in subsequent quarters. Why is that?

To begin with, the tax cuts arrived at a time when the natural consumption cycle is nearing an end. After a decade of uninterrupted shopping, how many more cars, cell phones, electronic gadgets and appliances do Americans feel the need to rush out and purchase. So we believe consumer demand has to a large extent been satiated.

Secondly, household debt now stands at an historic high ($12.8 trillion) and servicing that debt will become more problematic as short and long term interest rates continue their climb. Case in point: delinquency rates on credit cards and bank loans to consumers are already escalating.

Third, we know that wage growth has been anemic for years. Average hourly earnings in June was up 2.7% over the year (…just a whisper above the 2.5% pace when unemployment stood at 10% in October 2009!!) But inflation has now accelerated to 2.9%. Once consumer prices increase faster than pay, household purchasing power begins to erode and that will restrain real spending.

Fourth, higher gasoline prices have sapped much of the income gains received from tax cuts. The average driver has spent about $30 a month more at the pump so far this year, or 40% of the average monthly savings of $78 they received from the change in tax law. That, too, will cool discretionary shopping.

Other factors will constrain aggregate spending in the future. The U.S. is currently experiencing the lowest birth rate in 30 years, which removes an important source of expenditures from young households. In addition, the Administration's curbs on immigration will also limit increases in consumer demand. Remember, net migration into the US accounts for about 50% of the nation's population growth!

To be clear, we're not projecting a total shutdown in household expenditures, only that consumers will not be major engines of growth as they have in the past. Our forecast calls for PCE to increase at a 2.5% rate in the final half of this year and to increase less than 2% for all of 2019.

- **Another major contributor to GDP growth in 2Q was net exports. The rush by American farmers and manufacturers to ship goods to foreign markets prior before trade barriers are in place contributed more than a percentage points to last quarter's growth. But with fewer international customers to sell to during this trade dispute, US exporters will see their inventories pile up and likely face the hard choice of either tolerating thinner profit margins or laying off employees.**

- **The housing market has also woefully underperformed. Residential investment declined another 1.1% in Q2, after plummeting 3.4% in Q1. Unfortunately we do not see the dynamics changing for this industry the rest of the year. Homebuilders are battling higher labor costs, rising lumber prices, costly regulations, and a scarcity of suitable land. Prospective homebuyers are confronting the lowest inventory of homes for sale in two decades and that has pushed prices higher, effectively locking out young, first-time purchasers. And with mortgage rates creeping up, we expect home sales to remain relatively weak.**

- **One admittedly bright spot has been business capital spending. Non-residential fixed investment rose a healthy 7.3% the last quarter, and that followed a stronger 11.5% jump the first three months of the year. But most of these investments were done by energy companies who wanted to benefit from higher oil prices. Take out those outlays and business capital spending was unimpressive last quarter.**

Nor do we expect to see businesses to significantly ramp up spending given the looming political, trade and geopolitical uncertainties. The multiple investigations into Trump's relationship with Russia during the last presidential campaign have raised the specter of a gravely wounded White House, events that could play out in the November midterm elections.

At the same time, the geopolitical pot is boiling furiously. US relations are deteriorating with Iran, China over trade and its militarization of the South China Sea, North Korea as it drags its feet on denuclearization, and with Russia, Syria and Turkey over conflicts across the Middle East. This general lack of clarity in the outlook greatly complicates efforts to project earnings and compute rates of return on capital investments.

There is, however, one specific scenario that worries us most at this juncture --- sharply higher interest rates. But let me be clear here. I'm less concerned about the Federal Reserve raising rates too quickly --- or even the prospect of an inverted yield curve. The greater danger to this economic cycle is a suddenly steeper yield curve the next 12 to 18 months, with the 10-year Treasury rate climbing past 4%. Driving it higher will be the US government's efforts to finance a tidal wave of upcoming deficits.

We all know the US treasury market is the deepest and most liquid in the world and that is a big plus for this country. But do not make the mistake of believing that foreign investor appetite for US debt is infinite. It is not! In fact, we are already seeing evidence that the percentage of US treasury debt held by foreigners has waned.

That the US has to go hat in hand to investors to finance trillion dollar annual budget deficits when the economy is strong and with the lowest unemployment rates in nearly two decades has to be alarming.

The only other time the US expansion lasted this long was in the late 1990s. Economic growth and labor market conditions then were as robust as what we are experiencing now. Yet that economy generated significant budget surpluses, as it should under those circumstances! Today, we're looking at a universe of deficits.

This raises a disturbing question. If the US is utterly incapable of producing surpluses now, when the economy and labor markets are "the greatest ever," --- then when will it do so? Just imagine how much those deficits will explode once we do finally slip into recession!

There is yet another issue of grave concern. Raising funds in the capital markets to cover all that fiscal red ink may prove to be much more costly. Foreign central banks, like the ECB and BOJ, have already begun to transition away from monetary accommodation and are expected to lift rates within the next 24 months. That makes it more challenging for the Treasury to lure domestic and foreign investors to buy the upcoming avalanche of US debt when they are already top heavy with US dollar assets. A 3% handle on the 10 yr. yield, for example, yield will hardly be enough to offset the risk of owning so much US paper. We believe the equilibrium point that will clear the sale of the benchmark 10-year note will exceed 4%. Of course the problem with that is such a rate also greatly increases the chance of a recession in 2019 or 2020.

So while the Trump Administration may crow endlessly about how swell the economy performed last quarter, that 4.1% print in Q2 will quickly become a wistful memory. Our forecasts calls for the economy to average 2.5% in the final two quarters of 2018, and 2% for all of 2019.

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

- Actual
- Forecast

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):												
%	1.8	3.0	2.8	2.3	2.2	4.1	2.4	2.5	1.7	1.9	2.1	1.9
Personal Consumption Expenditures:												
PCE %	1.8	2.9	2.2	3.9	0.5	4.0	2.4	2.6	1.0	1.7	1.8	2.0
Inflation, end of period, year-over-year:												
CPI %	2.4	1.6	2.2	2.1	2.4	2.9	3.1	3.1	2.8	2.8	2.6	2.5
Unemployment Rate (end of period):												
%	4.5	4.4	4.2	4.1	4.1	4.0	3.6	3.8	3.9	4.1	4.2	4.4
Non-farm Payrolls, monthly avg. thousand:												
	166	187	128	204	218	211	170	160	130	110	115	98
Treasury 10-yr Note Yield % (end of period):												
	2.39	2.30	2.33	2.41	2.74	2.85	3.10	3.35	3.60	3.85	4.00	4.20
Federal funds rate % (end of period):												
	0.88	1.13	1.13	1.38	1.63	1.88	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	-2.5	2.6	1.6	2.2	1.8	2.5	2.9	1.6	2.2	2.6	2.0
Eurozone	-4.1	1.7	1.4	-0.9	-0.3	1.2	1.6	1.7	2.5	2.1	1.5
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	1.1	0.9
Canada	-2.8	3.1	3.1	1.7	2.2	2.5	0.9	1.4	3.0	2.2	2.0
India	6.3	8.4	8.6	6.7	4.9	7.4	7.9	7.1	6.6	7.4	7.3
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	2.3
Mexico	-4.7	5.2	4.0	3.9	1.4	2.3	2.7	2.9	2.1	2.0	2.4
Australia	1.2	2.8	2.6	3.6	2.4	2.6	2.5	2.4	2.4	2.8	2.6
Russia	-7.9	4.0	4.3	3.4	1.3	0.6	-2.8	-0.2	1.5	1.5	1.4
World	-1.9	4.2	3.0	2.6	2.9	3.0	2.8	2.6	3.3	3.1	2.7

© Copyright 2018 All rights reserved.
The Economic Outlook Group, LLC