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ECONOMIC TALKING POINTS

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August 1, 2018

The real danger to this expansion is not rising short-term rates, but an unexpected jump in long-term yields.

The Fed under Jerome Powell's steady hand chose to stand pat at its midsummer FOMC meeting. That was largely expected. So now the debate heats up on how many rate increases we will see later this year and in 2019.

But the real risk to the economy may not come from an aggressive Fed monetary policy or an inverted yield curve. Instead, it is that long-term rates could take off faster than expected. A suddenly steep yield curve the next 6 to 18 months has become a lot more probable and that could certainly extinguish this economic expansion.

Driving note and bond yields higher will be the US government's efforts to finance a tidal wave of upcoming budget deficits. The Treasury just announced it will have to go hat in hand to global capital markets and borrow $769 billion in just the second half of this year. Savor all you want of last quarter's 4.1% surge in GDP, the fact remains that our fiscal balance is deteriorating at an alarming pace.

That tell us we live in a bizarre parallel universe, one where we are celebrating robust growth and full employment---but distressed that the US government is so strapped for cash it has to borrow the most amount of money since the financial crisis a decade ago. A poorly timed tax cut and an upsurge in federal spending are to blame. The result: the US will be running trillion dollar deficits as far as the eye can see even under fairly optimistic growth assumptions, according to the CBO.

Can we raise such massive funds without substantially driving up longer-term rates? It's highly unlikely! While it is true the US Treasury market is the deepest and most liquid in the world --- and that is a big plus for this country --- 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 declined.

Then there's this inescapable reality: If the US is unable to make any headway to stem deficits when the economy and labor markets are "the greatest ever," (as described by the White House), then when will it ever be able to do so? Just imagine how much further those deficits will explode once we slip into recession!

Raising funds to cover all that fiscal red ink will prove to be more costly this time. Foreign central banks, like the ECB and BOJ, have already begun to transition away from monetary accommodation. That will make it more challenging for the Treasury to lure domestic and foreign investors to absorb the upcoming avalanche of new US debt. A 3% handle on the 10 yr. note, for example, 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 that benchmark note will have to exceed 4% by the second half of 2019.

Of course, the problem with sharply higher long-term rates so late in the business cycle is that it also greatly increases the chance of a recession in 2020, if not sooner.

That's why I believe the more crucial metric to monitor now is less short-term rates, but how quickly the yield on 10-year treasury notes climbs in the next 12 months.

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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