

# THE ECONOMIC OUTLOOK GROUP



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## ECONOMIC TALKING POINTS

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### The Jobs Report Should Tone Down Recession Fears

Can we finally lay to rest worries that a recession is near?

It has been astonishing how quickly sentiment has changed in the last several months about the economic outlook. Last summer there were expectations 2019 would become another muscular year of 3% growth.

By late fall, those forecasts shifted down to about 2.5%, and then in just the last several weeks the chorus warning of a recession this year grew much louder. But the latest jitters about an economic downturn really made little sense. The likelihood we will see two quarters of contraction is, in fact, more remote than ever.

Our own projection calls for the economy to expand 2% to 2.5% over the next 12 months, a forecast that seems even more credible given the outsized jump in payrolls for December and the upward revisions in employment for October and November.

So what was it that led so many to warn that a recession was now more likely in 2019?

Most pointed to the swan dive in stock prices and the mild inversion of the yield curve as evidence that the economy is in deep trouble. Such bearish views, however, reflect a growing tendency of analysts to fall into what we call the "legacy trap." They are captive of past trends. It's the notion that abrupt changes in the financial markets serve as reliable predictors of where the real economy is headed simply because such relationships have held up in the past.

Indeed, economic models of the US are typically based on such historical linkages and that, too, partially explains why so many model-driven forecasts have proven to be disastrously wrong in the last decade.

So let's briefly tap into the new reality.

December's 312,000 jump in payrolls and the 3.2% annual increase in average hourly earnings are not symptoms of an economy that's close to stumbling. Keep in mind that more than 300,00 of those hires came from the private sector. Manufacturing employment alone --- yes, that sector that has been most affected by the trade war with China so far--- jumped by 32,000 in December. That's the biggest monthly increase seen in 2018.

While the unemployment rate did jump from 3.7% to 3.9%, it did so for all the right reasons. The household survey showed 142,000 more Americans found jobs, but it came at a time when the labor force surged by 419,000.

Again, to understand where the economy is headed requires a less robotic reliance on antiquated economic models and a greater willingness to be more flexible in thought. We have to be more nuanced in our assessment of how the economy is evolving.

First, the Internet is the greatest deflationary engine in modern economic history. Consumers and corporate purchasing managers are much more savvy at using the Web to seek out values when purchasing goods and services.

Moreover, despite efforts by President Trump to reverse the process of globalization --- a White House policy we believed is ultimately doomed, the Internet and global competition have cramped the pricing power of companies. Any firm that seeks to widen profit margins by simply raising prices will immediately risk losing market share. And once you lose market share, it is hellishly difficult to get it back.

The Internet and global competition have thus prevented an outbreak of inflation in this 10-year old economic expansion. With inflation pressures still well contained, there is no reason for the Fed to be more aggressive in raising rates. Our view is the Fed will proceed with just one more increase in Q1 and then pause the rest of the year.

Secondly, wages are finally marching higher, which again is not symptomatic of economy on the rocks. Nor do we see any sign of a blow out wage & price spiral. That means companies are either going to have to absorb the additional labor cost or make it up by boosting productivity. Most likely we will see firms pursue both.

Third, companies continue to complain they can't find workers to fill job openings. Again, this is not what you expect of an economy winding down. In fact, the demographic group that has seen the largest drop in unemployment are those without a high school diploma. We have even heard anecdotal reports of recruiters standing outside prison gates waiting for inmates to be released as

potential hires. Bizarre? Yes, but not out of the realm of possibility given current labor market conditions.

Fourth, keep in mind we also have a much healthier banking system. Lenders are well capitalized, maintain adequate levels of liquidity, have implemented better risk management practices, and credit quality on their books is still very high. A mild slowdown in economic activity will pose no danger to bankers.

Fifth, while market-driven interest rates popped this morning following the better than expected jobs report, the benchmark 10 year treasury yield still remains at a remarkably low 2.65%, only 30 or so basis points above the overnight fed funds rate. That will sustain more spending by consumers and businesses in 2019.

What does all this suggest?

For one, it is a mistake to characterize the current economy as an “aging expansion that’s finally coming to an end.” Instead, the characteristics of economy tells us we are in the midst of a “long business cycle” due in large part to the extraordinary pace of how technology has profoundly altered how we shop, travel, eat, communicate, entertain ourselves, and how companies conduct their business. Our take is that this expansion is more likely in its 6<sup>th</sup> inning, not 8<sup>th</sup> or 9<sup>th</sup>.

Remember, it’s not the age of an expansion that leads to its demise. Recessions are triggered either by “painfully” high interest rates, or an energy shock, or the bursting of an asset bubble. (That latter is usually the result of gross human folly, such as the surge dot.com stock prices or the unrealistic jump of residential real estate values which also led to worthless MBS).

Bottom line:

The powerful December jobs report, along with improving wages, lack of troublesome inflation, low interest rates, moderate energy prices, and a healthier banking industry will together allow this expansion to endure thru 2019 and thus become the longest on record.

Are there risks out there? Of course! The geopolitical pot is boiling furiously. A full-scale global trade war, a clash with China in the South China Sea, instability in the Middle East that causes oil prices to spike, the fallout from the Mueller investigation are all significant event risks --- and we have to be cognizant of them. But there is no reason to raise the probability of recession based on economic fundamentals. It’s just not that easy for a modern, market-oriented, open economy to stumble into recession.

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## United States

	I 2018	II 2018	III 2018	IV 2018	I 2019	II 2019	III 2019	IV 2019	I 2020	II 2020	III 2020	IV 2020
<b>Real Gross Domestic Product (GDP):</b>												
%	2.2	4.2	3.4	2.7	2.5	2.6	2.2	2.1	1.8	1.8	1.3	1.5
<b>Personal Consumption Expenditures:</b>												
PCE %	0.5	3.8	3.5	3.0	1.8	2.3	2.0	2.2	1.2	2.0	1.1	1.6
<b>Inflation, end of period, year-over-year:</b>												
CPI %	2.4	2.9	2.3	2.7	3.1	3.4	3.1	3.0	2.8	2.8	2.6	2.5
<b>Unemployment Rate (end of period):</b>												
%	4.1	4.0	3.7	3.9	3.7	3.6	3.7	3.9	3.9	4.1	4.2	4.4
<b>Non-farm Payrolls, monthly avg. thousand:</b>												
	218	211	190	254	130	110	115	100	94	110	86	78
<b>Treasury 10-yr Note Yield % (end of period):</b>												
	2.74	2.85	3.06	2.76	3.10	3.40	3.65	4.00	4.00	3.85	3.80	3.70
<b>Federal funds rate % (end of period):</b>												
	1.63	1.88	2.13	2.38	2.63	2.63	2.63	2.63	2.38	2.38	2.13	2.13

## GDP Growth - Global Economy

Country	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
US	2.6	1.6	2.2	1.8	2.5	2.9	1.6	2.2	3.1	2.4	1.5
Eurozone	1.7	1.4	-0.9	-0.3	1.2	1.6	1.7	2.5	1.9	1.8	1.7
United Kingdom	1.7	0.7	0.3	1.8	2.9	2.2	1.9	1.8	1.3	1.2	1.4
Japan	4.6	-0.4	1.6	1.5	-0.1	1.1	1.0	1.6	1.1	0.9	0.7
Canada	3.1	3.1	1.7	2.2	2.5	0.9	1.4	3.0	2.2	2.3	2.1
India	8.4	8.6	6.7	4.9	7.4	7.9	7.1	6.6	7.2	7.0	7.2
China	10.5	9.5	7.8	7.7	7.3	6.9	6.7	6.9	6.5	6.1	6.0
Brazil	7.5	2.7	0.9	2.3	0.1	-3.5	-3.5	1.4	1.9	2.2	2.4
Mexico	5.2	4.0	3.9	1.4	2.3	2.7	2.9	2.1	2.0	1.9	1.6
Australia	2.8	2.6	3.6	2.4	2.6	2.5	2.4	2.4	3.0	2.8	2.9
Russia	4.0	4.3	3.4	1.3	0.6	-2.8	-0.2	2.0	2.2	2.0	1.9
World	4.2	3.0	2.6	2.9	3.0	2.8	2.6	3.3	3.1	2.8	2.7

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