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ECONOMIC TALKING POINTS

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Dangerous Times: What's Next For The US Economy?

Slightly faster economic growth expected in 2020. A look at three scenarios of how the presidential election may impact the economy in 2021 and 2022.

- **No recession expected in 2020 despite heightened geopolitical risks.**
- **Consumer spending to remain healthy.**
- **Rebound seen in business capital expenditures this year.**
- **Inflation to inch higher but stay well within the Fed's comfort zone.**
- **No change in monetary policy this year until 2021.**
- **Dollar to firm slightly in 2020, but will come under pressure next two years.**
- **Three scenarios on how the November election could impact GDP in 2021 and 2022.**
- **Buckle-up: Exogenous shocks to become more frequent…and more consequential!**

Our farewell message for 2019 is "good riddance." It was a year full of twists and turns on global trade, escalating tariffs, disruptions to supply chains, endless speculation over Brexit, uncertainty on the passage of USMCA, and nonstop criticism by President Trump of Fed monetary policy.

All these factors had cast a heavy cloud over the US and international economy. Businesses shut down capital spending and factories found new orders in free fall. Were it not for the resilience of the American consumer, the US economy might well have toppled into recession.

As grim as the last 12 months were for the real economy, it was a banner year for financial markets. Investors in equities saw returns that were more than 7 times nominal GDP growth (based on S&P 500). Bond investors also benefited thanks to low inflation and

the insatiable hunger for debt securities that were risk-free and provided a positive yield. With $17 trillion of foreign sovereign debt at negative rates, US fixed incomes looked exceptionally attractive. The result: Investors devoured US equities and bonds, which produced their biggest combined return in more than two decades.

So what can we expect in 2020 — and beyond?

The New Year certainly did not waste time shaking up the world with a geopolitical blow-up in the Middle East. The assassination of a top Iranian general and well-known terrorist leader by the US raised the specter of a hot war between the US and Iran. Not surprisingly, investors hurried back into safe assets (bonds, dollar and gold) and bid up the price of oil on fears that Iran may take action to block the Strait of Hormuz or order proxies to launch direct attacks against the US and its allies.

There is no doubt Teheran will retaliate in some form. But its leaders also know it would not be in their country's interest to score a devastating blow against the US, since that would only invite a more massive response by the White House. Iran's economy is already in shambles and cannot afford a prolonged conflict. Nor will it want to place the country's nuclear facilities in the cross hairs of US drones and bombers. So our assessment is that after a few tense weeks, the geopolitical temperature in the region will dial back from its momentary "white hot" state — to its usual restless boil. In short, we do not see this conflict escalating into a cataclysmic or protracted war that kicks up oil prices to triple digits and brings a global recession. (**The only major caveat to this is if Iran accelerates uranium enrichment in a firm commitment to develop one or more nuclear bombs. Such a step would prompt the US or Israel to carry out a pre-emptive strike.)**

In spite of these unsettling events, there are numerous reasons to be upbeat about the economy this year. To begin with, we are entering 2020 with more clarity on other key issues. Trade tensions with China have subsided…at least for now. Both Washington and Beijing saw a "phase one" deal as mutually beneficial. As the presidential campaign heats up, Trump can point to the interim trade accord as a demonstration of his successful negotiating skills. Xi Jinping, in turn, gets a breather so he could focus on his own set of vexing issues, namely China's weakened economy, the protests in Hong Kong and the harsh international criticism of its treatment and mass detention of Uighurs Muslims in Xinjiang.

But let no one be fooled about this "phase one" agreement. It's essentially a ceasefire and not some historic achievement that will end China's theft of intellectual property. Nor does it dramatically remove barriers for foreign firms who seek entry into its domestic market. While both countries have agreed to roll back some tariffs, their rivalry on trade and technology remains as intense as ever.

The state of the consumer in 2020

We assessed the outlook for consumer spending through two lenses. (1) What is the ***willingness*** of households to spend? (2) Do they have the ***ability*** to keep spending?

Let's tackle the first. Is there a willingness to spend?

Americans have been shopping nonstop for more than a decade. One could rightly wonder whether demand has been largely satiated by now? After all, how many more cars, flat screen TVs, iPhones, laptops and washing machines will be purchased when the growth in household formation has been averaging barely 1% a year over the past decade?

Our assessment is that personal consumption will grow just fractionally below last year's pace (2.8% increase in 2020 compared with an estimated 2.9% in 2019). So long as job and income security remains firm, Americans will continue to shop. And while consumer confidence levels have wobbled a bit lately, surveys still show that shoppers are, by and large, still upbeat about the economic outlook.

They will also benefit from the relatively low level of inflation. Headline CPI will remain in the range of 2.2% to 2.6% this year. The prospect that inflation can hover at such low levels so late in the business cycle is a testament to how technology, globalization and eCommerce have fundamentally altered the dynamics of pricing goods and even some services. Online shopping is now so easy, so frictionless and hassle free, it has kindled waves of "impulse buying." At the same time, retailers are offering discounts and sales far more frequently than in the past so they could (at least) hold on to market share and retain customer loyalty.

That leads us to the next critical question. After a decade of spending and borrowing, do Americans still have the ability to spend?

Here, again, there is good news. Wages should continue to climb faster than inflation, which helps boost purchasing power. By definition, rising purchasing power allows Americans to spend more as well as save more simultaneously. Tight labor markets and the competition to hire qualified workers and retain current employees will help lift annual average hourly pay into the 3.2% - 3.7% range in 2020, a pace still above the projected rise in consumer prices.

Higher real income and low interest rates should keep household balance sheets in good shape. Less than 10 cents out of each after-tax dollar of income went to servicing household debt late last year, the lowest proportion seen since the government began tracking such data in 1980. And while there has been a slight up tick in credit card and consumer bank loan delinquencies, it's a modest bounce off historic lows. Recent data from the Federal Reserve showed that household wealth surged to $113.8 trillion in 3Q 2019 as the value of personal assets (stocks, bonds and real estate) outpaced the increase in household debt.

As a result, consumers will continue to play their active role and keep the economy out of trouble in 2020.

Business investments

One big change in 2020 will come from the recovery in business capital spending. This sector made virtually no contribution to economic growth in 2019 for understandable reasons. Such costly projects can take years of planning to approve. Corporate leaders must first assume some level of future economic activity to compute returns on investments in new plant and equipments.

But 2019 was a year rife with uncertainties, due in part to the ominous implications of an inverted yield curve and what many executives viewed as incoherent policies from the White House on trade and tariffs. Fear of recession was quite palpable throughout the year. Purchasing managers across the country wondered whether the widening trade war would harm their relationship with foreign suppliers and ultimately their own bottom line.
With the economic outlook so murky, nonresidential fixed investment simply came to a stand still.

Fortunately, a somewhat brighter picture emerges for 2020. While the disruptions to trade will not completely disappear, we doubt Trump will announce any major new actions

against America's trading partners since that would risk jeopardizing the expansion in a US presidential election year.

Recession worries have also greatly receded now that the yield curve turned positive again. We advised clients last year to ignore the inversion of the yield curve as a predictor of the next recession because its shape was determined this time chiefly by central bank intervention and not natural market forces.

Lastly, companies know well that when operating in a fierce global competitive environment, they cannot indefinitely postpone critical investments that improve operating efficiencies and drives productivity. Given the scarcity of qualified workers and rising wages, firms will need to rely more on capital than labor to boost output in the future. We therefore expect nonresidential fixed outlays to increase 3.2% in 2020, after showing virtually no growth in 2019. However, most that pick-up will be in the second half of the year as Boeing resumes production of the 737 MAX.

Housing

Once sector that underperformed much of 2019 was housing. Only in the last quarter did we see residential real estate spring back to life. Single-family housing starts in November surged to its second highest in a decade. Permits for new construction, an important leading indicator of future starts, jumped up to its highest level in more than 10 years. The rebound in permits reflects confidence that housing demand will be stronger this year. That view was evidenced in the December survey by the National Association of Homebuilders, which showed industry leaders were the most optimistic they've been since June 1999.

Behind this sunny view is the fact that homebuyers face a critical shortage in the supply of homes for sale. The inventory of existing homes on the market in November was nearly 6% below the year ago level. There were also 3.3% fewer new single-family homes available.

With job creation going strong, household incomes rising and mortgage rates still attractive, the underlying demand for homes will strengthen in 2020. Our forecast calls for total housing starts to rise to 1.29 million units this year, compared with an estimated 1.265 in 2019. Both starts and sales, however, will slip in 2021 and 2022 as higher short and long-term rates begin to chip away at the affordability of buying a home.

Government outlays

At the time this report was written, Congress did not finish work on all twelve appropriations for the FY 2020 budget. But the Bipartisan Budget Act of 2019 stipulates that budget authority for FY 2020 and 2021 will be about $50 billion above that of FY 2019. It also suspended the debt ceiling thru July of 2021.

We do expect to see the passage of a $1.4 trillion budget that would boost funding for most government agencies. The President has already signed a massive $738 billion defense authorization, an increase of $21 billion from FY 2019. Overall, we see total federal spending adding about 0.20% to economic growth in 2020.

Net Exports

Now that the trade dispute with China has cooled, the stage has been set for a recovery in global trade flows and industrial output in 2020. Both China's official PMI survey and the private Markit/Caixin results showed manufacturing activity expanded in December. There was also an improvement in business sentiment, retail sales and exports. If this trend continues, it would suggest that China has regained its footing and that should be a boon to other emerging countries that export to the world's second largest economy.

While the passage of the USMCA deal has been held up as the Senate deals with the impeachment trial, we expected the trade pact will get rapid approval once it's up for a vote in Q1. The accord will formalize a new, updated trading relationship among the three participants. Its importance to the US cannot be overstated. More than one-third of US global exports go to Canada and Mexico.

The UK's December election also reduces some uncertainty over Brexit. We expect the country will leave the EU by the end of this month. Though the shadow of Brexit still looms over Europe, we assume PM Boris Johnson will ultimately be willing to negotiate a new economic relationship with the EU, even if talks go beyond the self-imposed year-end 2020 deadline. Given all the trials and tribulations the UK went through the past three years, Johnson will prefer to avoid a no deal divorce from the EU if at all possible.

Conditions in the international economy are therefore improving. With both China and the US showing signs of economic resilience, it should provide more support for Europe, Japan and the emerging economies. As the global economy improves, we expect to see a bigger up swing in US exports than of imports this year, which means that net exports will contribute to US GDP growth in 2020.

Monetary policy

Other than stabilizing the overnight repo market with additional purchases short-term treasury bills, we see no economic justification for the Fed to take action this year on interest rates. Our forecast has the Fed's main inflation gauge (core PCE) rising to 1.8% by midyear and 2.2% in 2021. These are well within the comfort zone of the Fed. At the same time, the unemployment rate will hover between 3.3% to 3.7% in 2020 and 2021.

We expect the fed funds rate (midpoint) to remain at 1.63% thru at least the first three quarters of the year. What happens beyond that period will depend on how the economy and financial markets perform after the election. Our assessment is that the Fed's next move will be to raise short-term rates in Q1 2021 as expectations of higher inflation begin to build.

Market interest rates

More significant for the economy will be what happens to market rates. The yield curve will gradually steepen throughout 2020 with the 10-yr Treasury rate climbing to 2.80% by year-end and 3.50% at the close of 2021. Several factors are behind this upward trend:

- Faster global economic growth will push up commodity prices and unsettle the bond market.
- US wages are seen accelerating as well, adding even more inflation pressure in the out years.

• The US Treasury will unload a cascade of new debt securities to finance annual trillion dollar budget deficits. But we believe such issuances will come at a time when global investors increasingly seek out lucrative opportunities in other developed and emerging markets as the world economy recovers. The competition for global savings will thus drive market rates higher.
• Widespread projections that the dollar's value will enter a weakening phase in the next three years also removes some luster from US fixed incomes.

US dollar

The inflation-adjusted dollar has appreciated about 10% since the start of 2018 for fairly obvious reasons. The US economy grew faster than Europe and Japan, and offered rare positive returns on sovereign debt. Investors also sought out US financial assets as a safe haven given the heightened tensions with China, the gridlock over Brexit and growing risks in the Middle East. We expect the dollar's value to creep higher in the first half of this year — but then begin to depreciate the second half. That decline could last through 2022 due to cyclical and technical factors.

1. As foreign economies recover, US and foreign investors will seek better diversification and rotate out of US financial assets to take advantage of lower valuations elsewhere.

2. Many foreign leaders and investors were furious at the way the Trump administration weaponized tariffs and the dollar solely to carry out the unilateral interests of the US, with little regard to how those policies affect allies and other key trading partners. Such tactics have led several countries and international organizations to develop an alternate global payment system that would diminish the dollar's role as a world reserve currency. While any new framework to replace the dollar will take time, the greenback's dominance in the world economy has likely peaked.

3. We believe the 18-month trade war with China has partially backfired on the US. One major lesson Beijing learned was the need to better diversify its source of imports away from the US, especially on essentials like agriculture and energy. China moved quickly last year to lock in major purchases of commodities from Latin America, Africa and the Middle East. This is a long term shift and it will come at the expense of US farmers and other American exporters.

Taken together, the dollar will likely show a 0.17% gain this year, but then commence a gradual two-year slide in 2021 and 2022 for a combined loss of 2.5%.

Summary GDP forecast – 2020

The US economy is expected to expand 2.4% in 2020, barely above the estimated 2.3% pace of 2019. The main catalysts for growth will come from consumer spending, a recovery in business capital expenditures, pick-up in government outlays and a smaller deficit in net exports.

Summary GDP forecast – 2021 & 2022

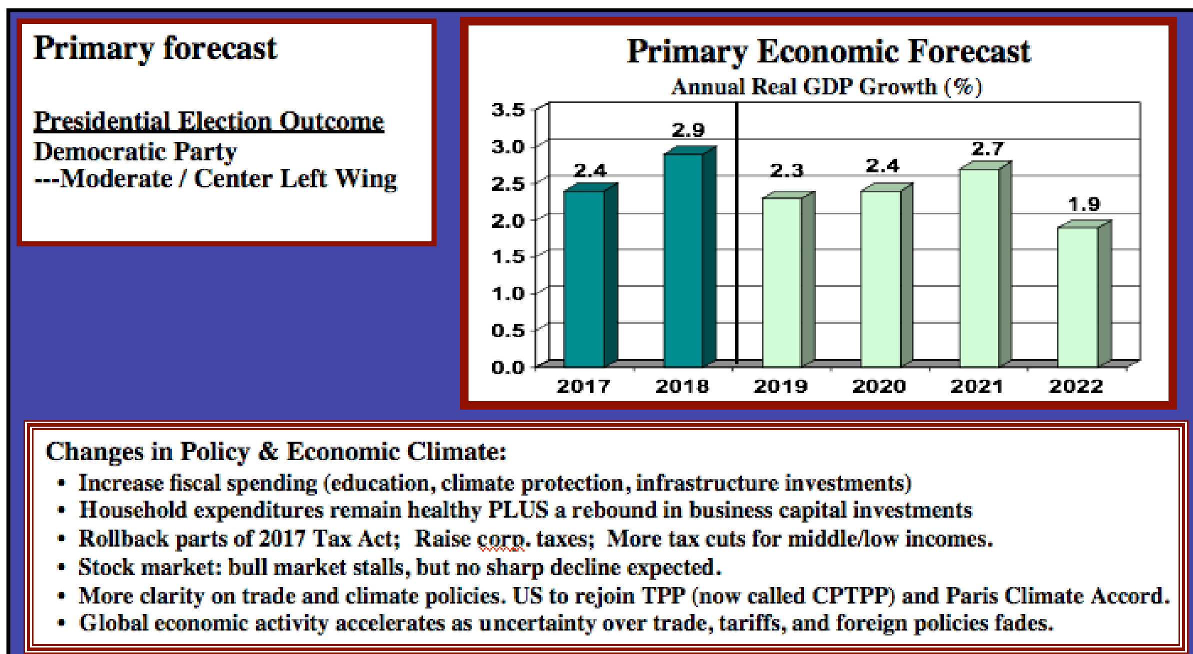
When it comes to forecasting business activity in 2021 and 2022 the calculus becomes more problematic. The diversity of policy recommendations among the main presidential candidates are so great that issuing a single forecast for those years would be of little value at this time. Instead, we chose to compute three different growth projections based on three different election outcomes, with one serving as our dominant scenario.

To help derive at three scenarios and assign one as most likely to materialize, we aggregated the results of four well respected, non-partisan polling organizations: Quinnipiac University, Pew Research Center, 538.com, and the Cook Political Report. We also assumed that whoever wins the presidency has the coattails to also bring in a like-minded Congress.

One additional adjustment was made to the macroeconomic model. Since the economy is now well into its record 11th year of growth, there is no US history we can look to for how an aging economic expansion responds to major shifts in policies. That challenge becomes even more daunting when trying to assess its performance in the 12th or 13th year of uninterrupted growth. As a result, we dialed down the sensitivity of how a long running expansion reacts to policy stimulus — and slightly dialed up its sensitivity to negative shocks. The reason? Depending on where an economy stands in the business cycle, its response to an identical event can differ. (Consider this analogy: Imagine a marathon runner at the start of a 26-mile race. That person has the energy and motivation to easily withstand strong headwinds, jostling, and even trip-ups in the beginning. But by the time this runner approaches that final grueling mile or two, the ability to recover from those identical hazards is dramatically reduced.)

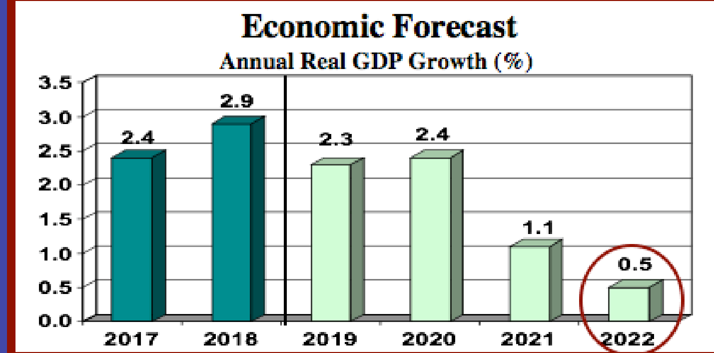
Below are the three projections, along with their aligned economic, political and foreign policies. The first scenario represents our primary forecast for 2021 and 2022, followed by two other outcomes from the November elections.

(1) Democrat - Moderate/Center Left (e.g., Biden, Klobuchar, Buttigieg,)
(2) Republican – Re-election of Donald Trump
(3) Democrat - Far left (e.g., Warren, Sanders)



Scenario 2

Presidential Election Outcome
Victory - GOP
---Donald Trump re-elected

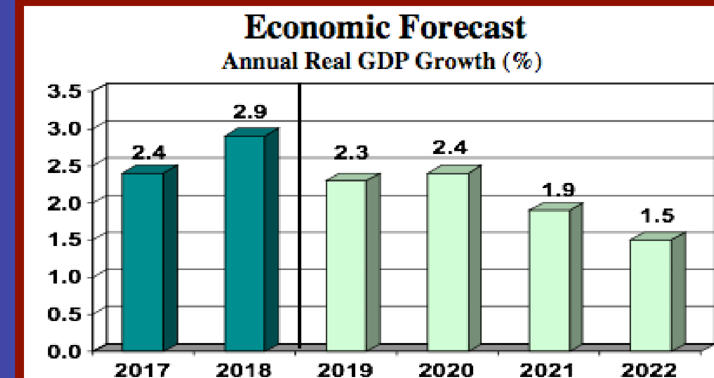


Changes in Policy & Economic Climate:

- Resumes tough stance on trade with China during second presidential term.
- Imposes higher tariffs on goods from Europe and other countries. More disruptions to supply chain networks.
- Trump unlikely to re-nominate Jerome Powell as Fed chair in 2022. Change unnerves financial markets.
- Geopolitical tensions worsen with Iran, North Korea, Venezuela and in the South China Sea.
- Faced with another four years of uncertain policymaking by the WH, businesses pull back on CAP EX.
- More deregulation likely.
- Slump in global economy continues. Recession threat looms 2H 2021 or in 2022.

Scenario 3

Presidential Election Outcome
Democratic Party
-- Liberal / Left Wing



Changes in Policy & Economic Climate:

- Favor policies seen less friendly to business.
- Sharp increase in both regulations and corporate taxes; may cool business capital spending and hiring.
- Steep tax cuts on middle/low incomes. Sharply higher rates "high income" households.
- Bear stock market likely as outlook for corporate earnings sour.
- Government outlays surge for health care, education, climate protection, infrastructure investments.
- Greater support for multilateral institutions and organized labor.

What are the greatest risks to this expansion?

If there is one certainty about the outlook it is that exogenous shocks will become more frequent…and more consequential! Below are risks that pose the most serious threats to the economy in the next 12- 36 months.

1. US sleepwalks into a national debt crisis. Given the long horizon of trillion dollar budget deficits, US and foreign investors scale back net new purchases of Treasury debt. As a result, market rates on notes and bonds surge and effectively choke off economic activity.

2. Cyber warfare: Russia, China, Iran and North Korea, either individually or jointly, launch a full-scale cyber attack against the US and disrupt economic activity.

3. In response to the killing of Iran General Qassem Soleimani, Teheran ramps up uranium enrichment in a commitment to develop one or more nuclear bombs. Such preparation would prompt the US or Israel to carry out a pre-emptive strike.

4. Tensions flare up in the South China Sea between the US and China. Any military confrontation could shut down one of the world's most important shipping routes and disrupt the flow of more than $5 trillion worth of goods.

5. India and Pakistan edge closer to another war as tensions soar over Kashmir and for India's maltreatment of Muslims in its country. Both nations possess more than 100 nuclear bombs.

US dollar to strengthen modestly in 2020 but then weaken next two years

(per U.S. dollar, year-end level)

US Dollar strengthens **US Dollar weakens**

	2017	2018	2019	2020	2021	2022
Euro (in US dollars)	1.20	1.15	1.12	1.14	1.18	1.20
Japanese yen	113	111	109	111	114	112
UK pound (in US dollars)	1.35	1.27	1.32	1.37	1.40	1.42
Canadian dollar	1.25	1.36	1.30	1.31	1.28	1.28
Chinese yuan	6.51	6.88	6.96	7.02	7.09	7.12
Brazil's real	3.31	3.87	4.02	4.20	4.30	4.28
Mexican pesos	19.79	19.68	18.93	20.10	19.85	19.80

United States

	I 2019	II 2019	III 2019	IV 2019	I 2020	II 2020	III 2020	IV 2020	I 2021	II 2021	III 2021	IV 2021	I 2022	II 2022	III 2022	IV 2022
Real Gross Domestic Product (GDP):																
%	3.1	2.0	2.1	2.2	1.9	2.8	2.5	2.3	2.4	3.3	2.4	2.5	1.5	2.2	2.0	2.1
Personal Consumption Expenditures:																
PCE %	1.1	4.6	3.2	2.8	2.2	4.3	3.0	2.5	1.9	4.1	3.0	2.7	1.6	2.4	2.2	2.0
Inflation, end of period, year-over-year:																
CPI %	1.9	1.6	1.7	2.1	2.2	2.4	2.5	2.6	2.6	2.5	2.6	2.4	2.4	2.5	2.3	2.2
Unemployment Rate (end of period):																
%	3.8	3.7	3.5	3.5	3.5	3.4	3.3	3.3	3.5	3.5	3.6	3.7	3.7	3.9	4.0	4.2
Non-farm Payrolls, monthly avg. thousand:																
	174	152	188	206	180	165	155	150	140	155	155	140	135	120	110	115
Treasury 10-yr Note Yield % (end of period):																
	2.42	2.00	1.65	1.88	2.00	2.15	2.50	2.80	3.10	3.20	3.45	3.50	3.75	3.75	3.85	4.10
Federal funds rate % (end of period):																
	2.38	2.38	1.88	1.63	1.63	1.63	1.63	1.63	1.88	2.13	2.38	2.38	2.38	2.38	2.38	2.13

Oil (Brent spot) & Gasoline (Average retail unleaded, $)

	End 2008	End 2009	End 2010	End 2011	End 2012	End 2013	End 2014	End 2015	End 2016	End 2017	End 2018	End 2019	End 2020	End 2021	End 2022
Crude oil per barrel	46	78	95	107	111	111	58	38	49	67	54	67	64	65	59
Gasoline	1.61	2.57	3.00	3.27	3.30	3.32	2.26	2.00	2.31	2.47	2.26	2.58	2.63	2.65	2.50

GDP Growth - Global Economy

Country	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
US	2.6	1.6	2.2	1.8	2.5	2.9	1.6	2.4	2.9	2.3	2.4	2.7	1.9
Eurozone	1.7	1.4	-0.9	-0.3	1.2	1.6	1.7	2.5	1.9	0.9	1.4	1.6	1.3
United Kingdom	1.7	0.7	0.3	1.8	2.9	2.2	1.9	1.8	1.4	1.0	1.5	1.7	1.3
Japan	4.6	-0.4	1.6	1.5	-0.1	1.1	1.0	1.9	0.8	0.9	0.9	1.5	1.0
Canada	3.1	3.1	1.7	2.2	2.5	0.9	1.4	3.0	1.9	1.5	1.8	2.3	1.5
India	8.4	8.6	6.7	4.9	7.4	8.0	8.1	7.2	6.8	6.5	6.6	7.3	0.0
China	10.5	9.5	7.8	7.7	7.3	6.9	6.7	6.8	6.6	5.9	5.8	5.8	5.7
Brazil	7.5	2.7	0.9	2.3	0.1	-3.5	-3.5	1.1	1.1	1.0	1.5	1.9	1.7
Mexico	5.2	4.0	3.9	1.4	2.3	2.7	2.9	2.1	2.0	0.2	1.4	1.7	1.2
Australia	2.8	2.6	3.6	2.4	2.6	2.5	2.4	2.4	2.7	1.8	2.2	2.6	2.3
Russia	4.0	4.3	3.4	1.3	0.6	-2.8	-0.2	1.6	2.5	1.2	1.5	1.7	0.9
World	4.2	3.1	2.5	2.6	2.8	2.8	2.6	3.4	3.2	2.6	3.0	3.2	3.0

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