The Washington Post

As stocks tumble, the U.S. wonders: Is this economy as good as it gets?

By Heather Long October 12, 2018

This year's economic performance has consistently exceeded expectations, as the stock market set records, growth accelerated and unemployment moved lower and lower. But the steep sell-off on Wall Street this week — with the Dow Jones industrial average dropping nearly 1,400 points over the past two days — underscored a growing concern among investors and economists that the economy may have nowhere to go but down.

Almost no one is forecasting an immediate recession, but several factors appear likely to diminish the economy's momentum.

President Trump's trade war with China is starting to take a bite out of growth, energy prices are rising, the global economy is slowing and U.S. interest rates are going up. These forces mean Americans will be paying more to buy staples and facing higher borrowing costs to purchase a home or car or invest in a business. And foreign countries will likely buy fewer U.S. exports as demand slows and tariffs kick in.

Just as the economy hits these bumps, the boost to growth from the giant tax cuts Trump enacted last December and additional government spending approved this year is expected to fade.

The result is that numerous economic forecasters expect slower growth next year and beyond and beyond, and some are even warning of the possibility of a recession in 2020.

The International Monetary Fund this week downgraded its forecast of U.S. growth, which it now predicts will be 2.5 percent next year. The IMF cited Trump's tariffs and rising interest rates. It expects 2.9 percent U.S. growth this year.

A similar story is playing out in the stock market, with Wall Street reassessing just how strong the future looks for American businesses. The Dow has lost 5 percent already this month, the worst October performance since the financial crisis of 2008. Experts say not to panic because the market was overdue to let off some froth, but it's a noticeable shift in sentiment after months of investors shrugging off any political or trade turmoil.

"The earnings outlook is not as positive as it was," said Chris Rupkey, chief financial economist at MUFG Union Bank. "The biggest boost for corporate earnings this year has been the biggest corporate tax cut in history. That supports current market valuations for this year, [but] what about 2019?"

Trump and his advisers dismiss the warnings, insisting the economy remains robust and the president can deliver growth of 3 percent or better for years to come. They say lower taxes and fewer regulations will continue to spur businesses to hire more workers, buy more equipment and build more factories and offices. And extra business investment should translate into higher productivity and growth.

The rough month for stocks began when the bond market got spooked by rising interest rates. Additionally, companies from multiple sectors, including Ford and Procter & Gamble, warn that tariffs, higher trucking prices, rising wages and other factors are driving their costs up and eating into profits.

In this new environment, economists say, expectations of how the economy may perform will need to be reconsidered. The stock market might not rise as quickly, but wages for the middle class might finally start to grow at a healthier rate. The tighter labor market also is a boost for people who have struggled to find work, including Americans with less education or with a felony conviction.

And while borrowers lament higher interest rates, savers, especially seniors, are celebrating that they can finally earn some interest from their savings accounts.

There is also no sign yet that the bull market, which began in March 2009 and is now the longest in modern history, is about to end. Despite the stock market dip, it's not even in an official "correction," commonly defined as a 10 percent decline.

In many ways, the markets and economy are in unchartered territory. No president in modern history has injected as much stimulus into the economy nine years into an expansion when unemployment was already so low. Between the tax cuts and additional spending on the military and domestic programs, Trump has pumped about $2 trillion into the economy.

There also hasn't been a trade war on this scale since the 1930s, nor has the Federal Reserve ever attempted to lift rates from near-zero levels before.

Economists say the U.S. faces several potential scenarios going forward. The strong economy could get too hot, triggering unexpected bouts of inflation. The Fed would likely respond by rapidly hiking interest rates, likely causing a recession. Or the economy could rise and then gradually slow down, a so-called "soft landing." Or, as the White House expects, the economy would stay at this new high.

Trump and his advisers say business spending is going to drive sustained higher growth.

"I really have a hard time imaging that [growth] next year won't be north of 3 percent, given how much capital spending we've already had this year," Kevin Hassett, the head of Trump's Council of Economic Advisers, said at an event this week. "The capital spending boom is happening almost exactly according to our models."

The Fed, led by Jerome H. Powell, a Trump appointee, is predicting a soft landing. Powell and his team believe they can achieve a “Goldilocks scenario” by gradually raising interest rates in the coming months to ensure the economy doesn’t suffer excessive inflation, but not pushing rates up so fast as to cause business leaders and consumers to close their wallets and panic in the stock market. The Fed currently predicts growth of 3.1 percent this year, slowing to 2.5 percent next and 2 percent in 2020.

Earlier this week, Trump called the Fed “crazy” and criticized Powell numerous times for “going wild” by raising interest rates too fast, even though they remain below 3 percent, a low level by historical standards.

“We’re in the eighth inning of this expansion, and it’s possible there will be a recession in 2020,” said **Bernard Baumohl, chief global economist at the Economic Outlook Group.** “The economy will be in a state of transition from robust growth to considerably slower growth in the second half of 2019.”

For now, all eyes are on business and consumer spending, the key drivers of the U.S. economy. American families continue to spend at a healthy rate, and consumer confidence is near 20-year highs. But the housing market has noticeably cooled in recent months — mortgage rates topped 5 percent this week for the first time since 2011 — and auto sales appear to have peaked, potential warning signs that the middle class can’t spend much more.

“It wouldn’t take much for there to be a significant decline in consumer sentiment that seemingly comes out of nowhere,” said Peter Atwater, president of Financial Insyghts.

Business investment has seen a noticeable pickup from about 5 percent at the end of last year to 11.5 percent in the first quarter of this year and 8.7 percent in the second quarter, according to government data. The White House touts this often as evidence that businesses big and small want to invest for the future.

But Rajeev Dewan, head of the economic forecasting center at Georgia State University, says the levels of business investment are still far short of what they were in the late 1990s, the last time the United States had a productivity boom. “I always look at technology investment. It would need to be 20 percent plus to sustain this year’s level of growth,” Dewan said.

What path the economy is on will reveal itself soon — likely early next year.

Trump is fond of touting that second quarter growth this year was 4.2 percent, and many experts think he will be pleased again on Oct. 26 when third quarter growth comes out just days before the midterm election.

But next year could be very different.

“It probably won’t be long before there is evidence of slowing economic data,” said Paul Ashworth, chief U.S. economist at Capital Economics.

###