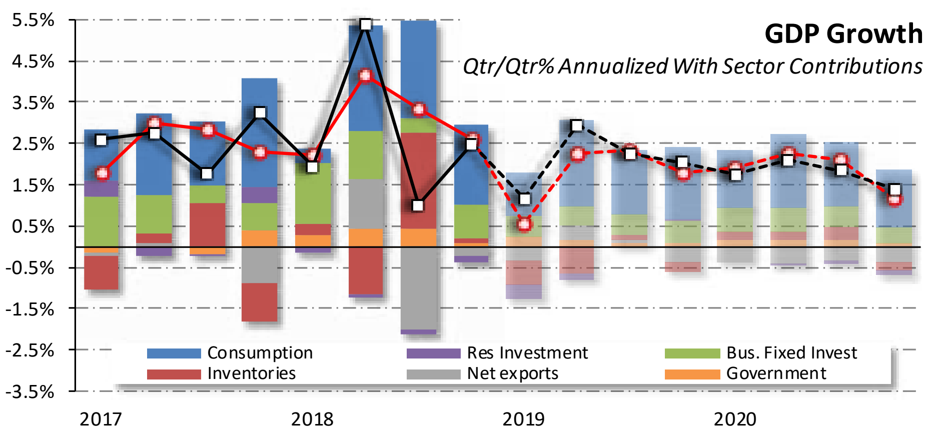
Forecast Update: Synchronized Global Slowdown

Three major themes dominate our updated forecast. The first is the global slowdown. The second is recent weakness in the US. The third is the Fed and its ability to conduct policy consistent with its goals.

GDP growth is tracking less than 1% in the first quarter. By the time it is reported in April, it will likely be stronger than it now looks; data released to date are still mostly from the time of the shutdown. Still, the shutdown lasted long enough to leave a mark. We expect GDP growth of just 0.5% in the first quarter, in part because inventories accumulated in December and January have to be worked off, and in part because the early February data suggest only a partial rebound. We have penciled in a bounce in the second quarter, but growth tails off from 2.5% to about 1.5% over the course of the forecast period, mostly because the Fed — despite its stated good intentions — will keep policy too tight through the end of the expansion.



Source: Bureau of Economic Analysis and FTN Financial

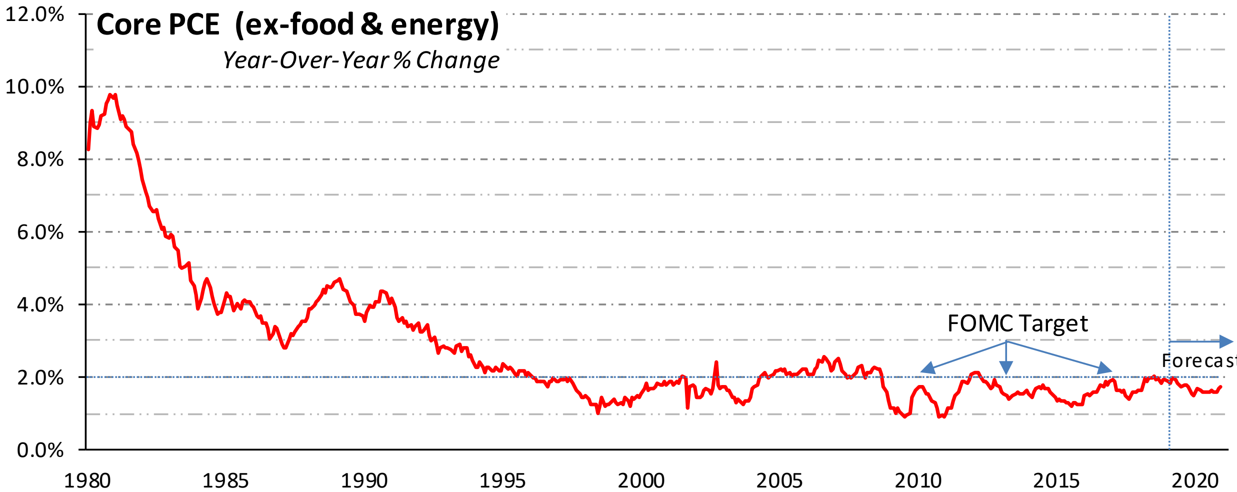
The core PCE started the year in a 1.75-2.0% range. We expect it will fall back to just above 1.5% by year end. A tight domestic job market and faster wage growth support faster inflation. But slowing global demand will free up considerable excess productive capacity this year and competition will encourage companies to offset wage increases with productivity growth.

CONTENTS

ECONOMICS

Chris Low, Chief Economist
212.418.7909
chris.low@ftnfinancial.com

Rebecca Kooshak, Economic Analyst
212.418.7966
rebecca.kooshak@ftnfinancial.com



Source: Bureau of Economic Analysis

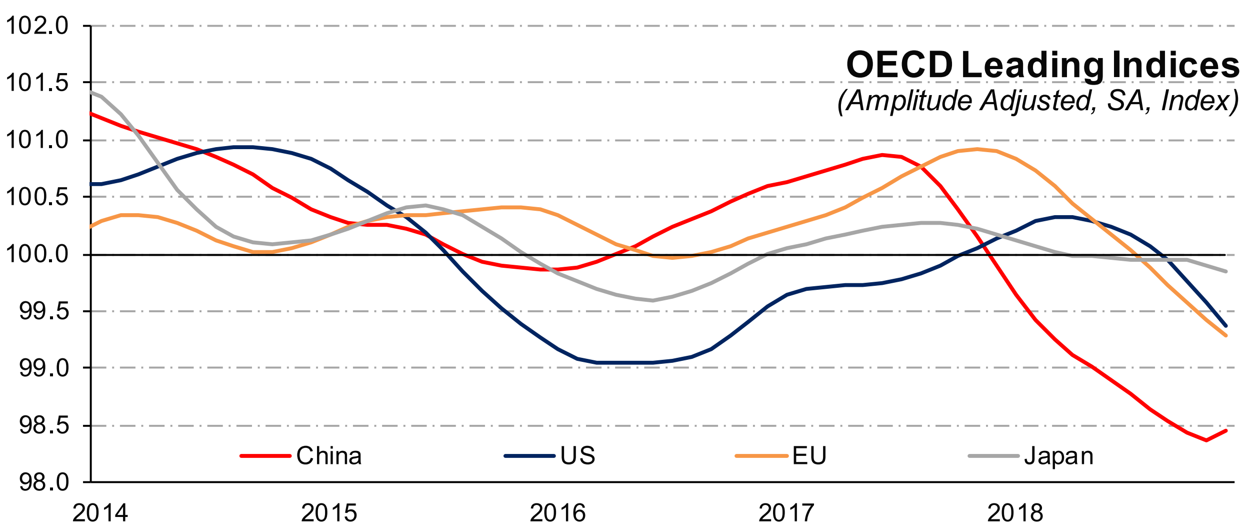
We expect the Fed to adopt a much friendlier tone this year — indeed, it has already — but it is unlikely to shift from a tight stance to a neutral one. That is, they say they are neutral, but the 2.5% policy rate is in fact tight, as evidenced by the partially inverted yield curve and low inflation breakeven rates.

The Fed has the highest policy rate among all advanced economies. Last year, only a handful of emerging market central banks hiked more than the Fed, and only because they were heading off currency collapse as capital flooded out of their markets into ours in response to the very generous risk-free return created by the Fed.

We expect the Fed will adopt inflation averaging after a review, already underway, is completed. Inflation averaging should prompt a rate cut in the third quarter. Unfortunately, The Fed's bias against inflation and failure to recognize international disinflationary influences are likely to prevent rates from dropping enough for inflation to exceed 2%.

Part I: The global slowdown

On Wednesday, the OECD revised its 2019 global growth forecast from 3.5% to 3.3%, with downward revisions in 18 of 20 OECD economies. In addition, the OECD notes deteriorating confidence and hiring plans suggest risks tilted to the downside. Indeed, the quarterly forecast warns, "vulnerabilities in China, Europe and financial markets could derail the global economy."



Source: OECD, Bloomberg

On Thursday, the ECB cut its 2019 growth forecast from 1.7% to 1.1% and its 2019 inflation forecast from 1.6% to 1.2%. The cuts may not have been big enough to justify restarting quantitative easing, but they were big enough to restart the ECB's long-term bank credit facility. As The Wall Street Journal pointed out on Friday, this won't do much to help the economy, though it will keep the banks solvent, preventing the economy from a much bigger lurch downward.

This week in China, policy makers announced a slew of new stimulus designed to prevent GDP growth from slowing from 6.4% to less than 6% this year. But, because China also wants to limit credit growth to the growth rate of GDP, meaning it will slow from 9.7% to 6.0%-6.5%, it's questionable whether the stimulus will be adequate to hit the growth target. Perpetual stimulus in China has reduced its effectiveness. When the year ends, China will undoubtedly report 6%, GDP growth, as promised. As in 2015, however, the actual growth rate will almost certainly be considerably less than 6%.

Emerging market economies face record corporate bond repayments after three years of steady, but elevated, financing needs in 2016-18. This year, $400bn in US dollar denominated emerging market corporate bonds mature, compared to $300bn last year, and $1.3 trillion mature in the three years from 2019 to 2021.

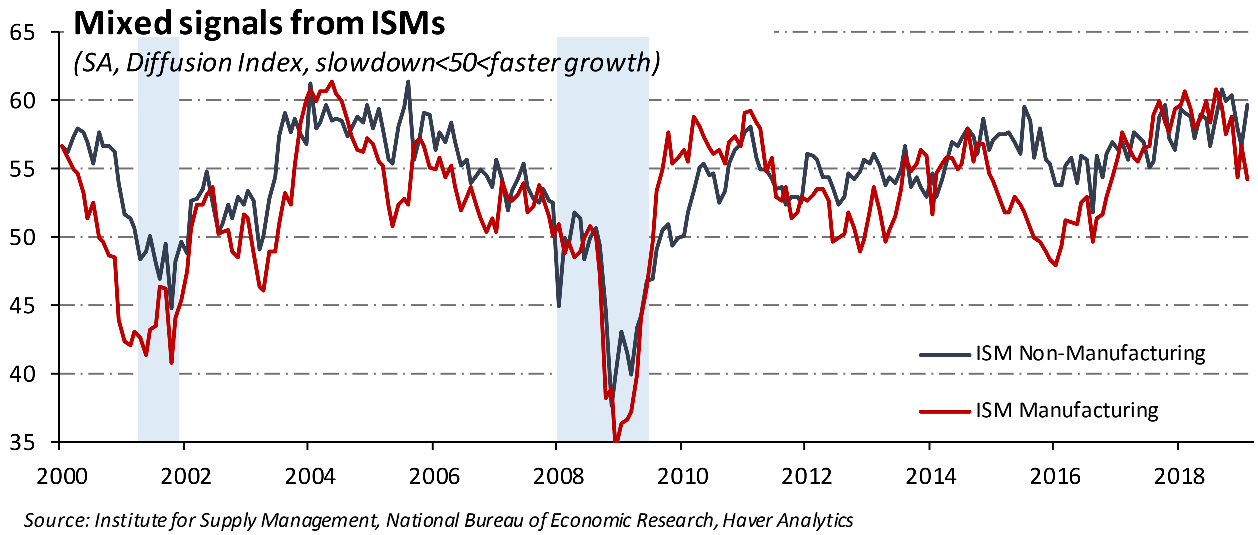
Slower global growth means lower global inflation. For the US, the global slowdown has three important considerations: the trade deficit will be wider as export demand shrinks; the global interest rate environment will be lower; inflation here will be lower thanks to cheaper imports and reduced export opportunities.

Part II: The US slowdown

Economic growth peaked in last year's second quarter, slowed modestly in the third, and downshifted again, hard, at the end of the year, with particular weakness in consumer spending and manufacturing. The record-long partial government shutdown from December 22 through January 25 (35 days) was almost certainly a factor, but it was not the only one. The Conference Board claims the Fed's decision to raise rates in December hurt consumer confidence more than the shutdown.

Consumers accounted for the slowdown in fourth-quarter GDP, with December's biggest-drop-in-a-decade retail sales as the standout data point for the quarter. Car sales weakened further in January and February, however, suggesting consumption could remain under pressure for a time. Consumer confidence fell in December and January, and only partially recovered in February.

Small business confidence cratered in January, also likely reflecting the shutdown. We know from the household employment survey self-employed workers were hard hit in January, a reflection of the myriad government contractors affected by the shutdown. Early February data point to a rebound in activity, though only a partial rebound. For example, both manufacturing and nonmanufacturing PMIs fell in December and January. The nonmanufacturing index rebounded in February, but the manufacturing index fell to a new two-year low.



As the chart shows, the nonmanufacturing ISM is prone to volatility. The ISM's are diffusion indices, indicating the percentage of respondents growing or shrinking from one month to the next, but not the magnitude of growth. When the index jumped in February, in part thanks to a decade high in the orders index, but hiring plans ticked down to a new three-year low, it suggests only a partial recovery of the orders lost in December and January.

It's noteworthy the still all-time high in the nonmanufacturing index was in the post-Katrina bounce in September 2005. Fourteen years ago, the index was lifted in part because thousands of companies reported much stronger orders after the storm. But it was not the start of a new, stronger period of growth. On the contrary, it marked the beginning of the slowdown culminating in the 2007-09 recession. There's no reason to think it cannot be different this time, of course, but the shutdown clearly hurt a lot of service providers. It would be wise to wait and see what happens in the March numbers, especially given the weakness in manufacturing.

As the chart demonstrates, both manufacturing and nonmanufacturing indices fall in recessions, but manufacturing alone tends to drop in the occasional hard slowdowns during expansions, including those in 2012 and 2015. With the index at 54.2, it is still a long way from the lows under 50 in those two periods. Nevertheless, a two-year low is noteworthy.

Part III: The Fed struggling to hit its targets

The best thing about the Fed's current communications regime is that we know exactly what they are trying to do and why. The downside is that it tells next to nothing about how successful policy will be, or how flexible the committee will be when its forecast misses the mark. As a result, there are years when it appears the Fed says one thing and does another. Last year was such a year, which is hard to shake while thinking about what the Fed will do in 2019.

> The Fed hiked rates four times last year. The first three went off without a hitch, but the fourth provoked considerable backlash from traders, the press, and the public. A rate hike was fully priced into markets on December 19, suggesting the reaction was not because the Fed hiked rates but because the Fed signaled two or three more hikes in 2019 when everyone was expecting a pause.

Poor December communications were not the only problem with the Fed last year, however. Remember, the FOMC not only expected inflation to exceed 2% last year and this year, they wanted inflation to exceed 2%. Instead, inflation peaked in July and fell to 1.8% at the end of last year. Which begs the question: if the Fed's policy is taken in stride, but inflation falls short of the Fed's target as a result of that policy, isn't that a policy failure too? By this standard, the December hike was a mistake, and the September hike was a mistake as well.

At the start of 2018, The FOMC communicated three things: 1) faster growth is ok as long as productivity accelerates. 2) The Fed has a 2% symmetrical inflation target. In order to achieve it, the Fed will conduct policy in a way that results in a couple of years of inflation above 2%. 3) In order to achieve this inflation goal, the FOMC expected to raise interest rates three — and maybe four — times.

Growth accelerated, as expected, but productivity kept pace and inflation — which picked up to 2% in the first half — fell back under 2% over the course of the second half. As a result, inflation not only failed to exceed 2%, it fell short of the Fed's 2% inflation target again.

At Powell's December 19 press conference, The New York Times' Binyamin Appelbaum asked Chairman Powell if the Fed's inflation target was symmetrical, implying the decision to raise rates that day certainly suggested otherwise. Powell had a hard time arguing otherwise, because, on the face of it, the Fed seemed to abandon its stated goals in favor of its pre-determined interest rate forecast.

A cynical read of last year's performance by the Fed would conclude Powell was dissembling when he said the Fed would tolerate faster growth, likely because he did not want to declare war on the President's tax cut just as it was initiated. As for the inflation target, a cynic might think the FOMC couldn't help treating 2% as a ceiling. The cynic would say, in theory, the FOMC likes the idea of inflation averaging 2%, but participants are so nervous any overshoot will get away from them, they cannot bring themselves to allow it in practice.

If we allow for the idea the Fed's forecast was wrong, however, it suggests a more charitable, and likely more accurate, interpretation. **Chairman Powell was not lying when he said the Fed has a symmetrical target. As he tells it, the Fed relied on a forecast that told them inflation would overshoot considerably unless they raised rates four times.** The Fed's forecast boils down to the idea that stable inflation comes from GDP growth equal to growth in the workforce plus growth in productivity. With no way to predict productivity, the Fed assumes it will fall back to the five-year trailing average.

Hence, the Fed worries about inflation when growth exceeds 2%, because believes in a growth speed limit determined by 1.5% productivity growth + 0.5% population growth. Hence, any growth above 2% is not sustainable. See Wednesday's speech by John Williams for a more detailed explanation of why g-star, the growth target, is 2%. The g-star concept is flawed because it ignores productivity, but it has been central to Fed thinking as long as we have followed the Fed.

Powell likely meant what he said about productivity last year, but he should have added because the Fed does not know where productivity comes from, it has to get strong and stay strong for years before the Fed will acknowledge any change.

All of this is relevant in 2019 because once again the Fed has stated a number of goals that should result in lower rates. We have sketched in a rate cut in the third quarter based on the hope they will adopt a policy consistent with their goals.

1. **The end of r-star targeting and shift to risk management.** Chairman Powell foreshadowed this shift in his August 2018 Jackson Hole speech. Once rates are close to neutral, the Fed will shift to risk-management based policy. In the simplest terms, this means they will hike if inflation gets too high, and ease if it is too low.
2. **The Fed is on the cusp of shifting to inflation averaging.** We look for this change to be adopted around midyear. The result will be a lower-for-longer approach to interest rates.
3. **Temporary disruptions aside, the economy was on a slowing track throughout most of last year.** It would be just like the Fed to get over-excited by a dead-cat bounce in Q2. But the underlying trend will reassert. Remember, a flat yield curve is not only an indicator of recession, it is a cause. The Fed has inverted the Treasury curve from the 1-year through the 5-year. The fed funds rate is too high relative to market rates, which will interfere with credit intermediation.

The Fed still has a symmetrical inflation target in 2019. But if the Fed adopts temporary inflation targeting, as they likely will toward the middle of this year, the target will be higher. As explained by New York Fed President John Williams in a recent speech, average-inflation targeting is when "a central bank purposefully aims to achieve an above-target inflation rate in 'good' times when the lower bound is not a constraint. Properly designed and implemented, such an overshoot can offset the inflation undershoot during 'bad' times so that the longer-run average inflation rate and inflation expectations are in line with the target."

What we don't know is how much higher than 2% the inflation target will be. And of course, the same things that prevented the Fed from achieving its goals last year will impede the Fed this year, too. That is, even when the Fed's goals are laudable, achieving those goals depends in large part on forecasting accuracy.

Bottom line: when monetary policy is too tight, interest rates fall

Last year, the Fed tightened too much. The shift from tightening to neutral is a step in the right direction, but the FOMC is nowhere near acknowledging a need to further shift to reversing some of last year's damage. In other words, the Fed thinks policy is neutral now, but it is not. The ECB is in the midst of a similar pivot. It has stopped its march toward tightening, but has not yet reinstituted easing. As for China and the PBOC, arguably the most important arbiters of global credit growth in the past decade, they have promised stimulus in 2019, but considerably less than last year's.

The net result is tighter global credit, slower global growth and lower global inflation. Because Fed economists insist the only acceptable way to think about US inflation is in terms of the US labor market and American inflation expectations — excluding the easily observable, lower-than-optimal inflation expectations in the bond market — inflation imported into the US is always a surprise. Hence, US inflation should surprise to the downside this year, which in turn will pull interest rates lower. A Fed rate cut in September will result in a further drop in yields.

In an ideal world, the 2019 Fed would follow the course of the 1996 Fed and cut rates several times, until the yield curve has a 50-60bp positive slope again. But, that is wishful thinking. Few remember what the FOMC did in 2006 to achieve its only successful post-war soft landing, let alone why they did it. For now, one rate cut will have to do. We expect it in September. In the meantime, we look for market interest rates to grind lower over the course of the year, so that the Treasury yield curve is just as flat at the end of the year as it was at the start despite the rate cut in Q3.

– Chris Low, Chief Economist

The Week Ahead

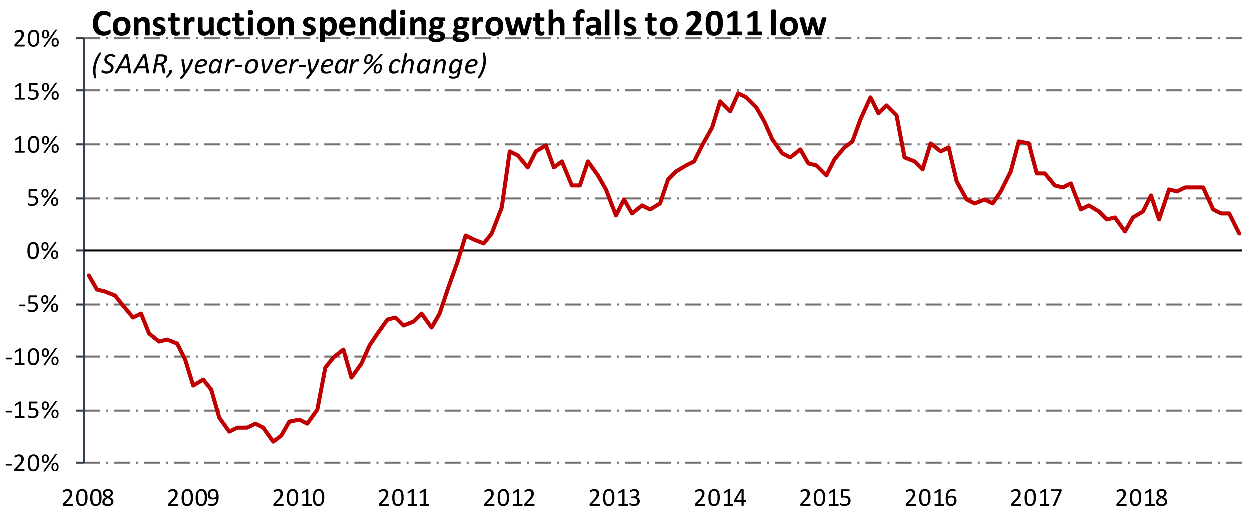
This Week's Numbers

		PRIOR	CONSENSUS HIGH	CONSENSUS LOW	CONSENSUS MEDIAN	FTN
Monday, March 11	Retail Sales Advance MoM - Jan	-1.2%	1.4%	-0.9%	0.1%	**-0.1%**
	Retail Sales Ex Auto MoM - Jan	-1.8%	1.5%	-0.6%	0.3%	**0.3%**
	Retail Sales Control Group - Jan	-1.7%	0.9%	-0.3%	0.6%	**0.3%**
	Retail Sales Ex Auto and Gas - Jan	-1.4%	1.4%	0.3%	0.6%	**0.4%**
	Business Inventories - Dec	-0.1%	0.6%	0.4%	0.6%	**0.6%**
Tuesday, March 12,	CPI MoM - Feb	0.0%	0.3%	0.2%	0.2%	**0.2%**
	CPI Ex Food and Energy MoM - Feb	0.2%	0.3%	0.2%	0.2%	**0.2%**
	CPI YoY - Feb	1.6%	1.6%	1.5%	1.6%	**1.6%**
	CPI Ex Food and Energy YoY - Feb	2.2%	2.2%	2.1%	2.2%	**2.1%**
Wednesday, March 13	PPI Final Demand MoM - Feb	-0.1%	0.3%	0.0%	0.2%	**0.2%**
	PPI Ex Food and Energy MoM - Feb	0.3%	0.3%	0.0%	0.2%	**0.2%**
	PPI Ex Food, Energy, Trade MoM - Feb	0.2%	0.3%	0.2%	0.2%	**0.2%**
	PPI Final Demand YoY - Feb	2.0%	2.0%	1.7%	1.9%	**1.8%**
	PPI Ex Food and Energy YoY - Feb	2.6%	2.7%	2.5%	2.6%	**2.3%**
	Durable Goods Orders - Jan P	--	3.5%	-4.7%	-0.7%	**-1.5%**
	Durables Ex Transportation - Jan P	--	1.0%	-1.4%	0.3%	**0.0%**
	Cap Goods Orders Nondef Ex Air - Jan P	--	0.5%	-0.8%	-0.1%	**-0.3%**
Thursday, March 14	Construction Spending MoM - Jan	-0.6%	1.0%	0.2%	0.6%	**0.5%**
	New Home Sales MoM - Jan	3.7%	3.4%	-7.4%	0.5%	**-1.0%**
	New Home Sales - Jan	621k	642k	575k	624k	**615k**
Friday, March 15	Industrial Production MoM	-0.6%	1.0%	0.1%	0.5%	**1.0%**
	Capacity Utilization	78.2%	78.8%	78.1%	78.6%	**78.8%**
	Manufacturing (SIC) Production	-0.9%	0.6%	0.1%	0.5%	**0.7%**
	U. of Mich. Sentiment - Mar P	93.8	98.0	94.0	95.5	**96.0**

Review

This week, construction spending growth slowed to an eight-year low, the OECD and ECB significantly cut eurozone GDP forecasts, and the US added just 20k jobs in February, taking the 12-month average to 209k.

- December construction spending of $1.29tn fell 0.6% m/m, missing the 0.1% consensus and dragging y/y growth to its slowest rate since June 2011. Private residential construction fell 1.3%, with private single-family residences, in particular, dropping to a -4.97% y/y rate. The Beige Book reported residential construction was steady or slightly higher across the US, perhaps referencing multi-family construction, which slowed to 3.1% growth.



Source: Census Bureau

- The OECD cut its global growth forecast from 3.5% to 3.3% y/y in 2019. The forecast for the EU was slashed from 1.8% to 1.0%, led by cuts to Italy and Germany. Turkey and Canada also had huge downward revisions, but US growth was revised only marginally lower, from 2.7% to 2.6%. EU weakness was attributed to slowing trade growth, both externally and internally. The external slowdown reflects declining orders from China and Asia, which in turn suggests the US-China trade slowdown may reflect something other than tariffs. After all, Europe and China cut tariffs on each other's goods this year as a gesture of defiance aimed at US President Trump and their trade is slowing anyway. Policy uncertainty and lower confidence also contributed to weakness, prompting the OECD to advise EU governments to coordinate "a fiscal and structural push" — i.e., fiscal stimulus.

- The ECB slashed its 2019 Eurozone growth forecast from 1.7% to 1.1%. The inflation forecast was also cut, from 1.6% to 1.2% y/y. Mario Draghi cited a particularly weak manufacturing sector reflecting slow external demand, which is lasting longer than previously anticipated. Draghi expects these factors to unwind and the expansion to continue at a slower pace. Underlying inflation, Draghi said, "continues to be muted," citing Eurostat's HICP inflation rate of 1.5%. (Interestingly, this week's EU PPI report showed a 3.0% yr/yr rise, higher than the 2.9% consensus, and energy was not a driving factor.) As expected, key interest rates were kept unchanged until the end of 2019 or longer, principal payments from its asset purchase program will continue to be reinvested, and a new series of quarterly targeted longer-term refinancing operations (TLTRO-III) will begin in September. Draghi, in opposition to the OECD, advised euro-area governments with high debt levels to rebuild fiscal buffers, i.e., raise taxes. If anyone is going to take crazy structural risks with the European economy, apparently, it should be the ECB, not governments. After the meeting, "people familiar with the matter" told Bloomberg News that policy committee members think the new growth forecast is unrealistically high.

- Nonfarm payrolls rose only 20k in February, but January payrolls rose 311k. Neither number is believable on its face, but the average 160k is reasonable enough. AHE rose 0.4% in February and 3.4% year-on-year, the unemployment rate fell from 4.0% to 3.8%, and prime-age participation increased, all indications of still-solid employment demand.

The Atlanta Fed raised its forecast this week from last Friday's 0.3% to 0.5%. The modest increase reflects stronger-than-expected government spending and government transfer payments revealed in the latest Treasury statement.

The NY Fed revised its Nowcast up from last week's 0.88% to 1.4%. New single-family houses sold, ISM-non-manufacturing, and the lower unemployment rate accounted for most of the change.

Next week, China's PBOC will release data on aggregate financing, foreign direct investment, and new yuan loans. (New yuan loans account for more than four-fifths of all loans.) On Tuesday, in the US, CPI is expected to remain unchanged at 1.6%. On Thursday, the Bank of Japan holds its monetary policy meeting and while rates are expected to remain unchanged, tweaks to target rates for JGBs account for most of the movement in the mostly static market for JGBs.

The next FOMC meeting is on March 20 and the next scheduled speech is from Lael Brainard on the 12th. Powell, however, will be on CBS' 60 Minutes over the weekend to explain the Fed's forthcoming adjustments to its policy.

Preview

Note: ★ = High Impact Event
All times Eastern Standard

Sunday, March 10

★ 7:00pm – US: Jay Powell interviewed on CBS' 60 Minutes.

Monday, March 11

- 2:00am – Japan: Machine Orders
- 3:00am – Germany:
  - Merchandise Trade
  - Industrial Production
- 8:30am – US: Retail Sales - Jan
- 10:00am – US: Business Inventories
- 11:30am – US: $48bn 3M and $39bn 6M Treasury Bill Auctions
- 1:00pm – US: $38bn 3Y Treasury Note Auction

★ 7:00pm – US: Jay Powell gives welcoming remarks at DC conference.

Tuesday, March 12

- 5:30am – UK:
  - Monthly GDP
  - Merchandise Trade
  - Industrial Production
- 6:00am – US: NFIB Small Business Optimism

★ 8:30am – US:
  - CPI
  - Real Average Hourly Earnings

★ 8:45am – US: Fed Governor Lael Brainard speaks in DC.
★ 1:00pm – US: $24bn 10Y Treasury Note Auction

- 7:50pm – Japan: PPI

Wednesday, March 13

- 12:30am – Japan: Tertiary Index
- 5:00am – Italy: Unemployment Rate
- 6:00am – EU: Industrial Production
- ★ 8:30am – US:
  - PPI
  - Durable Goods Orders – Jan P
  - Capital Goods – Jan P
- 10:00am – US: Construction Spending
- ★ 1:00pm – US: $16bn 30Y Treasury Bond Auction
- 10:00pm – China:
  - Fixed Assets Ex Rural
  - Retail Sales
  - Property Investment

Thursday, March 14

- 3:00am – Germany: CPI
- 3:45am – France: CPI
- 8:30am – US:
  - Import Price
  - Export Price
- 10:00am – US: New Home Sales – Jan
- 11:30am – US: 4W and 8W Treasury Bill Auctions

Friday, March 15

- ★ Japan: Bank of Japan monetary policy announcement
- ★ 3:55am – Japan: Bank of Japan Governor Haruhiko Kuroda speaks at B20 summit in Tokyo.
- 6:00am – EU: CPI
- 8:30am – US: Empire State Manufacturing Survey
- 9:15am – US:
  - Industrial Production
  - Capacity Utilization
- 10:00am – US:
  - JOLTS Job Openings - Jan
  - University of Michigan Consumer Sentiment
- 4:00pm – US: Treasury International Capital

– Rebecca Kooshak, Economic Analyst