ECONOMIC WEEKLY

Forecast Update: Slow Growth and Low Inflation

GDP growth was surprisingly strong in the first quarter, but the source of the unexpected strength — inventories and foreign trade — will detract from growth as soon as the current quarter. If consumption and business investment do not reaccelerate soon, the economy will be flirting with recession within a quarter or two.

Our new forecast includes a significant bounce in spending in the second quarter. Strong car sales in March plus solid job growth in March and April support a spending rebound, though recent trends in income and the household employment report do not. We opted to build the rebound into the forecast in part because the December-January government shutdown likely explains the first quarter's weakness. Nevertheless, we will be closely watching employment and income over the next few months after both have flashed warning signals.

Household employment peaked in November

The Bureau of Labor Statistics conducts two surveys every month. The establishment survey tracks the number of employees on company payrolls as well as hours worked and average hourly pay. The household survey also measures employment, this time by querying heads of households rather than employers. It also tracks labor force participation, unemployment, and status of unemployment.

The payroll survey is less volatile thanks to a bigger sample size and the "birth-death adjustment," a trend-based plug intended to account for employees added at startups not in the "sampling frame." The birth-death adjustment corrects for the biggest non-sampling error in the establishment survey, and it improves payroll data accuracy most months. But, the birth/death fix can diminish the survey's accuracy at economic turning points, creating the appearance of job growth continuing for months after it turns negative. The BLS corrects these overshoots and undershoots years later when they incorporate benchmark revisions based on annual surveys of every employer in the US.

The household survey has a different problem, sample size. While the establishment survey catches about a third of the job sites in the US, the household survey captures only 60,000 households, or 0.005%, of the 127 million in the US. As a result, an employment change of 500k is required just to give 90% confidence in the direction of the change in any given month.

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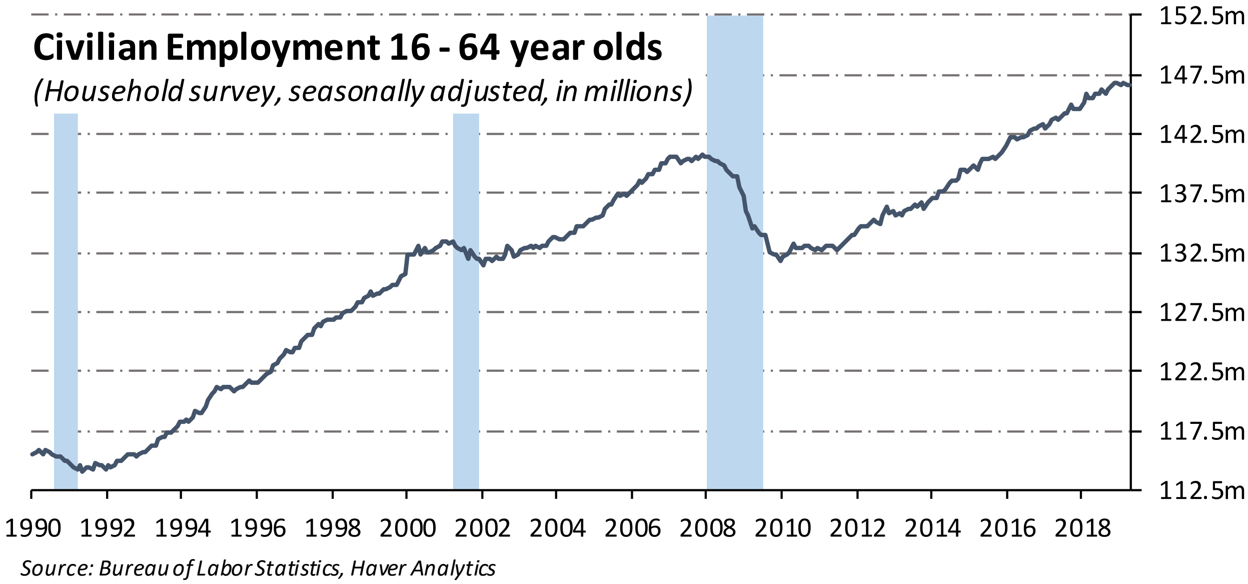
Comparing the household and payroll surveys, the household survey will pick up an employment turn first, but because the data are more volatile, a turn in the household is typically confirmed by a turn in the establishment survey before it is established to a believable degree.

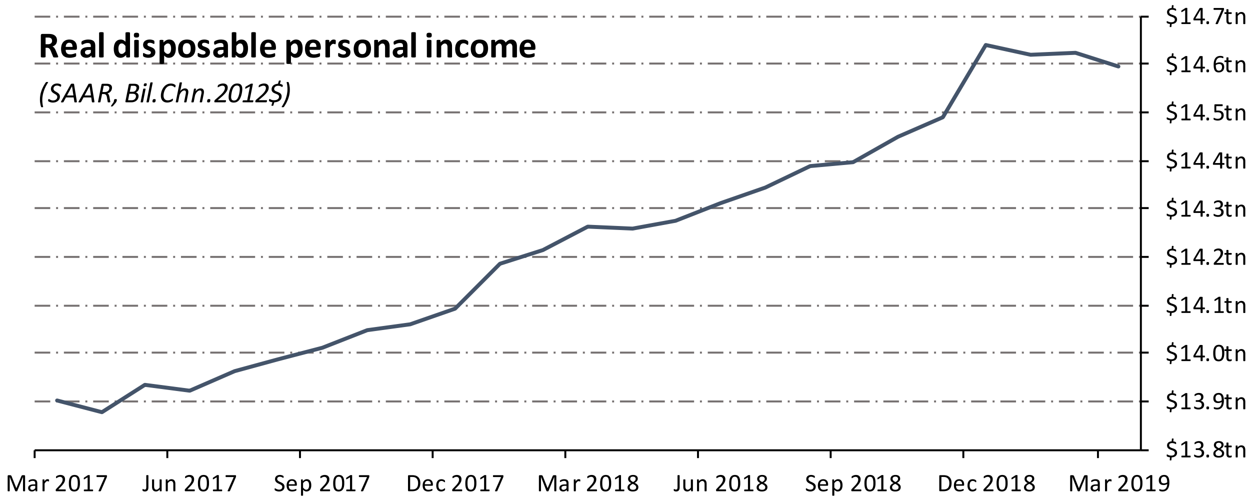
Nevertheless, when household employment fails to rise for three or four months — April makes four months since the December peak — it bears watching. As the below chart demonstrates, this kind of slow patch is quite rare. The last sustained soft patch like this was in 2013.



The household employment survey suggest the US economy stalled in the first quarter. If the weakness continues through the second quarter, it would be consistent with a recession. The payroll survey suggests the economy is still motoring along at a respectable speed, however. Given the strengths and weaknesses of the two surveys, we have no recession in our forecast, but we have boosted the odds and will watch the employment data closely for the next few months.

Income

Real after-tax income peaked in December. It fell in January, was flat in February, and fell again in March. The government shutdown is the most likely cause, and as a result, income should recover in the second quarter. After all, average hourly earnings are growing about 1.5% faster than inflation and employment is growing at a 1.75% rate. Real income should be growing at about a 3% rate. If employment really is growing, of course.



Source: Bureau of Economic Analysis

Part of the January income shortfall reflects federal employees not paid during the shutdown. Their paychecks were mailed in February. Federal contractors went unpaid in January and — for those billing quarterly — received less in March. That may explain the March drop.

There are other factors at work in the data further clouding the picture. Dividend income soared in December, likely reflecting one-time payouts related to last year's tax cut. Not surprisingly, given the bigger-than-usual increase in December, dividend income fell in January. Some of the Q1 weakness may simply be disappointment after the outsized December gain. The pullback in January was small compared to the December rise, after all.

We are analyzing income more closely than usual, too. Like the household employment data, there are enough cross currents to dismiss recent weakness. But if the weakness persists, it is reason to worry. For now, it is one more reason to slightly increase the odds of a 2019 recession.

The current quarter and beyond

Q2 is shaping up as a real mixed bag.

The biggest growth challenges are a general slowdown in economic activity, suggested by the drop in both ISM manufacturing and nonmanufacturing indices to multi-year lows, an ongoing inventory correction, the previously mentioned weakness in income and household employment, abysmal April car sales, and a trade deficit that is growing again.

On the plus side are signs of life in housing. Some housing indicators have risen, suggesting we could break a five-quarter losing streak in residential investment as soon as this quarter. There are also signs of life in business investment. In April, nonresidential fixed investment started the quarter on a 3.9% pace, more than a percentage point faster than in Q1.

Going forward, we are watching several key areas that will affect 2019 growth:

1. **The China trade deal.** A deal was near completion — indeed it should have been completed this week — until China redlined domestic reforms necessary to comply with the agreement from the deal. Perhaps Chinese negotiators sensed weakness in President Trump's pleas for Fed rate cuts. Or maybe China's entrenched bureaucracy was unwilling to make changes, even at Xi Jinping's

behest. It now appears the US will rely on tariffs to encourage US companies to move production away from China, something already happening, and something the Commerce Department has been quietly urging on CEOs for months.

According to *Bloomberg News*, "From Sushi to Ski Gloves: US Needs China More than You Think." The gist is that 80-90% of a number of goods come from China. And yet, *Bloomberg* also notes "Very Few [Chinese] Firms Can Live with 25% Tariffs." Only about 60 of the thousand or so listed Chinese exporters have margins of more than 25%.

These two conflicting observations suggest, when it comes to tariffs, it's a mistake to do a static analysis and assume everything coming from China will continue coming from China. It's also a mistake to think China's currency won't drop, alleviating some of the tariff burden, or that consumer prices will rise dollar for dollar with costs.

We expect tariffs will translate into modestly weaker US growth, something like 0.25% over the next year, a more significant loss of Chinese growth in 2019 and 2020, a transitory inflation increase of a tenth or two followed by a deflationary drag of a tenth or two reflecting the economic impact.

> Tariffs are taxes. Like all tax increases, where they are levied has little effect on who pays them. Broad import tariffs will translate into a slight one-time increase in US inflation, lower profit margins in the US and China, and a further shift in imports from China to alternative manufacturers in the US and elsewhere.

2. **The Fed's transitory claim.** Chair Powell and the rest of the FOMC would like us to believe that weakness in both growth and inflation is transitory, but strength is real. We wrote about the Fed's confirmation bias last week. The upshot is the Fed is likely to hold fast on rates until to cut, either by a recession scare or by severe weakness in the financial markets. A market catalyst is already in the works.

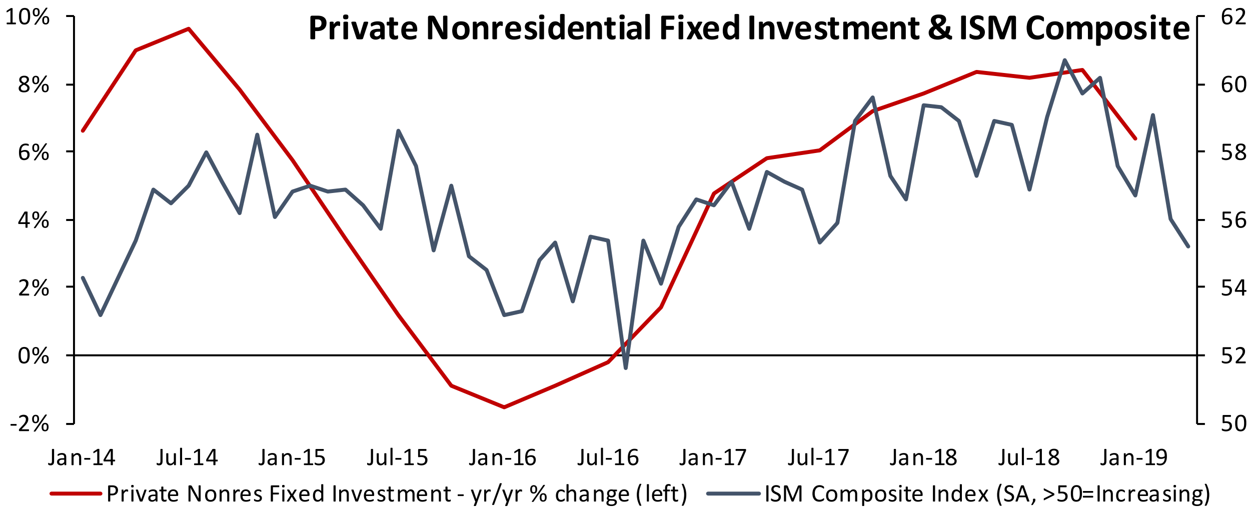
3. **The stock market.** The wealth effect is hogwash. Even when fluctuating asset prices seemed to impact growth in the nineties and 2000s, it was because higher house prices allowed homeowners to borrow more, not because other assets, including stocks, were higher. (This 2005 Case, Shiller, and Quigley paper, which found a significant housing wealth effect but no stock market wealth effect, was the peak of wealth effect understanding before the financial crisis.) Stock prices can rise and fall by double digits without affecting consumption. Since the Great Recession, with mortgage financing rules quite a bit tougher, even house price movement does not affect real economic growth the way it used to.

That does not mean the stock market does not affect the outlook, however, because the Fed treats the stock market as a barometer for economic activity. In April, when stocks were at a record high, Fed hawks worried about financial stability. If stocks fall more than 10-15%, however, equities will be one more reason to ease.

> Chair Powell insists there is no Fed put, which is to say, the Fed does not target a particular level for stocks. But when stocks tank, the Fed acts. Or, as Powell explained in January, Fed polices work through markets, so when markets move, sometimes it is appropriate for the Fed to adjust. At the moment, stocks are about 4% off their highs, meaning they would have to drop two-three times as far before the Fed even considers intervening. The drop triggering Powell's January pivot to patience was 17% from peak to trough.

4. **Consumers**. Retail sales and consumption are always critical to the US economy. Given recent weakness, they need to be watched.

5. **Business fixed investment**. Weak business investment was one of the bigger surprises at the turn of the year. There are signs of life in the second quarter, but the ISM surveys, manufacturing and nonmanufacturing, suggest business investment will weaken further in the year ahead.



Source: Bureau of Economic Analysis, Institute of Supply Management

The trade-talks breakdown will further hurt US investment spending in the short run, but it may boost investment longer term, as some manufacturing will almost certainly return to the United States.

To give just one example, several years ago, we spoke to a Tennessee manufacturing CEO. The business was doing well and the company had planned to build a second factory in the US, but when Congress passed Obamacare, it tipped the balance and the company opted to build in China instead. Now, with a lower US corporate tax rate and an import tariff, he's thinking about moving production onshore again.

Bottom line: Slowdown, not recession if Fed comes to its senses

The Fed continues its fight to keep inflation in check, though participants clearly do not realize (yet) that is what they are doing. Demand faltered in the first quarter, and an inventory correction will shift final-sales weakness into GDP weakness in the second.

We expect growth will slow to about 1.5% by the second half of this year, at which point the Fed should adjust the fed funds rate lower in response to persistently weak inflation.

The biggest risk to the forecast remains the Fed. It's not clear if they really believe their own transitory inflation story, but they certainly sound like they do. With inflation likely to continue grinding lower, however, and with growth likely on the weaker side of trend for a time thanks to the inventory correction, we expect the FOMC will capitulate and cut in September, followed by another cut next year, allowing the economic expansion to continue.

– Chris Low, Chief Economist

The Week Ahead

This Week's Numbers

		PRIOR	CONSENSUS HIGH	CONSENSUS LOW	CONSENSUS MEDIAN	FTN
Tuesday, May 14, 2019	NFIB Small Business Optimism - Apr	101.8	103.0	100.0	102.0	**102.0**
	Import Price Index MoM - Apr	0.6%	0.8%	0.6%	0.7%	**0.6%**
	Export Price Index MoM - Apr	0.7%	0.7%	0.2%	0.6%	**0.6%**
Wednesday, May 15, 2019	Retail Sales Advance MoM - Apr	1.6%	1.3%	-0.1%	0.2%	**-0.1%**
	Retail Sales Ex Auto MoM - Apr	1.2%	0.8%	0.4%	0.7%	**0.5%**
	Retail Sales Ex Auto and Gas - Apr	0.9%	0.6%	0.3%	0.4%	**0.3%**
	Retail Sales Control Group - Apr	1.0%	0.7%	0.3%	0.3%	**0.3%**
	Industrial Production MoM - Apr	-0.1%	0.5%	-0.5%	0.0%	**-0.2%**
	Manufacturing (SIC) Production - Apr	0.0%	0.2%	0.0%	0.1%	**0.1%**
	Capacity Utilization - Apr	78.8%	79.0%	78.4%	78.7%	**78.7%**
	Business Inventories - Mar	0.3%	0.2%	-0.1%	0.0%	**-0.1%**
Thursday, May 16, 2019	Housing Starts - Apr	1139k	1287k	1180k	1210k	**1200k**
	Housing Starts MoM - Apr	-0.3%	13.0%	3.6%	6.2%	**5.4%**
	Building Permits - Apr	1269k	1320k	1270k	1293k	**1240k**
	Building Permits MoM - Apr	-1.7%	2.1%	0.5%	1.3%	**-2.3%**
Friday, May 17, 2019	Leading Index - Apr	0.4%	0.3%	0.2%	0.2%	**0.2%**
	U. of Mich. Sentiment - May P	97.2	101.5	96.0	97.8	**97.6**

Review

Over the weekend, President Trump announced tariffs would increase on Chinese goods from the current 10% to 25% on $200bn in goods effective May 10. He warned an additional $325bn of Chinese goods may also be slated for tariffs. This week's trade data showed declining imports from China, but an increase in the services and goods trade deficit over the year. With respect to ongoing Brexit tensions, the UK and Ireland were the week's outliers in that they signed a bilateral deal.

- Chinese goods have been subject to a 10% tariff on $200bn of goods since September 24, 2018. These tariffs were scheduled to rise to 25% beginning January 1, 2019, but trade negotiations were going well, and the President postponed the increase as long as negotiations continued to make headway. The White House always cautioned a deal may not be reached (as noted in this April 4 *Reuters* article).

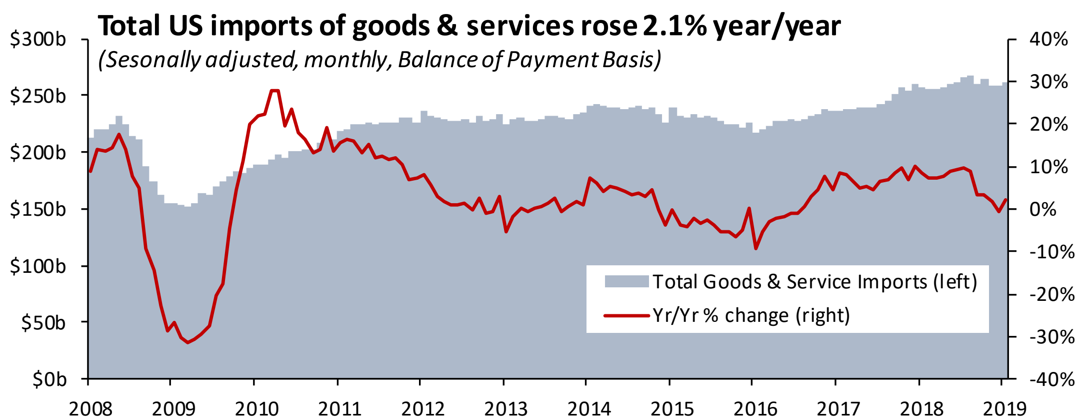
The following list is a recap of tariffs announced in 2018 (continued on following page):

1. On washing machines and solar cell imports (Announced January 22, 2018)
2. On imported steel and aluminum from all nations, with temporary exclusions to some countries (Announced March 9, 2018)
3. A $50bn list of Chinese goods subject to 25% tariffs (Announced June 15, 2018)
   - July 6, 2018 $34b went into effect
   - Aug 23, 2018 $16bn went into effect

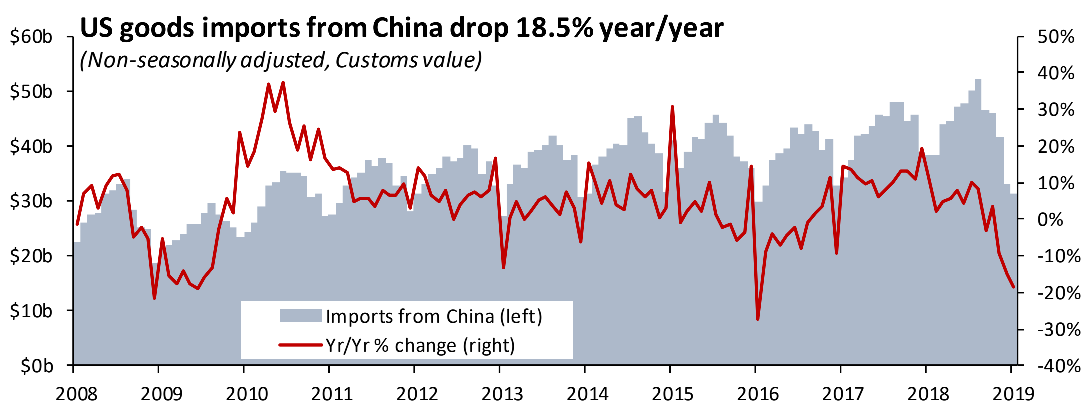
   (Full list of 1,102 tariff lines can be found here starting on pg 10.)

4. Another $200bn list of Chinese goods subject to a 10% tariff was published a few months later (Announced July 10, 2018)
    - September 24, 2018 5,745 products of the originally proposed 6,031 "tariff lines" (products or partial products) went into effect. 217 products were removed from the original list, which include smart watches and Bluetooth devices, certain chemical inputs for manufactured goods, textiles and agriculture, bicycle helmets, and car seats and playpens. (*Full tariff list can be found here*.)

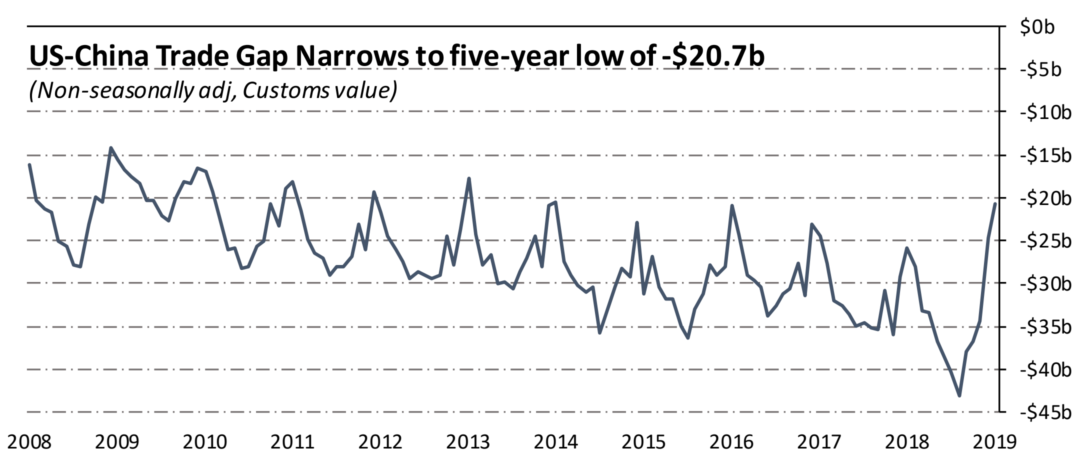
- The US trade balance at the end of March rose 1.5% from February (or $0.7 billion) to $50 billion. While exports rose (1% to $212 billion) imports rose more, possibly due to importers front-running price increases. A significant share of US imports have shifted from China to Mexico, Vietnam, South Korea, and France.



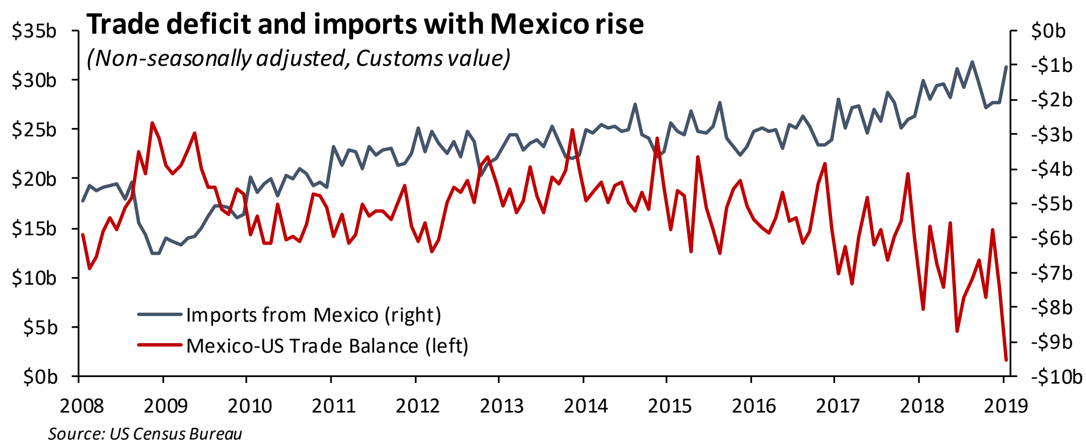
Source: US Census Bureau



Source: US Census Bureau, FTN Financial



Source: US Census Bureau



- President Trump expanded sanctions on Iran to include the country's metal industry: iron, steel, aluminum, and copper are all now under sanction. Iran's top three exports — oil, petrochemicals, and metals — have been targeted for US sanctions.

- The UK and Ireland signed a deal Wednesday allowing citizens to travel freely between the countries and access cross-border social services after the UK exits from the EU. The deal, a non-binding memorandum of understanding, was signed by Theresa May's de facto deputy David Lidington and Irish deputy premier Simon Coveney. It reduces tensions around the backstop issue of citizens, the *FT* reports, but still does not resolve the cross-border movement of goods and services.

The Atlanta Fed revised its GDPNow Q2 growth forecast from 1.7% to 1.3% on an unexpected narrowing of the goods trade deficit. The NY Fed revised its Nowcast from 2.15% to 2.2% on higher exports and inventories from goods imports.

Preview

Note: ★ = High Impact Event
All times Eastern Daylight

Sunday, May 12

- 10:55am – US: San Francisco Fed President Mary Daly gives commencement address at Syracuse University. (FOMC voter in 2020)

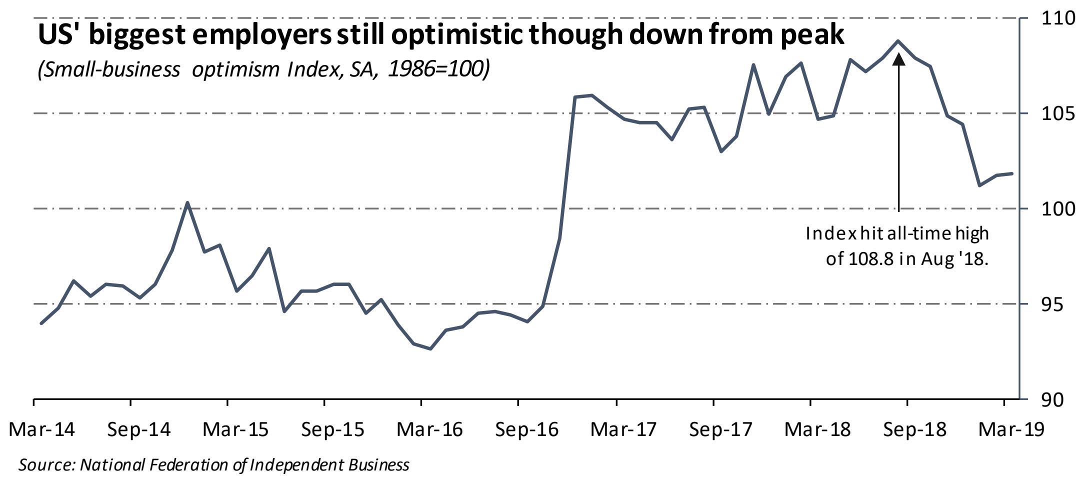
Monday, May 13

- Secretary of State Mike Pompeo visits Moscow to meet with Foreign Minister Sergei Lavrov to discuss Venezuela, Syria, and the Ukraine.
- India hosts a WTO mini-ministerial meeting of 25 developing countries to participate in discussions over the significance of the WTO, reforms, and global trade.
- 1:00am – Japan:
  - Leading Index
  - Coincident Index
- ★ 9:05am – US: Boston Fed President Eric Rosengren and Fed Governor Clarida speak at "Fed Listens Event." (Rosengren is an FOMC voter.)

- 11:30am – US: 3M and 6M Treasury Bill Auctions
- 7:50pm – Japan: Trade Balance

Tuesday, May 14

- OPEC monthly oil market report
- 2:00am – Germany: CPI
- ★ 3:15am – US: New York Fed President John Williams speaks at Swiss National Bank/IMF conference on the International Monetary System in Zurich. (Permanent FOMC voter)
- ★ 4:30am – UK: Labor Report
- 5:00am – Germany: ZEW Survey
- 6:00am – US: NFIB Small Business Optimism – Apr

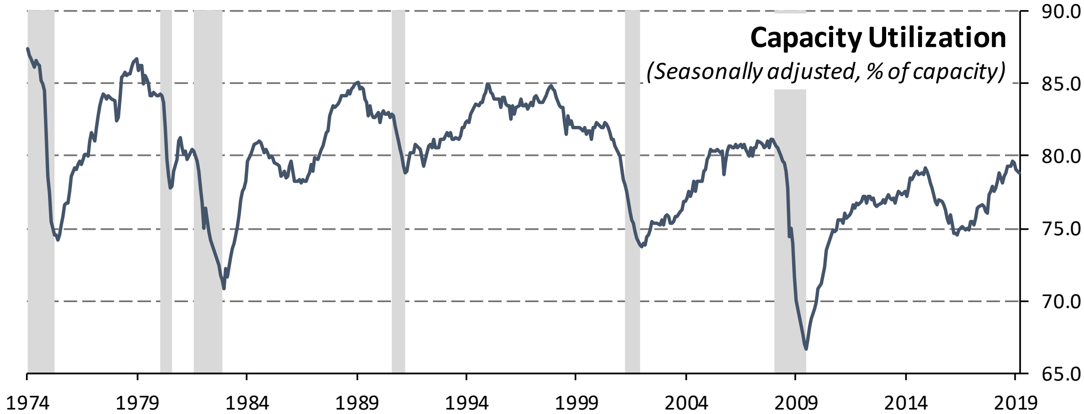


- 8:30am – US:
  - Import Price Index (Last: 0.6% m/m Con: 0.8% m/m)
  - Export Price Index (Last: 0.7% m/m Con: 0.6% m/m)
- ★ 12:45pm – US: Kansas City Fed President Esther George speaks. (FOMC voter)
- ★ 10:00pm – China:
  - Fixed Assets Ex Rural
  - Retail Sales
  - Unemployment Rate
  - Property Investment

Wednesday, May 15

- ★ 2:00am – Germany: GDP - Q1 P
- 2:45am – France: CPI
- 8:30am – Canada: CPI
- 9:00am – Canada: Existing Home Sales
- ★ 5:00am – EU:
  - GDP - Q1 P
  - Employment - Q1 P

- ★ 8:30am – US:
  - Retail Sales
  - Empire Manufacturing - May
- ★ 9:15am – US:
  - Industrial Production
  - Manufacturing Production
  - Capacity Utilization



Source: Federal Reserve Board, National Bureau of Economic Research

- 10:00am – US:
  - NAHB Housing Market Index
  - Business Inventories
- 12:00pm – US: Richmond Fed President Thomas Barkin speaks. (FOMC voter in 2020)
- ★ 4:00pm – US: Treasury International Capital – Mar
- 7:50pm – Japan: PPI
- 9:30pm – China: New Home Prices – Apr

Thursday, May 16

- 1:30am – France: Unemployment Rate – Q1
- 5:00am – EU: Trade Balance
- ★ 8:30am – US:
  - Housing Starts
  - Building Permits
  - Philadelphia Fed Business Outlook
- 10:30am – Canada: Bank of Canada's Financial System Review
- 12:05pm – US: Minneapolis Fed President Neel Kashkari speaks on monetary policy and economy. (FOMC voter in 2020)
- 1:00pm – US: Former Fed Chair Ben Bernanke and former Treasury Secretary Robert Rubin discuss policies for mitigating the next recession.

Friday, May 17

- 12:30am – Japan: Tertiary Index
- 4:30am – Hong Kong: GDP - Q1 F
- 5:00am – EU:
  - CPI – Apr F
  - Construction Output - Mar
- ★ 10:00am – US:
  - Leading Index
  - University of Michigan Sentiment
- 11:15am – US: New York Fed President John Williams meets with Community League of the Heights.
- 2:00pm – US: New York Fed President meets with Asian Americans for Equality in Chinatown.

– Rebecca Kooshak, Economic Analyst