

 **ECONOMIC CURRENTS**

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A Fork in the Road

Structural Change Watch List

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There are two types of shifts that economists monitor:

- 1 Type-1 shifts are cyclical and tend to play out over a short period of time, a few of months or a quarter. The sharp draining of inventories we saw in the second quarter of 2018 is an example. Now that firms realize demand has picked up faster than anticipated, they will replenish empty shelves quickly.
- 2 Type-2 shifts are structural, or secular, in nature. They take years to take root and sometimes longer to play out. The housing market in the wake of the housing bust provides a useful example. Few people were willing to buy or invest in a home that was still falling in price, despite record-low mortgage rates.

Most economists focus their efforts on type-1, or cyclical shifts, because financial markets are inherently short-term. Market participants want to know what will happen in the next quarter, not years down the road. The problem with short-term thinking is that it fails when setting strategy and determining how to manage shifts in economic tides. Type-2 shifts are more important because they determine the contour and length of any business cycle.

The Great Recession is a case in point. The mountain of bad debt that caused the housing bust took years to accumulate and then restructure. The lingering effects and resulting caution in lending limited the pace of recovery. In fact, it took much longer for employment to reach the previous peak, even though the U.S. economy recovered more rapidly than its peers. The resulting undercurrent of low wages and lost wealth still haunt us despite a stronger economy.

Trade Tensions Weigh on Growth

Real GDP picked up to a 4.1% pace in the second quarter, the strongest since 2014. The key drivers were a rebound in consumer spending, a reopening of federal government spigots and a u-turn in trade. China scrambled to stock up in soybeans ahead of retaliatory tariffs, a one-time event which added more than a percent to overall growth in Q2. Housing suffered, as foreigners pulled back.

Growth is expected to average a 2.9% pace in the second half while overall growth comes in at 2.8% in 2018. That marks a 0.2% shortfall in the forecast relative to last month. Uncertainty on trade and escalation of tariffs are the primary reason. A study by the Atlanta Federal Reserve shows that nearly one third of manufacturers, retailers, transportation and warehousing firms are downgrading their plans for investment in response to tariffs and fears of a trade war. The bulk of that weakness shows up as a shortfall in investment and rise in prices in 2019.

We have a short-lived trade skirmish with China baked into the outlook; that includes tariffs on \$250B on imports from China and \$50B in retaliation. Some of those tariffs have already been levied.

Powell Hikes Rates

A rate hike at the Federal Reserve's next meeting in September is all but a done deal. The initial effects of tariffs and even retaliation, will produce more, not less, inflation. Our forecast holds for a fourth rate hike in December.

Type-2 shifts are easier to identify than type-1 shifts because they are already underway. The Federal Reserve's efforts to raise short-term interest rates after an unprecedented period of near-zero rates is a good example. It marks a fundamental shift in the policies of the last decade, which were designed to hold down both short- and long-term rates.

Another turnaround in policy is the appetite to stimulate via deficits and debt. Inflation and interest rates tend to pick up when so much of the economy is concentrated on sustaining basic needs, like retirement and medical care, instead of investments in infrastructure and R&D. This is especially true when much of the funding for that debt is dependent on foreigners.

“Tariffs raise costs, dampen growth and, in the worst-case scenario, trigger a recession.”

Much of what we have become accustomed to over the last decade - low rates, low inflation, increased global integration - are reversing. The result will be a shock to the financial system and how business is conducted. I don't know many traders who remember what it was like to battle the great bear markets triggered by former Fed Chair Paul Volcker's efforts to break the back of inflation.

This edition of **ECONOMIC CURRENTS** focuses on type-2 shifts, how they determine the contour and length of the expansion and, perhaps more importantly, identify potential catalysts of the next downturn. Few economists believe policy makers still have the basic tools needed to dampen the effects of the next recession, let alone deal with another financial crisis. This marks a major departure from the long-held belief in the “Greenspan put,” or the ability of one person, a “Maestro,” to keep the music playing.

We have come to the proverbial fork in the road where economic, political and technological integration, which eased movement of goods, people and ideas across borders, is reversing. Challenges to NAFTA, the Eurozone, membership in the European Union, technology and the institutions that supported those shifts will create bottlenecks. Even business executives are being held up at the border regardless of their global entry status. Some of the shifts will be welcome if they inhibit theft of intellectual property. The jury is still out on the costs.

Top 10 List

1 Public debt burdens will rise.

The U.S. Treasury department will need to borrow a staggering \$769 billion during the second half of fiscal year 2018; that's up 63% from last year. The nation's debt is expected to hit \$21.5 trillion by the end of September, even before Congress and the administration open government spigots wider. The Senate currently plans to spend even more in fiscal year 2019.

- 1 The president is pushing to compensate farmers hit by retaliatory tariffs. He has threatened to shut down the government on October 1 if he doesn't get funding for a border wall.
- 2 The House of Representatives is working on tax cuts 2.0 to extend cuts passed last December.
- 3 The Treasury is trying to further reduce taxes on capital gains by indexing them to inflation; it is not clear whether the executive branch has the authority.

Federal deficits will cross \$1 trillion dollars in fiscal year 2019. Add increased deficits from entitlement spending for the aging of the baby boom generation to the additional interest expense associated with the sheer volume of debt we are issuing. There is no precedent.

The White House has said tariffs will increase revenues and lower the deficit. The difficulty with that statement is the impact tariffs have on the economy. Tariffs raise costs, dampen growth and, in the worst-case scenario, trigger a recession. Even if long-term rates do not rise, increased government spending will eventually crowd out other spending, notably investment in infrastructure by both the public and private sectors.

To quote deficit watcher Greg Valliere of Horizon Investments, “There's an insatiable demand for Treasury paper, domestically and from abroad. That will persist – until it doesn't. We're in uncharted waters, there have never been such consistently high deficits in a period of peace and prosperity, when red ink should be declining.”

2 Inflation is heating up.

Overall inflation has picked up in 2018, with gains more broad-based than earlier in the cycle. Service-sector inflation has finally accelerated, which is a welcome trend at the Federal Reserve where officials have struggled in recent years to get inflation to reach the 2% target. Upward pressure on shelter and hospital costs is expected to be significant this year.

Pipeline inflation has accelerated in response to stronger growth abroad, a rebound in manufacturing, surging transportation costs and new tariffs that have prompted a flurry of price hikes in the third quarter. Combined with low productivity growth, these factors are dry tinder for inflation.

3 Interest rates are rising.

The Fed has made its position clear: It will continue to gradually raise rates as long as inflation is close to (slightly above or below) the 2% target, where it is today. This is at the same time that Fed officials are allowing the bloated balance sheet to shrink, which will put additional upward pressure on rates. The Fed is essentially removing the ceiling it had maintained on Treasury and mortgage rates.

The decision to reduce the Fed's balance sheet was made before the tax cuts and spending increases. That means the federal government will have to rely on foreign buyers to buy even more debt now that the Fed is stepping back.

China holds the largest amount of Treasury bonds among foreign investors but has already slowed the pace of buying to stimulate its indebted economy. Japan is the second largest; it has picked up much of the slack but now faces an appreciation in the yen, which could be countered most easily by slowing its Treasury bond purchases. Russia has sold its holdings in recent months but is not one of the largest foreign investors.

4 Debt in nonfinancial firms is surging.

In the wake of the financial crisis, low (near-zero) interest rates enabled many companies to stay in business by exchanging expensive debt for cheaper debt despite poor performance. A good portion of those borrowers used the debt to fund stock buybacks and dividend payouts, which juiced investor returns but did little to build a foundation for future growth.

Productivity and wage growth have suffered, especially for firms engaged in what we term financial engineering instead of investment. The spillover has been national in

scope, which explains at least a portion of the weakness in aggregate productivity and wage growth data.

More recently, the junk bond market has taken off as retail investors replace institutions in the reach for yield. This shift has lowered interest expenses and increased debt for the riskiest firms. It also increases the risks of default and bankruptcy when interest rates rise and/or the expansion falters. Companies able to lower their dependence on debt should do so now before access to credit tightens.

5 Protectionism is intensifying.

From the UK vote to leave the European Union (Brexit) to the escalation of trade tensions and retaliation between the U.S. and its trading partners, tariffs are becoming more of a new norm than a negotiating tactic. There was some hope of a reprieve following talks with the president of the European Commission. China, however, has once again increased tariffs on U.S. goods following White House threats of new tariffs on Chinese imports.

This is at the same time that the administration continues to push for bilateral trade agreements, which are even harder to enforce than multilateral agreements. One of the strengths of the Trans-Pacific Partnership (TPP) that the administration decided to quit was the upgrading of older trade agreements like NAFTA to include protections for intellectual property. That would have isolated China. The goal was to make China to play fairly by showing a unified front. Multilateral agreements force countries that violate them to face the ire of many instead of just one trading partner.

“The silver lining of tight labor markets is that it forces companies to...find efficiencies and accelerate the adoption of new technologies.”

NAFTA negotiations with Mexico have progressed further than talks with Canada. There is hope that a bilateral agreement can be achieved with Mexico this fall. Canada faces more challenges. A particular sticking point is what is known as the sunset clause that would allow NAFTA to expire. That would undermine investment in Canada, where many feel they would be better off reverting to the previous free trade agreement with the U.S. that existed prior to NAFTA.

In response, multinationals are starting to rethink where and how they operate. The risk to global supply chains is real. Some companies have already decided to move some of their production out of the country, fearing they could lose access to lucrative markets abroad.

“Another turnaround in policy is the appetite to stimulate via deficits and debt.”

We have seen a dramatic jump in lobbying by large firms seeking exclusions on tariffs. Those able to curry favor with the administration have been successful in suppressing other exclusions they view as threats to their business. The result is an industrial policy through which the government, not the market, plays a heavy hand in determining winners and losers. This tends to spur corruption and undermine a country's competitiveness. Russia's economy offers an extreme example.

6 Spending on defense and border security are rising.

Shoring up our national defense and border security have become top priorities, not only in the U.S. but abroad. These expenditures slow the movement of goods and people across borders at the same time that they siphon funds from other areas like basic infrastructure.

Firms will need to figure out ways to plan for delays and/or work with government on technology to speed security checks. Even then, the risk is more time spent at the border.

7 Immigration is slowing, and poised to decline.

Everything from the Great Recession to more hostile laws and arrests of illegal immigrants has deterred border crossings. Now the administration has turned its sights on legal immigration. Some 200,000 spouses of legal immigrants working in the U.S. were recently forced to give up their jobs while restrictions on a wide variety of visas have intensified. The goal, to cut legal immigration by at least half, is exacerbating labor shortages in agriculture, construction and the tech sector.

The curbs have begun to take a toll on foreign students entering the U.S. One of the primary reasons foreign students come to study in the U.S. is to have access to the U.S. labor market, which they are now losing. Foreign students pay full tuition; the shortfalls will curtail universities' ability to offer scholarships to students here.

Moreover, the effects of immigration curbs will continue to affect migration trends even if they are rolled back. The reality of how fast the environment can change for immigrants has dampened the desire to come to the U.S.

The results will leave employers wanting even as the economy slows. **Pew Research** has one study that suggests a contraction in the labor force by 2020 if immigration continues to slow.

8 Diversity in the labor force is increasing.

Millennials, the most diverse and highly educated generation we have ever produced, now make up the largest share of the labor force. Some 30% of millennials are considered new minorities (Hispanic, Asian or more than two races) by researchers. Add millennials' liberal views on sexuality to an increase in labor force participation by the over-65 crowd and the math becomes simple. The labor force will become much more diverse across a spectrum of measures. A more telling trend for the long term is occurring among children: The majority of children born since 2007 are minorities, which will make **whites a minority group in their cohort**.

The good news is that diverse teams make better decisions and boost the bottom line. The problem is that most companies are still struggling to leverage diversity and deal with the tensions that accompany it. Older workers often resent reporting to younger managers, while ageism can be a hurdle for older workers even attaining a job. This is all on top of the tensions across race, religion, gender, gender identity, disabilities and people with criminal records.

Tight labor markets open the door to a more diverse pool of job applicants. Firms that leverage diversity will win; those that don't will lose, especially once the economy falters.

In response, human resource departments need to be upgraded to do more than just adhere to the law when it comes to diversity. They need to improve dealing with conflict resolution and be more cognizant of what works and what doesn't when building diverse teams. It's not just about checking a box; it's about achieving critical mass to reap the full benefits of problem solving and strategizing. (There is a whole industry that has emerged in this arena, which is peddling a lot of misinformation, especially when it comes to managing millennials.)

9 Adoption of new technologies will accelerate.

The silver lining of tight labor markets is that it forces companies to find efficiencies and accelerate the adoption of new technologies. **Recent research** suggests much of the innovation is concentrated among a small group of large tech firms: Facebook, Amazon, Apple, Netflix and Google, nicknamed FAANG. These companies have almost unlimited access to capital, talent and cutting-edge research via partnerships with universities.

Others were left behind, either because they couldn't commit to the kind of investments needed in the wake of the crisis or were limited in their access to new technologies. Some of the largest tech firms now wield what is considered monopoly control, which limits startups.

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Incentives to invest and upgrade systems are intensifying. Now is the time to for those who can make the shift to do so. That should result in a spurt of investment, which we have seen pick up since the middle of last year. The most recent data were less encouraging because investment gains during the second quarter were concentrated in the oil industry. The fly-in-the-ointment is the new tariffs that squeeze margins and crimp exports.

10 Growth in China is slowing.

Finally, no structural change list is complete without talking about China. When I started this list in 2000, China was a key factor and has been ever since. The focus initially was on how rapidly China could grow and how that pace could reshape the global landscape.

China has come of age. Given its larger base, it cannot grow as rapidly as it once did. The economy is already slowing with risks to the downside. The Chinese stock market has plummeted, debt has ballooned and a trade war with the U.S. is looming.

The Chinese government has attempted to offset actual and perceived threats from disruptions to trade by adding stimulus to the economy, which will only increase its debt woes. The more China slows, the harder it will be to service debt obligations. A collapse in the peer-to-peer lending market

cost many their savings and triggered protests that prompted the police to shut down Beijing's financial district.

The broader issues are the spillover effects of a pronounced slowdown in the world's second largest economy. Emerging markets are likely to be hit hardest as demand for commodities wanes. That, coupled with the leverage many of those economies took on to participate in China's belt and road initiative, could further compromise emerging and commodity-based economies. This is to say nothing of the targets that U.S. multinationals are becoming in China as threats of a trade war escalate.

Most worrisome is how an erosion of living standards in China could spur social unrest, which would no doubt encourage China's military ambitions. A go-to for autocratic leaders under pressure in their own countries has always been to find an enemy abroad. Combined with the vacuum left in the region by the U.S. abandoning TPP, China's neighbors are becoming more nervous. China already controls much of the South China Sea, which is a critical trade route, and could easily disrupt supply chains by delaying ships from or headed to the rest of the world.

Bottom Line

We are changing course and with that shift comes unintended consequences. Governments that engage in choosing winners and losers seed corruption and inefficiencies. China's doubling down on the support of its inefficient but politically influential state-owned enterprises is an extreme example. This enables an autocratic leader to stay in power at the expense of the country's economic potential.

In the U.S., steel and aluminum companies with close ties to the administration are able to obstruct waivers for their competitors who have nowhere else to get their inputs but from abroad. The result diminishes competition, further undermines productivity and our potential to deliver on the wage front.

The silver lining is our youth. Millennials have the diversity and education to actually enhance productivity growth, boost the bottom line and raise living standards. That will require hitting the reset button on how companies manage their workers and decide to embrace instead of belittling youth. They represent an asset that China does not have because the one-child policy left a generation dominated by men, which undermines the entire concept of leveraging diversity.

Economic forecast — August 2018

	2017(A)	2018	2019	2017:4(A)	2018:1(A)	2018:2(A)	2018:3	2018:4	2019:1	2019:2	2019:3	2019:4
National outlook												
Chain-weight GDP ¹	2.2	2.8	2.3	2.3	2.2	4.1	2.9	2.8	1.8	1.9	1.7	1.9
Personal consumption	2.5	2.5	2.3	3.9	0.5	4.0	2.3	2.5	2.0	2.0	1.9	2.3
Business fixed investment	5.3	6.9	3.2	4.9	11.5	7.4	4.2	5.3	2.3	1.7	1.9	2.2
Residential investment	3.3	0.3	0.2	11.1	-3.4	-1.1	-1.6	0.1	-1.3	0.6	2.6	5.0
Inventory investment	19.1	20.1	56.2	13.7	25.8	-23.7	32.1	46.5	50.6	60.3	58.6	55.0
Net exports	-713.7	-749.0	-812.8	-748.6	-751.0	-703.9	-756.4	-784.6	-797.9	-807.9	-817.0	-828.3
Exports	3.0	4.7	4.3	6.6	3.6	9.3	-0.9	4.4	4.3	4.7	5.3	6.7
Imports	4.6	4.7	5.3	11.8	3.0	0.5	6.4	7.1	4.9	4.8	5.1	6.5
Government expenditures	-0.1	1.8	2.2	2.4	1.5	2.1	3.4	3.6	2.0	1.5	1.2	0.9
Federal	0.7	3.5	4.4	4.1	2.6	3.5	7.6	8.1	4.7	2.2	1.1	0.1
State and local	-0.5	0.7	0.9	1.4	0.9	1.4	1.0	0.9	0.4	1.0	1.2	1.5
Final sales	2.2	2.8	2.1	3.2	2.0	5.1	1.6	2.5	1.8	1.7	1.7	2.0
Inflation												
GDP deflator	1.9	2.4	2.4	2.5	2.0	3.0	2.4	2.5	2.4	2.3	2.3	2.2
CPI	2.1	2.6	2.3	3.3	3.5	1.7	2.9	3.0	2.8	1.9	1.4	1.4
Core CPI	1.8	2.2	2.4	2.2	3.0	1.8	2.4	2.6	2.6	2.4	2.3	1.9
Special indicators												
Corporate profits ²	3.3	13.5	2.5	3.3	5.9	12.9	13.8	13.5	13.0	5.0	4.1	2.5
Disposable personal income	2.6	2.6	2.1	2.3	4.4	2.6	1.2	1.0	2.7	2.3	2.6	2.8
Housing starts (mil.)	1.2	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3
Civilian unemployment rate	4.4	3.9	3.7	4.1	4.1	3.9	3.8	3.7	3.6	3.7	3.7	3.8
Total nonfarm payrolls (thous.) ³	2176.7	2493.1	865.9	556.3	632.3	647.7	615.5	597.7	303.1	188.3	179.0	195.5
Vehicle sales												
Automobile sales (mil.)	6.3	5.5	5.1	6.2	5.7	5.5	5.4	5.3	5.2	5.2	5.1	5.0
Domestic	4.6	4.0	3.8	4.5	4.1	3.9	4.0	3.9	3.8	3.8	3.8	3.7
Imports	1.7	1.5	1.4	1.7	1.6	1.5	1.4	1.4	1.4	1.4	1.3	1.3
Lt. trucks (mil.)	10.9	11.6	11.2	11.5	11.5	11.8	11.5	11.5	11.3	11.2	11.0	11.1
Domestic	9.0	9.3	9.1	9.4	9.3	9.5	9.2	9.3	9.2	9.1	9.0	9.1
Imports	1.9	2.3	2.1	2.1	2.2	2.3	2.3	2.2	2.1	2.1	2.0	2.0
Combined auto/Lt.truck	17.2	17.0	16.3	17.7	17.2	17.3	16.9	16.8	16.5	16.4	16.1	16.1
Heavy truck sales	0.4	0.5	0.4	0.4	0.5	0.5	0.5	0.5	0.5	0.5	0.4	0.4
Total vehicles (mil.)	17.6	17.5	16.7	18.1	17.6	17.8	17.4	17.3	17.0	16.9	16.5	16.5
Interest rate/yields												
Federal funds	1.0	1.8	2.7	1.2	1.5	1.7	1.9	2.3	2.4	2.7	2.9	2.9
10-year treasury note	2.3	3.0	3.4	2.4	2.8	2.9	3.0	3.2	3.3	3.4	3.4	3.5
Corporate bond BAA	4.4	4.8	5.3	4.3	4.5	4.8	4.9	5.1	5.2	5.3	5.3	5.4
Exchange rates												
Euro/Dollar	1.1	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2
Dollar/Yen	112.1	109.2	106.5	112.9	108.3	109.1	110.3	109.2	108.1	106.9	106.1	105.1

¹ In 2016, GDP was \$16716.16+ billion in chain-weighted 2009 dollars.

² Corporate profits before tax with inventory valuation and capital consumption adjustments, quarterly data represents four-quarter percent change.

³ Total nonfarm payrolls, quarterly data represents the difference in the average from the previous period. Annual data represents 4Q to 4Q change.

Quarterly data are seasonally adjusted at an annual rate. Unless otherwise specified, \$ figures reflect adjustment for inflation. Total may not add up due to rounding.

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