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Election Years and Recessions

The 2020 Outlook

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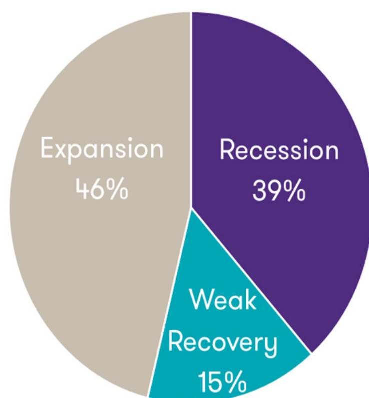
Most people assume that incumbents are able to manipulate the economy to avoid a recession in a presidential election year. That is wrong. Recessions or an economy so weak that it might as well have been a recession occurred during more than half of all presidential elections since 1860. (See Chart 1.) That is the first election that coincides with the National Bureau of Economic Research (**NBER**) recession dating.

The 1932 presidential election, which occurred three years into the Great Depression, is included in that tally. Incumbent President Herbert Hoover lost to Franklin D. Roosevelt for his perceived role in the Depression. The blame went so deep that shanty towns filled with homeless were renamed "Hoovervilles" because of their perceived link to the president.

Chart 1

Economic Performance: Presidential Election Years (1860-2016)



Source: NBER, Grant Thornton LLP

The 1992 presidential election, which occurred nearly a year and a half into what was termed a "jobless recovery," is also included. Incumbent President George H.W. Bush lost to William J. Clinton, at least in part because the economy was still struggling. Clinton campaigned on the slogan "It's the economy, stupid."

Why can't the president waive a magic wand and have the economy surge in an election year? Because there are too many variables out of his control. The 1960 presidential election provides one example. Incumbent Vice President Richard M. Nixon blamed his loss to John F. Kennedy on a recession in 1960.

The 1980 presidential election provides another. Incumbent President Jimmy Carter lost to Ronald Reagan at least in part because the economy had slipped into what would become one of the worst recessions of the post-WWII era. A whole new era of stagflation emerged, as inflation accelerated along with unemployment. That was the beginning of the end for auto and other production workers; many suffered permanent job losses.

The challenge in 2020 is China, the 800 pound gorilla in the room. It has shifted from being the single largest driver of global growth to a drag in recent years. The effects are being felt from Japan to Germany and across most emerging markets. A surge in debt, widespread corruption and an aging labor force are all contributing to the slowdown. The one-child policy and a sharp drop in birthrates in the 2000s has literally left China without enough workers.

Many are waiting for China to offset that weakness with stimulus. I wouldn't hold my breath. China has been unable to stimulate as it once did because its debt has proven debilitating. The escalation of trade tensions with the U.S. did not cause those problems but has exacerbated losses.

Given that backdrop and the administration's commitment to tariffs and trade wars, risks for the U.S. economy in 2020 are to the downside. The trade landscape remains a minefield and will likely get worse:

- Chances are high that China will test the administration with its pushback on subsidies to state-owned enterprises and intellectual property theft, even if a "phase one" deal on agricultural imports is reached.
- Hong Kong remains in disarray; any overt crackdown on demonstrators could lead the U.S. to levy more sanctions and tariffs on China.
- The European Union (EU) has threatened to retaliate against Airbus-related tariffs with new tariffs of its own. This has prompted the administration to renew its threats to levy vehicle and parts tariffs on the EU, which would idle production in both the U.S. and Europe.
- France just announced a new round of digital taxes targeted at our tech behemoths. The White House has concluded investigations into the French digital taxes and is expected to soon retaliate.
- The president launched a surprise round of steel and aluminum tariffs on Argentina and Brazil this week. He accused the two countries, which are suffering from their own economic crises, of unfairly devaluing their currencies, which is hurting our farmers.

The president could also shut down the federal government again on December 20. The continuing resolution to keep it open until then still lacks the funding for the border wall he wants. Republicans and Democrats have been reluctant to fund the wall; they are funding what they see as more effective ways to secure the borders. This is what derailed budget talks in late 2018.

Why do we care? Because threats of a trade war, a government shutdown and a tone-deaf Federal Reserve brought the economy to the brink of recession a year ago. The question is whether we can avert it again. The Fed has done its part by admitting its mistakes and reversing three of four rate hikes in 2019.

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The part of the outlook that the president can control comes down to two decisions:

1. He could delay additional tariffs and funding for the border wall, which would raise the ire of his base, but allow the expansion to continue at a slower pace.

- OR -

2. He could double down on his nationalist agenda and play directly to his base, but risk the economy falling into recession.

This special edition of *Economic Currents* provides two scenarios for the 2020 outlook. The first assumes that the president hits the pause button on tariffs and the border wall, even if that means breaking campaign promises. The second assumes that the president will levy more tariffs and rattle markets. The Fed would be forced to cut rates sooner and more aggressively under such a scenario but would be unable to avert a recession.

Our main scenario still includes a recession in 2020. Trade hawks within the administration clearly have the president's ear and believe they can reduce trade deficits with high tariffs. They have consistently underestimated the costs of a full-blown trade war.

Could the impeachment proceedings further complicate the outlook? They remain more of a political than an economic event, but could contribute to uncertainty if they have an impact on how the president behaves. That is above my pay grade.

Scenario 1
A Benign Slowdown

Chart 2 compares a benign slowdown with a recession scenario. Real GDP growth slows but does not collapse in 2020 if the president hits the pause button on trade:

- **Consumer spending** moderates in response to weaker job gains, a deceleration in wage growth and an overhang of student debt. The silver lining is a rise in mortgage refinancing, which is freeing up cash for discretionary purchases.
- **Home buying and building** stabilize after a spurt in early 2020. A modest rise in employment offsets the drag of slightly higher mortgage rates.
- **Business investment** is expected to pick up slightly. A pause in the trade war would allow CEOs some room to move forward on short-term investments, but not lift the veil of uncertainty regarding trade policy entirely.
- **Inventories** are expected to be drained after mounting in anticipation of rising tariffs. We should also see a sharp reduction in inventories when Boeing's 737 Max is no longer grounded.
- **Government spending** is expected to slow, as federal spending moderates. Congress has approved only marginal increases after juicing spending in fiscal years 2018 and 2019.
- The **trade deficit** is expected to further widen as growth in the U.S. continues to outpace growth abroad. Exports should pick up in response to the resumption of agricultural exports to China, while a return of the Boeing 737 Max will boost aircraft exports.

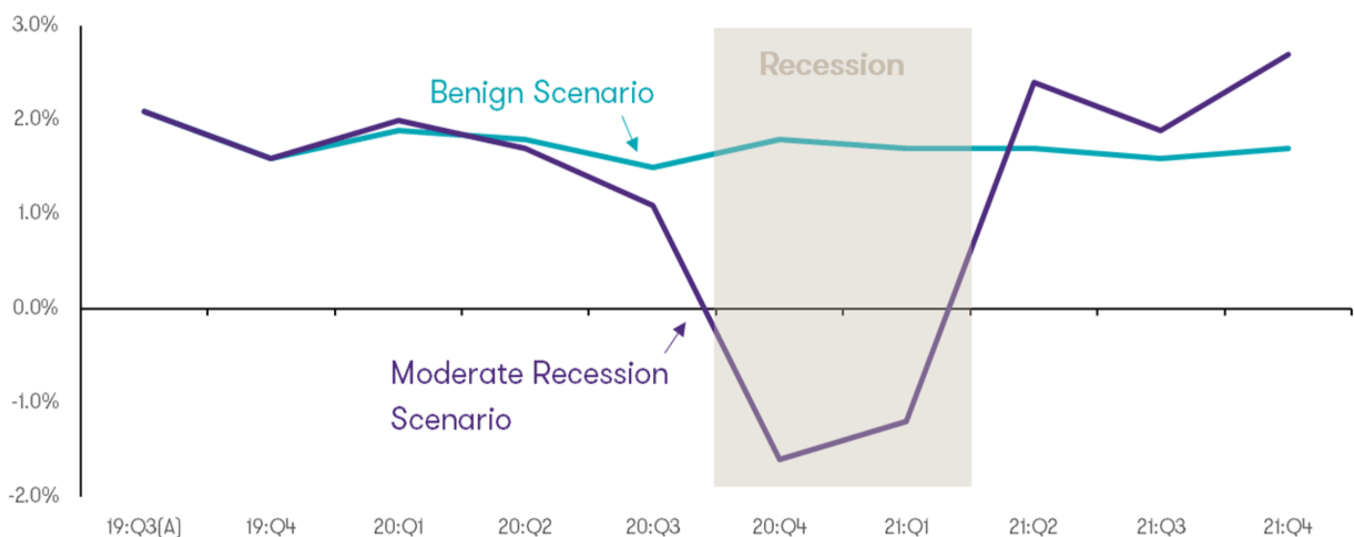
Implications

Inflation and wage gains are expected to remain subdued as participation in the labor market continues to rise. The Fed is expected to cut rates at least once in response to the shortfall in inflation and wages. It will also increase the size of its balance sheet to keep the overnight lending markets functioning.

The Fed has stopped purchasing mortgage-backed securities. That shift, coupled with a move to allow mortgage-backed securities to roll off the Fed's balance sheet, has widened the spread between mortgage rates and the 10-year Treasury yield. This will push up mortgage rates faster than Treasury bonds as the expansion continues. The yield on the 10-year Treasury bond is expected to rise back above 2% by year-end in 2020.

Profit margins are expected to continue to narrow, while defaults on corporate debt continue to creep higher. This could eventually take some of the steam out of the stock market. The major stock indices are expected to end the year only slightly above where they started the year. That will overstate the performance of profits in the broader economy; the S&P 500 is dominated by the largest and most profitable firms and accounts for less than half of all corporate profits.

Chart 2



Source: Bureau of Economic Analysis, Grant Thornton LLP

Scenario 2
A 2020 Recession

Real GDP growth is expected to drop into negative territory in the second half of 2020 if the president doubles down on his trade agenda:

- **Consumer spending** will eventually contract as tariffs kick in, inflation picks up and purchasing power erodes. Job losses, turmoil in financial markets and the fears that the trade wars are spreading will exacerbate losses.
- **Home buying and building** is expected to fall with a drop in employment but the losses will be small compared to other recessions. Shortages of affordable housing and rentals remain acute.
- **Business investment** is expected to be hardest hit. Escalating trade wars and recessions abroad will compound supply chain disruptions and complicate decisions on where to invest.
- **Inventories** will drain as producers pull back and run out of room to outrun changes in tariffs.
- **Government spending** is expected to remain tepid. Automatic stabilizers - unemployment insurance, food stamps, etc. - will kick in, but the administration is in the process of scaling back many of those programs. Congress would be wise to think of ways to stimulate the economy before it actually falters.
- The **trade deficit** will narrow but for the wrong reasons. Exports and imports will both slow as growth at home and abroad eventually contracts. Trade flows have already slowed significantly in response to global weakness and tariffs.

> "Trade hawks in the administration prefer trade wars, regardless of the threat to the economy. They are betting on loyalty over economic performance."

Implications

Inflation will pick up in response to escalating tariffs. The Federal Reserve will look through those increases and cut short-term interest rates back to zero. The Fed will also expand the size of its balance sheet to bring down long-term interest rates. It will go to great lengths to avoid using negative rates.

The yield on the 10-year Treasury bond is expected to approach 1%. Weak growth at home and recessions abroad are expected to exacerbate the flight to safety of the U.S. dollar. The dollar will appreciate even as rates fall. A similar phenomenon occurred during the height of the financial crisis in 2008-09.

Profits will contract in response to the drop in demand at home and abroad. Defaults on corporate debt will continue to rise along with bankruptcies. Bankruptcies in the corporate sector could even make the recession deeper this time around, depending on how tight credit conditions become. The stock market is expected to correct as financial market volatility picks up. The broader stock market indices could easily fall at a double-digit pace between now and the end of 2020. Losses are expected to persist into early 2021.

Bottom Line

The administration's trade policies have left little room to maneuver. Either the president backs off his campaign promises, holds the line on tariffs and the economy slows. Or, he risks a recession by doubling down on trade wars and heightening uncertainty.

Trade hawks in the administration prefer trade wars, regardless of the threat to the economy. They are betting on loyalty over economic performance. Doves are more concerned about the risk of a recession and the blow that current trade policies are dealing to his followers.

Who will the president listen to? The only constant has been his willingness to march to his own drummer, which means that trade policy is still a toss-up in 2020. That leaves us with a slowdown at best, a recession at worst.

Economic forecast — December 2019

	2019	2020	2021	2019:2(A)	2019:3	2019:4	2020:1	2020:2	2020:3	2020:4	2021:01	2021:02
National Outlook												
Chain-Weight GDP[1]	2.3	1.6	0.5	2.0	2.1	1.6	2.0	1.7	1.1	-1.6	-1.2	2.4
Personal Consumption	2.6	2.4	1.1	4.6	2.9	2.4	2.7	2.4	1.9	-0.4	-0.6	2.3
Business Fixed Investment	2.2	0.9	-0.4	-1.0	-2.6	1.0	1.8	3.3	2.1	-3.2	-5.1	2.4
Residential Investment	-1.6	1.1	-0.5	-2.9	5.1	4.3	2.5	-1.5	-2.9	-1.4	-1.2	1.2
Inventory Investment	82	14	-2	70	80	62	53	7	14	-17	-27	-6
Net Exports (bil $ '12)	-975	-1046	-1116	-981	-988	-987	-1008	-1021	-1062	-1092	-1091	-1097
Exports	-0.3	-0.2	0.2	-5.7	0.9	-3.3	0.1	4.0	0.9	-3.2	-3.1	1.4
Imports	1.3	1.9	2.1	0.0	1.5	-2.5	2.5	4.3	5.4	1.0	-2.2	1.7
Government Expenditures	2.2	2.0	0.9	4.8	1.6	0.6	1.9	4.0	1.0	0.8	0.8	0.6
Federal	3.3	3.3	0.4	8.3	3.4	-0.7	4.0	8.1	0.5	-0.5	0.0	-0.2
State and Local	1.6	1.2	1.2	2.7	0.5	1.4	0.6	1.5	1.3	1.5	1.3	1.2
Final Sales	2.1	1.9	0.5	3.0	2.0	2.0	2.2	2.5	1.0	-1.1	-1.0	2.0
Inflation												
GDP Deflator	1.8	2.0	2.3	2.4	1.7	1.7	2.0	2.4	2.3	2.0	2.7	2.0
CPI	1.8	1.8	1.5	2.9	1.9	2.5	1.4	2.2	1.1	-0.3	1.7	1.7
Core CPI	2.2	2.4	2.1	1.9	2.9	2.3	2.4	2.3	2.6	2.1	2.1	1.9
Special Indicators												
Corporate Profits[2]	2.2	-3.6	8.4	1.3	-0.8	2.2	5.0	0.6	0.5	-3.6	-2.8	1.3
Disposable Personal Income	2.9	1.7	1.3	1.5	2.9	0.9	2.4	1.2	1.5	1.0	0.6	1.9
Housing Starts (mil.)	1.26	1.27	1.23	1.26	1.28	1.31	1.30	1.29	1.27	1.20	1.18	1.22
Civilian Unemployment Rate	3.7	3.6	4.6	3.6	3.6	3.5	3.5	3.5	3.6	3.9	4.2	4.5
Total Nonfarm Payrolls (thous.)[3]	1568	293	-1301	136	790	347	341	166	107	-321	-655	-450
Vehicle Sales												
Automobile Sales (mil.)	4.9	4.3	4.2	5.0	4.8	4.7	4.7	4.7	4.2	3.6	3.6	4.2
Domestic	3.5	3.1	3.0	3.5	3.4	3.3	3.3	3.3	3.0	2.6	2.6	3.0
Imports	1.4	1.3	1.2	1.5	1.4	1.4	1.4	1.4	1.2	1.0	1.0	1.2
Lt. Trucks (mil.)	12.0	11.5	11.5	12.1	12.3	12.1	12.0	11.9	11.4	10.7	10.6	11.3
Domestic	9.6	9.4	9.4	9.7	9.9	9.7	9.7	9.6	9.4	8.9	8.8	9.2
Imports	2.4	2.1	2.1	2.4	2.4	2.4	2.3	2.3	2.0	1.8	1.8	2.1
Combined Auto/Lt.Truck	17.0	15.8	15.7	17.1	17.0	16.8	16.7	16.6	15.6	14.3	14.2	15.5
Heavy Truck Sales	0.5	0.4	0.4	0.5	0.6	0.5	0.5	0.5	0.4	0.3	0.3	0.4
Total Vehicles (mil.)	17.5	16.2	16.0	17.6	17.6	17.3	17.2	17.1	16.0	14.6	14.5	15.9
Interest Rate/Yields												
Federal Funds	2.2	1.3	0.1	2.4	2.2	1.7	1.6	1.6	1.3	0.5	0.1	0.1
10-Year Treasury Note	2.1	1.8	1.4	2.3	1.8	1.8	1.9	2.0	1.9	1.5	1.1	1.3
Corporate Bond BAA	4.4	3.9	3.5	4.6	4.0	3.9	4.0	4.1	3.9	3.6	3.3	3.4
Exchange Rates												
Dollar/Euro	1.10	1.13	1.12	1.11	1.09	1.09	1.10	1.11	1.11	1.12	1.13	1.12
Yen/Dollar	105.8	105.3	109.9	107.3	108.0	107.2	105.7	105.1	105.2	105.2	105.2	108.0

1. In 2018, GDP was $1863.8 billion in chain-weighted 2012 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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