Grant Thornton

OCTOBER 11, 2018

Latest Intelligence from NABE

“Too Good to be True”

Diane C. Swonk, Chief Economist

Fairy Tale Economy?

A chorus of speakers from the Federal Reserve and the ranks of business economists has been cheering great data on the economy:

- The unemployment rate is down to 3.7%, the lowest level since the height of the Vietnam War;
- Inflation is slightly above the Fed’s 2% target;
- Wages are moving up in fits and starts; and
- Overall economic growth is accelerating. Real GDP will easily come in close to 3% in 2018, making it one of the strongest years of the expansion. (The last two years when growth came anywhere near this pace were 2015, when consumer spending rose as energy prices fell, and 2005 as the housing market peaked.)

Consensus forecasts in both the private and public sectors (including the Federal Reserve and the Congressional Budget Office) suggest that the good times will continue to roll. Unemployment is widely expected to drift lower, while interest rates move up gradually. Most business economists I know believe the expansion will last through 2019, making it the longest of the post-war era.

“This is a remarkably positive outlook,” Fed Chairman Jay Powell reflected during his **remarks** to the National Association for Business Economics’ (NABE) 60th annual meeting in Boston on October 2. He went on to say that some have asked “whether these forecasts are too good to be true,” which he acknowledged was “a reasonable question!”

Less Than Two Years and Counting

Real GDP growth is expected to rise 2.9% in 2018, an acceleration over 2017. Fiscal stimulus and tighter labor markets are providing an extra boost to growth this year.

Prospects for 2019 are slightly lower than our peers’ because we have forecast a full-blown trade war with China. The costs of such a dramatic shift in policy are difficult to fully capture in a simple economic model because they extend beyond price effects to major supply chain disruptions and over time, undermine investor confidence.

The real pain is reserved for 2020 when the end of fiscal stimulus compounds losses associated with trade, the Federal Reserve gets ahead of itself on rate hikes and the yield curve inverts. The Fed is eventually forced to reverse course and lower rates again but will not be able to do so quickly enough to reverse the damage. This is a relatively benign scenario that does not include contagion associated with Chinese defaults.

Broader contagions require coordinated global efforts to resolve, something less likely to occur today than during the financial crisis. The new U.S. bias toward bilateral trade agreements, which one could argue infringes on the sovereignty of even our closest allies, is not sitting well. If the U.S. was willing to pummel Canada and then embrace its government to reach a modified agreement to achieve a managed trade agreement, what might we require from trading partners elsewhere in the world?

“Another rate rise and a related correction in equity prices tie for second place on economists’ list of downside risks.”

Later in the week, one of Powell’s closest allies on the Federal Open Market Committee (FOMC), President John Williams of the New York Federal Reserve Bank, underscored the theme. He told Mike McKee of Bloomberg, “This is a bit of a **Goldilocks** economy” in response to the drop in the unemployment rate in September.

In this edition of **Economic Currents**, we take a closer look at the factors driving this rosy consensus, how the Fed is likely to react and the risks of a misstep. The timing of our NABE annual meeting was prescient given the announcement of a preliminary new trade agreement between the U.S., Mexico and Canada at the same time that trade tensions with China are growing. We were calculating real-time analysis of the potential impact of those shifts on the domestic and global economies on a scale difficult to replicate by any one economics department or think tank. The only NABE meeting to beat that timing was the one that took place in Washington, D.C. October 4-7 in 2008 as the global economy imploded with the financial crisis. Our theme was “Addressing Future Economic Challenges.”

NABE Consensus

The NABE **survey** of members for the 2018-2020 forecast is very similar to my team’s with the expansion performing well into 2019. Our forecast at Grant Thornton is more pessimistic for 2020; we have an actual recession for that year. More than half of NABE participants believe risks are tilted more to the downside than the upside. This contradicts forecasts by the Federal Open Market Committee (FOMC) where consensus is building that risks to the economy are to the upside, not the downside.

Growth for 2018 is widely expected to come in close to 3%, slightly ahead of the last survey taken in June. Additional fiscal stimulus, via spending, is the primary reason for the upward revisions. The verdict on tax cuts is still out given the surge in stock buybacks and dividends as opposed to increased business investment.

Growth for 2019 is expected to slow by at least 0.5% but remain well above the economy’s growth potential. Curbing fiscal stimulus will lead to a slowdown. The impetus from tax cuts is expected to dissipate just as federal spending is poised to fall late in the year. If Congress cannot agree on a fiscal 2020 budget, federal spending at the start of fiscal year 2020, which starts in the fourth quarter, will contract.

Unemployment is expected to drop to 3% by the end of 2019, the lowest level since the postwar boom of the 1950s, and 0.5% beneath that expected by the FOMC. It’s below my team’s forecast and raises the question: What do such low unemployment levels mean for inflation? Our forecast points to a higher level of unemployment with slightly higher inflation than the NABE consensus, largely due to recent increases in tariffs. My concern is that firms appear to be waiting for trade tensions with China to abate before committing to major investments in 2019.

The core Personal Consumption Expenditures (PCE) deflator, the Fed’s preferred inflation measure, is expected by NABE economists to move slightly above the 2% threshold and remain there through the end of 2019. That’s higher inflation than the FOMC expects but still a relatively benign forecast given the quadruple threats of bottlenecks in supply chains, labor shortages, low productivity and rising tariffs.

Catherine L. Mann, Citi’s global chief economist, warned during our meeting about the risk for a spike in inflation in early 2019. That is when most companies will lose the cushion that tax cuts played in blunting the impact of tariffs on margins. My team has a spike in inflation in early 2019 to reflect those shifts.

Persistent Rate Hikes

The Fed is expected to make good on its forecast for four rate hikes in 2018 followed by another three in 2019. This marks a notable shift from earlier in the cycle when NABE survey respondents discounted the Fed’s forecasts.

The core leadership at the Fed appears to be willing to go much further than that. Key members of the FOMC, the Board of Governors and the New York Fed President, are now arguing that the Fed will likely be forced to raise rates to the point where financial conditions move from “accommodative” to “tight” to ward off an unwanted rise in inflation.

President Eric Rosengren of the Boston Fed spoke to attendees and argued that policy makers "will likely need to move interest rates gradually from a mildly accommodative stance to a mildly restrictive stance in order to best fulfill our mandate—stable prices and maximum sustainable growth."

Rosengren also warned about burgeoning asset price bubbles, most notably in commercial real estate. His concerns are understandable given the view he showed us of current real estate development from the top floor of the Boston Fed's offices; building cranes and new office towers (mostly for biotech firms) filled the skyline.

At the same time, many within the Fed are raising their estimates of what the high water mark on rates will be. This means we are likely to see FOMC members start to add rate hikes to their forecasts in 2019 for the new consensus forecasts in December.

Add the fact that the Fed can only react, not anticipate, shifts in economic conditions, and the risk that the Fed overshoots on rates rises. The weakness associated with tariffs and the uncertainty over a trade war with China will not show up in the data until well into 2019 and 2020, with the effects compounding over that period. Trade is like a snowball rolling down a snow-covered mountain; it starts out small, almost unnoticeable, until it comes close to reaching the bottom when it threatens to crush anyone or anything in its path.

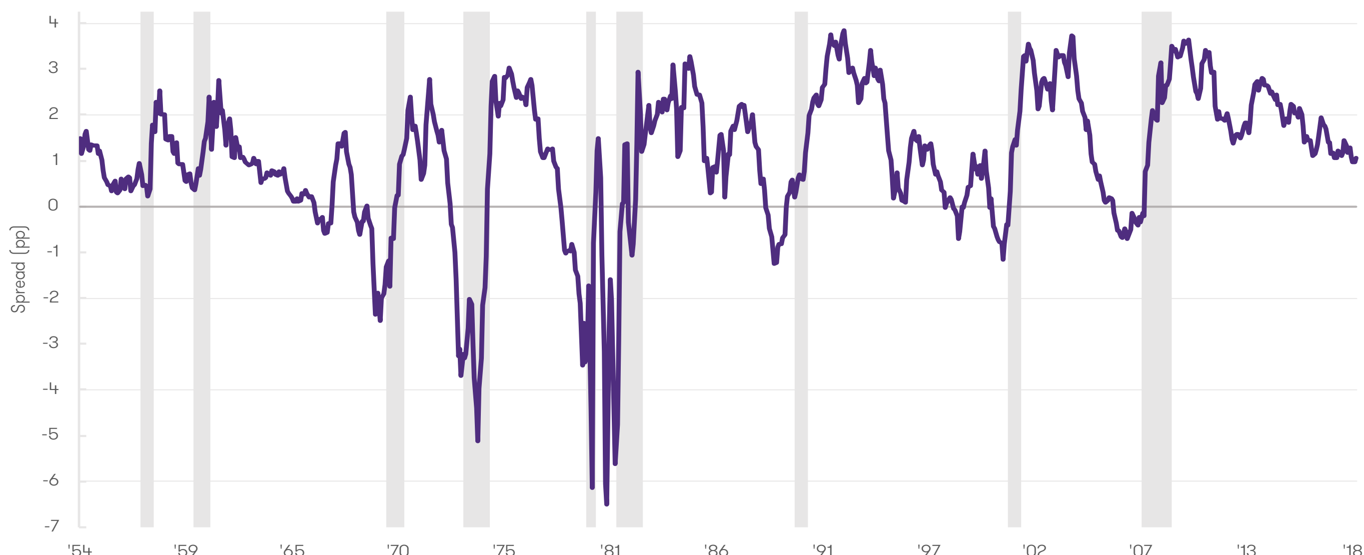
We also heard significant concerns about the Fed's ability to counter the next recession. The FOMC cut rates by an average 5% during each of the last three recessions but will not likely have that latitude before it hits zero in the next cycle. The fed funds target is currently between 2% and 2.25% and expected to hit a peak at 3% or slightly above. That means interest rates could hit the zero bound before they have fallen enough to stimulate growth.

Chairman Jay Powell did not rule out another expansion of the Fed's balance sheet if the economy falters. That would be highly controversial and has already made the Fed a political piñata for both major political parties. He also said he would not rule out negative short-term rates, which have been used abroad. The Fed decided against such an extreme during the financial crisis, in part because of the limited role that banks play in lending in the U.S. relative to other economies. There are also significant concerns about how negative rates could affect the short-term commercial paper market, which seized up and left firms without funding at the onset of the financial crisis.

Bond Yields Rise

The 10-year Treasury bond is expected to rise to 3.5% by the end of 2019; the yield curve is expected to narrow. (NABE forecasts were made prior to the recent jump in bond yields.)

Chart 1. Prerecession Yield Curve Inversions
Difference Between 10-year and Effective Federal Funds Rate, 1954-2018



Values less than zero imply that the yield on banks' overnight deposits at the Federal Reserve is greater than the yield on 10-year Treasuries. **Source:** FRED

Indeed, there was considerable talk that we may all be underestimating the upside on long-term interest rates. The Federal Reserve is removing the ceiling on rates by allowing its holdings of Treasury bonds and mortgage-backed securities to mature and roll off its balance sheet; it is no longer a net buyer of Treasury bonds. This is at the same time the Treasury is issuing more bonds to finance ballooning federal budget deficits.

The neutralizer has been the willingness of the rest of the world to buy our debt. China, which has its own debt problems, is no longer buying Treasury bonds at the pace it once did. China is still the largest foreign holder of U.S. Treasury bonds. This means we have to raise rates to attract more foreigners to buy what is rapidly becoming a growing mountain of debt issuances.

There is no inversion of the yield curve expected in the NABE forecast through 2019. This is important because we have seen a yield curve inversion before every major recession. Credit availability contracts when lenders have to borrow at short-term rates that are higher than they can charge for making long-term loans. The problem is timing. Sometimes the yield curve inverts well ahead of a recession. We saw this in mid-2006, a full year and a half before the onset of the 2008 recession. (*See* Chart 1.)

The offset to rising rates in the near term is the reserve-currency status of the dollar. Investors still prefer Treasury bonds over nearly every other asset class when uncertainty is high, which could put a lid on long-term rates.

Recession 2020?

Recessions are by their very nature difficult to time because they are often triggered by an external shock or, in the case of the financial crisis, mass panic. The FOMC does not have a recession in its forecasts through 2021. Yet most economists can come up with a litany of factors that could knock us off-course the next two years. Two-thirds of NABE survey respondents believe we will enter a recession by 2020.

Chairman Powell showed his cards when talking about the length of the expansion. In an **interview** with Judy Woodruff of PBS the day after he spoke at NABE, Powell said, "Eventually, external events, exogenous events happen, and not every business—business cycles don't last forever. But there's—there's really no reason to think that this cycle can't continue for quite some time, effectively indefinitely."

Times like this make me nervous. Complacency about risks tends to be greatest when the expansion crests.

"[A] hike in tariffs could work out like the oil shocks of the 1970s."

-Professor Carmen Reinhart, Harvard University

Downside Risks

Trade Tensions

Trade tensions topped the list of risks with over 40% of NABE economists citing that as the number one threat to their forecasts. The warning from Reinhart, one of the foremost experts on financial crises, underscores the concern. The fear is that a spike in prices related to tariffs could erode purchasing power and lead to a stagflationary cycle.

Trade tensions with China pose a particular threat. A further escalation of tariffs could trigger a much worse slowdown for the world's second-largest economy and spillover effects for the rest of the world. The debt problem in China is acute.

The Chinese government is reopening its spigots to blunt the effects of a trade war. No one is quite sure how its debt problems will end. Defaults will eventually surge but we don't have much data on the terms of those loans, given how opaque China's official data is known to be. The aftershocks of defaults could roil global financial markets.

Most are betting that China will avoid a full-blown financial crisis and instead go through a prolonged slowdown. Japan's post-bubble economy was used as an example. The spillover effects from a slowdown in China will be much larger than those from Japan, given China's reach into both developing and developed economies. Think about the effect China had on global commodity markets during the 2003-13 decade in reverse. The threats associated with trade tensions with China are so great that the International Monetary Fund (**IMF**) just lowered its forecast for global growth in 2018 and 2019. What happens in China does not stay in China.

> “...there’s really no reason to think that this cycle can’t continue for quite some time, effectively indefinitely.”
>
> **- Federal Reserve Chairman Jay Powell**

The outline of a new NAFTA agreement released on September 30 was seen as welcome news (even though our Mexican colleagues were quick to nickname it NAFTA 0.5 instead of NAFTA 2.0). The announcement erased immediate concerns that NAFTA would fail. It included much-needed upgrades to intellectual property protections lifted directly from the template provided by the Trans-Pacific Partnership (TPP).

The new NAFTA was rebranded as the U.S. Mexico Canada Trade Agreement (USMCA). Our international colleagues were quick to point out that the words “free trade” were scrubbed from the title.

The details are sparse. What we do know is that content rules on vehicles and parts are more regressive than progressive:

- Vehicles must satisfy higher North American content levels to travel tariff-free across the borders.
- The vehicle rules stipulate content will be produced by workers earning at least $16 per hour.
- The number of vehicles that can cross tariff-free are capped by quotas.

These shifts, coupled with the continuance of steel and aluminum tariffs, will raise the cost of producing in North America. Production in Mexico is expected to be hit the hardest.

Next up is production in the U.S. The old Detroit vehicle makers will more easily absorb the new costs than the foreign transplants. Most producers will either automate or move manufacturing to cheaper markets with more upside for sales than the U.S., where sales have peaked.

There are other problems with the agreement: a version of a sunset clause and restrictions on negotiating separate trade agreements with China. That restriction reduces trust that the U.S. will stay committed to other trade agreements. Questions have been raised about how far the U.S. should be able to go in dictating USMCA partners’ trade negotiations with other countries.

Dairy farmers gained a bit more but even their gains are less than advertised. Other farmers are paying more for steel needed for irrigation equipment; they are also being penalized by retaliatory tariffs from China.

Rising Rates, Collapsing Stock Prices

Another rate rise and a related correction in equity prices tie for second place on economists’ list of downside risks. As noted above, the Fed is now more likely to overshoot and allow long-term rates to rise faster. That could undermine the stock market, which has ridden a wave of low rates, cheap credit and tax cuts.

An Overhang of Corporate Debt

Non-financial debt is surging, especially in the high-yield market. Retail buyers are coming in as terms for loans to companies are easing. Moreover, the usually tight relationship between high-yield bonds and emerging-market debt has fallen apart in recent months. That either means that investors are overestimating the risk of a default in emerging markets or underestimating risks in the corporate high-yield market; the latter is more likely.

Bottom Line

The original “Goldilocks and the Three Bears” tells the story of three bachelor bears and an old woman who vandalizes their cottage only to jump out a window upon their return. She is never seen by anyone again. I am glad I heard the lighter version as a child.

Glossing over the original tale offers a useful metaphor. Even fairy tales are not what they seem. We all want to see a happy ending but rarely do when an expansion ends. The real fairy tale is the now-popular idea that business cycles are dead. Moral of the story: Enjoy the good times, realizing that they eventually come to an end and cannot continue “indefinitely.” Magic is an illusion, as another tale taught us when Toto revealed the Wizard of Oz to be nothing but a man behind a curtain.

Economic forecast — October 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*	2.2	2.9	2.5	2.3	2.2	4.2	3.4	2.8	2.0	2.1	2.2	2.1
Personal Consumption	2.5	2.6	2.6	3.9	0.5	3.8	3.6	2.2	2.4	2.5	2.6	2.4
Business Fixed Investment	5.3	7.0	4.5	4.9	11.5	8.7	2.2	7.2	3.7	3.9	3.8	3.5
Residential Investment	3.3	0.2	0.5	11.1	-3.4	-1.3	-1.2	-1.8	-0.7	2.7	4.7	3.2
Inventory Investment	19.1	28.1	57.2	13.7	25.8	-31.3	51.1	66.8	60.1	58.4	52.1	58.2
Net Exports	-713.7	-763.3	-869.1	-748.6	-751.0	-696.0	-788.7	-817.5	-837.3	-859.6	-879.3	-900.3
Exports	3.0	4.0	3.5	6.6	3.6	9.3	-5.5	4.0	4.5	4.6	4.9	5.1
Imports	4.6	4.7	6.1	11.8	3.0	-0.6	8.3	6.9	6.0	6.3	6.1	6.4
Government Expenditures	-0.1	1.9	2.4	2.4	1.5	2.5	4.1	3.6	2.3	1.5	1.2	0.5
Federal	0.7	3.7	4.5	4.1	2.6	3.7	8.4	8.2	4.8	2.2	1.1	-0.1
State and Local	-0.5	0.9	1.1	1.4	0.9	1.8	1.6	0.8	0.8	1.0	1.3	0.9
Final Sales	2.2	2.8	2.3	3.2	2.0	5.4	1.5	2.4	2.1	2.2	2.3	2.0
Inflation												
GDP Deflator	1.9	2.3	2.5	2.5	2.0	3.1	1.8	2.8	2.9	2.3	2.3	2.6
CPI	2.1	2.6	2.4	3.3	3.5	1.7	2.1	3.6	2.8	1.8	1.5	3.1
Core CPI	1.8	2.2	2.5	2.2	3.0	1.8	2.1	2.4	3.0	2.3	2.3	2.5
Special Indicators												
Corporate Profits**	3.3	7.4	2.4	3.3	5.9	7.3	7.5	7.4	6.5	4.0	4.1	2.4
Disposable Personal Income	2.6	2.8	2.3	2.3	4.5	2.5	2.4	1.0	2.6	2.7	2.9	2.1
Housing Starts (mil.)	1.2	1.3	1.3	1.3	1.3	1.3	1.2	1.3	1.3	1.3	1.3	1.3
Civilian Unemployment Rate	4.4	3.9	3.6	4.1	4.1	3.9	3.9	3.7	3.5	3.6	3.6	3.6
Total Nonfarm Payrolls (thous.)***	2176.7	2464.5	1453.9	556.3	632.3	634.3	580.2	617.6	400.1	433.0	319.0	301.9
Vehicle Sales												
Automobile Sales (mil.)	6.3	5.5	5.0	6.2	5.7	5.5	5.4	5.4	5.3	5.1	4.8	4.7
Domestic	4.6	3.9	3.7	4.5	4.1	3.9	3.9	3.9	3.9	3.8	3.6	3.5
Imports	1.7	1.5	1.3	1.7	1.6	1.5	1.5	1.5	1.4	1.3	1.2	1.2
Lt. Trucks (mil.)	10.9	11.7	11.3	11.5	11.5	11.8	11.7	11.6	11.5	11.3	11.1	11.1
Domestic	9.0	9.4	9.2	9.4	9.3	9.5	9.4	9.3	9.3	9.2	9.1	9.1
Imports	1.9	2.3	2.1	2.1	2.2	2.3	2.3	2.3	2.2	2.1	2.0	2.0
Combined Auto/Lt.Truck	17.2	17.1	16.2	17.7	17.2	17.3	17.0	17.0	16.8	16.4	15.9	15.8
Heavy Truck Sales	0.4	0.5	0.5	0.4	0.5	0.5	0.5	0.6	0.5	0.5	0.4	0.4
Total Vehicles (mil.)	17.6	17.6	16.7	18.1	17.6	17.8	17.6	17.6	17.3	16.9	16.3	16.2
Interest Rate/Yields												
Federal Funds	1.0	1.8	2.8	1.2	1.5	1.7	1.9	2.2	2.4	2.7	3.0	3.2
10-Year Treasury Note	2.3	2.9	3.4	2.4	2.8	2.9	2.9	3.2	3.3	3.4	3.5	3.6
Corporate Bond BAA	4.4	4.7	5.1	4.3	4.5	4.8	4.8	4.9	5.0	5.1	5.1	5.3
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	109.8	107.8	112.9	108.3	109.1	111.5	110.3	109.2	108.1	107.4	106.4

1. In 2016, GDP was $16716.164 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.

Copyright © 2018 Diane Swonk – All rights reserved. The information provided herein is believed to be obtained from sources deemed to be accurate, timely and reliable. However, no assurance is given in that respect. The reader should not rely on this information in making economic, financial, investment or any other decisions. This communication does not constitute an offer or solicitation, or solicitation of any offer to buy or sell any security, investment or other product. Likewise, this communication serves to provide certain opinions on current market conditions, economic policy or trends and is not a recommendation to engage in, or refrain from engaging, in a particular course of action.

"Grant Thornton" refers to Grant Thornton LLP, the U.S. member firm of Grant Thornton International Ltd (GTIL), and/or refers to the brand under which the GTIL member firms provide audit, tax and advisory services to their clients, as the context requires. GTIL and each of its member firms are separate legal entities and are not a worldwide partnership. GTIL does not provide services to clients. Services are delivered by the member firms in their respective countries. GTIL and its member firms are not agents of, and do not obligate, one another and are not liable for one another's acts or omissions. In the United States, visit grantthornton.com for details.

© 2018 Grant Thornton LLP | All rights reserved | U.S. member firm of Grant Thornton International Ltd